A Critical Analysis of the Legal Environment in Respect of the Private Equity Industry in South Africa

by

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Declaration

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Abstract

This dissertation aims to answer a fundamental question relating to the South African legal and economic framework in which private equity operates. This being:

- To what extent does the law address/regulate the structure of private equity funds and the relationships between the various parties related to a fund, that is: investors, the fund manager and underlying portfolio investments? This thesis also discussed how the law could better regulate the private equity industry.

The dissertation consists of five chapters. Chapter one raises such fundamental questions as 'what is the nature of private equity?' by looking at the parties involved, the private equity cycle, returns, liquidity, the risk, and the private equity market. In addition, it assesses whether private equity satisfies the criteria to be regarded as a separate asset class.

Chapter two provides an analysis of the key features of private equity fund formation in South Africa. The choice of the most appropriate legal structure of a private equity fund starts with the choice of the most effective and suitable legal vehicle. Chapter two includes a discussion of the general private equity fund structure, the regulatory requirements of private equity firms, and certain regulatory considerations relevant in operating a private equity fund in South Africa. The discussion at certain instances reference private equity fund formation in foreign jurisdictions such the US, UK, Australia, and Canada.

Chapter three introduces an analysis of corporate governance as it pertains to private equity funds. Firstly, it discusses the role of corporate governance regulation in stimulating investment. Secondly, it discusses the importance and benefits of corporate governance from the perspective of private equity managers; and seeks to explain the link between the private equity business model and corporate governance that is based on the assertion that there are two levels of corporate governance involved in private equity investing. The first level of governance relates to the private equity fund's underlying portfolio investee companies and this includes *inter alia*, a discussion on the duties of the fund manager, particularly in their capacity as serving as directors on the boards of such companies. The second level of governance relates to the private equity fund itself which focuses on the relationship between the private equity firm and the investors that invest in the private equity fund.

Chapter four examines two key impediments namely tax legislation and exit alternatives; and show how legislation could effectively address the former and how the lack of exit routes is an impediment to the growth of the local private equity industry.

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Chapter five states that, the development of the above mentioned regulatory framework will only be successful if the private equity industry participants themselves acknowledge and actively address the disadvantages and real risks posed by the private equity industry on the South African financial system.

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Opsomming

Hierdie verhandeling is daarop gemik om 'n fundamentele vraag te beantwoord wat verband hou met die Suid-Afrikaanse regstelsel en die ekonomiese raamwerk waarin privaat-ekwiteit funksioneer. Dit is:

- In watter mate reguleer die reg die struktuur van privaat-ekwiteit fondse en die verhoudings tussen die verskillende partye wat betrokke is in 'n fonds, naamlik: beleggers, die fondsbestuurder en onderliggende portefeulje beleggings? Hierdie verhandeling bespreek verder hoe die reg die privaat-ekwiteit bedryf beter kan reguleer.

Die verhandeling bestaan uit vyf hoofstukke. Hoofstuk een lig fundamentele vrae soos 'wat is die aard van privaat-ekwiteit?' deur te kyk na die betrokke partye, die privaat-ekwiteit siklus, opbrengste , likiditeit, die risiko, en die privaat-ekwiteit mark. Verder beoordeel die verhandeling of privaat-ekwiteit voldoen aan die kriteria dat dit as 'n aparte bateklas beskou kan word.

Hoofstuk twee verskaf 'n ontleding van die belangrikste kenmerke van die vorming van privaat-ekwiteit fondse in Suid-Afrika. Die keuse van die mees geskikte regstruktuur van 'n privaat-ekwiteit fonds begin by die keuse van die mees doeltreffende en geskikte regstruktuur. Hoofstuk twee sluit 'n bespreking in van die algemene privaat-ekwiteit fonds struktuur, die regulatoriese vereistes van privaat-ekwiteit firmas en sekere regulatoriese oorwegings wat by die bestuur van 'n privaat-ekwiteit fonds in Suid-Afrika relevant is. Die bespreking maak ook verwysing na die skep van ekwiteit fondse in buitelandse jurisdiksies soos die VSA, die Verenigde Koninkryk, Australië en Kanada.

Hoofstuk drie ontleed korporatiewe bestuur, soos dit betrekking het op privaat- ekwiteit fondse. Eerstens, word die rol van korporatiewe bestuur regulering vir die stimulasie van beleggings bespreek. In die tweede plek word die belang en voordele van korporatiewe bestuur vanuit die perspektief van privaat-ekwiteit bestuurders bespreek; en streef daarna om die skakel tussen die privaat-ekwiteit besigheidsmodel en korporatiewe bestuur, wat gebaseer is op die hipotese dat daar twee vlakke van korporatiewe bestuur betrokke is in privaat-ekwiteit beleggings, te verduidelik. Die eerste vlak van bestuur het betrekking op die privaat-ekwiteit fonds se onderliggende portefeulje maatskappye waarin die fonds belê en dit sal onder andere 'n bespreking oor die pligte van die fondsbestuurder, veral in hul hoedanigheid as direkteure op die direksies van bogenoemde onderliggende portefeulje maatskappye, insluit. Die tweede vlak van bestuur het betrekking tot die privaat-ekwiteit fonds self, wat fokus op die verhouding tussen die privaat-ekwiteit firma en die beleggers wat belê in die privaat-ekwiteit fonds.

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Hoofstuk vier ondersoek twee belangrike struikelblokke naamlik belastingwetgewing en alternatiewe om uit beleggings uit te tree; en toon hoe wetgewing effektief die eersgenoemde kan aanspreek en hoe die gebrek aan uittreemoontlikhede 'n struikelblok vir die groei van die plaaslike privaat-ekwiteit bedryf kan wees.

Hoofstuk vyf stel voor dat die ontwikkeling van ʼn regulatoriese raamwerk slegs suksesvol sal wees indien die deelnemers aan die privaat-ekwiteit bedryf die nadele en werklike risiko's van die privaat-ekwiteit bedryf op die Suid-Afrikaanse finansiële stelsel erken en aktief aanspreek.

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Chapter One: The Fundamentals of Private Equity Investing

1. Introduction

Private equity is multi-faceted and a complex business. South African policymakers should understand the fundamentals of private equity as an asset class because it forms an important part of the financial markets.[1] Private equity has its benefits, such as widening the availability of capital, increase the effectiveness of company valuations, identify companies with significant growth potential and facilitate their transformation.[2] On the other hand, there are risks commonly associated with private equity investing such as conflicts of interest, lack of transparency and disclosure, and high leverage. However, it will be argued that the growth of the South African private equity industry will depend on creating an environment in which investors and regulators alike clearly see the advantages and disadvantages of private equity.

Equity and debt are the two main sources of capital available to finance a company. Equity is an ownership interest in a company in the form of shares.[3] Any company, whether it is a start up company or an established company that requires capital for expansion, has varying needs for working capital.[4] For instance, a company might consider setting up an agreed overdraft facility with a commercial bank, enabling the company to acquire extra capital when needed. However, this method of financing should not be used unless the borrower has a positive cashflow with which to offset the interest payments and the repayment of the debt. Additional methods, by which companies can access capital markets for capital raising, are via the issuing of equity.[5] With regard to debt finance, the lenders have the legal right to interest payments and repayment of the debt, irrespective of the success or failure of the borrowers' company. Equity finance, typically through the issue of shares, is provided in exchange for the redemption of ownership rights. The providers of equity finance therefore become part owners of the companies in which they invest and accordingly participate in sharing all the risk and returns in the company. The providers of equity finance realize their investment by selling their shares in the companies in which they have invested.[6] Equity financing for companies is available from a variety of sources. Sources of equity financing include

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[1]Lerner, J., Sorensen, M. and Strömberg, P. (2011), 'Private equity and long-run investment: The case of innovation', The Journal of Finance, 66(2), at pages 445-477.
[2]Lerner, J., Sorensen, M. and Strömberg, P. (2011), 'Private equity and long-run investment: The case of innovation', The Journal of Finance, 66(2), at pages 445-477.
[3]See Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', 5th edition, Wiley and Sons, ISBN 0470650915.
[4]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', 2nd edition, Elsevier Inc.
[5]See Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', 5th edition, Wiley and Sons, ISBN 0470650915.
[6]See Bartlett, J.W. (1995), 'Organising the Pooled Investment Vehicle (PIC), Equity Finance: Venture Capital, Buy-outs, Restructuring and Reorganisations', 2nd edition, Vol. 3. Aspen.

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private individuals, investment banks, insurance companies, large corporations, as well as venture capital and private equity funds.[7]

Private equity investing as a source of equity finance has always been and still remains a very topical subject.[8] According to a Coopers and 3i study, the growth phase experienced in the global private equity industry began approximately in 1992 and continued through the end of that decade, which was largely due to three factors.[9] Firstly, there was a greater acceptance of private equity as a legitimate asset class by the majority of sophisticated investors.[10] Secondly, modern portfolio theory encourages diversification and postulates that adding asset classes that are not highly correlated to an investors' investment portfolio lowers risk and provides superior risk-adjusted returns.[11] According to Vento, diversification is a general technique for reducing investment risk by investing in a variety of assets.[12] A simplistic way of describing diversification is provided by the proverb 'do not put all your eggs in one basket' because placing each egg in a different basket is more diversified. There is more risk of losing one egg, but there is less risk of losing all the eggs.[13] Thirdly, rebalancing had increased allocations to private equity investments as the strong United States of America ('US') equity markets before 11th September 2001 had resulted in shrinking allocations (in percentage terms) to other asset classes.[14] These factors led institutional investors to make greater allocations to private equity. Despite obvious weaknesses such as limited liquidity, conflicts of interest, excessive fees charged by private equity firms and lack of transparency, private equity has become an attractive investment choice amongst investors and as a source of equity financing.[15]

[7]Gerland, B and Margulis, J (2005), 'Angel capital; how to raise early-stage private equity financing', John Wiley and Sons, 2005. Venture capital and private equity funds are more fully defined in paragraph two of this chapter.

[8]See paragraph two of this chapter for the definition of private equity.

[9]Coopers and 3i (2004),'Global Private Equity Review of the Global Private Equity and Venture Capital Markets'. Available at www.3i.com, assessed in August 2012.

[10]An asset class is a group of assets that exhibit similar characteristics, are subject to the same laws and regulations and behave similarly in the marketplace. Available at www.tiaa-cref.org/public/advice-guidance/education/saving-for-retirement/basics/asset_classes?p=1331944007105, accessed in August 2015. Discussed in greater detail in paragraph one of this chapter.

[11]See O'Sullivan, A. (2007), 'Economics: Principles in Action', Prentice Hall Publishers.

[12]Vento, J.J. (2013), 'Financial Independence (Getting to Point X): An Advisor's Guide to Comprehensive Wealth Management', John Wiley and Sons, at chapter 9.

[13]In finance, an example of an undiversified portfolio is to hold shares in only one company. It is not unusual for the share price of a single company to go down forty percent in a year. However, it is less likely for a portfolio of thirty different companies share prices to all go down that much. Available at http://en.wikipedia.org/wiki/Diversification_%28finance%29#cite_note-3, accessed in April 2015.

[14]Rebalancing is the process of buying and selling portions of an investor portfolio in order to set the weight of each asset class back to its original state. For example, say the percentage of listed shares in an investor portfolio have increased due to an increase in the market value of such listed shares then the investor may increase the exposure to private equity by rebalancing its portfolio (namely set the weight of each asset class back to its original state). In addition, if an investor's investment strategy or tolerance for risk have changed, the investor can use rebalancing to readjust the weightings of each asset class in the portfolio. Available at http://www.investopedia.com/articles/pf/05/051105.asp, accessed in April 2015.

[15]The risks commonly associated with private equity are highlighted later in this chapter and discussed in greater detail throughout this thesis.

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In South Africa private equity is a major asset class,[16] just like property, bonds and listed equities.[17] The South African private equity market has the potential to grow albeit not as big as in the US and Europe. However, the growth of the South African private equity industry will depend on creating an environment in which investors and regulators alike clearly see the advantages and disadvantages of private equity. Private equity as an asset class has clear and demonstrable benefits for the South African economy, but also poses several dangers.[18] According to D'Angelo, private equity risk management by investors of private equity funds lags that of other asset classes.[19] D'Angelo states:

> 'The private nature of the industry, relationships between investors and private equity managers, and long time horizon and illiquid nature of these investments create some challenges relative to other asset classes with regard to monitoring investments and risk.'[20]

Gilligan and Wright listed several of the pertinent criticisms of the private equity industry:

> 'Private equity has been criticised both for the way that it finances and operates individual investments and for the way that it operates its own business. At the level of the individual investment, the criticisms include: using 'excessive' levels of debt to acquire corporations; using 'complex' structures to reduce or eliminate tax; aggressively managing businesses to reap 'short-term' profit at the expense of long-term performance; under-investment in new products and process; lack of consultation with workers prior to and after an acquisition. At the level of the fund, the criticisms include: a lack of public information on the funds and their investors; criticisms of the compensation of partners and staff of the funds; concerns on the minimum regulatory capital requirement of fund structures; and reiteration of concerns regarding the use of 'tax havens'.'[21]

In terms of the advantages of private equity to the economy, it is argued that private equity focuses on value creation which is predominantly driven by real growth.[22] In addition, private equity clearly

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[16]There are many different types of assets, for example property, bonds, cash equivalent and listed equities. Listed equities represent shares of ownership in publicly held companies and are typically traded via a stock exchange. As mentioned in an earlier footnote, an asset class is a group of assets that exhibit similar characteristics, are subject to the same laws and regulations and behave similarly in the marketplace. Available at www.investopedia.com/terms/a/assetclasses.asp, accessed in April 2015.

[17]KPMG and South African Venture Capital and Private Equity Association, (2014), 'Private Equity and Venture Capital Industry Performance Survey of South Africa covering the 2013 calendar year', Survey 2014.

[18]Strömberg, P. (2009), 'The Economic and Social Impact of Private Equity in Europe: Summary of Research Findings', Stockholm School of Economics, Institute for Financial Research, September 2009, at page 6, available at SSRN 1429322.

[19]D'Angelo, E. (2008), 'Limited Partners' Perceptions and Management of Risk in Private Equity Investing', Kellog School of Management, Zell Center for Risk Research, at page 2.

[20]D'Angelo, E. (2008), 'Limited Partners' Perceptions and Management of Risk in Private Equity Investing', Kellog School of Management, Zell Center for Risk Research, at page 2.

[21]Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at page 1.

[22]Makhene, M. (2009), 'Alternative Growth: The Impact of Emerging Market Private Equity on Economic Development', Neumann Business Review, Spring 2009, at pages17-47.

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shows a positive impact on employment and spurs economic growth via innovation.[23] According to a European Private Equity and Venture Capital Association (EVCA) study, private equity has been found to contribute to increased economic growth.[24] However, Gatauwa and Mwithiga argue that the studies analysing the interrelationship between private equity and economic growth have not clearly highlighted the influence of regulation on the impact of private equity on economic growth.[25] Stromberg, on the other hand argues that the relationship between private equity and economic growth could be in the reverse, that is, economic growth contributes to private equity activity.[26] Stromberg, argues that the challenge for studies with regard to the interrelationship between private equity and economic growth is to control for the reverse causality explanation in that growth causes private equity investment, rather than vice versa.[27] Stromberg states:

> 'The private equity industry has found itself caught up in the prevailing political debate concerning the need for reform of financial services regulation. However, much of the debate about private equity tends to be based on hearsay or, at best, isolated examples, with little reference to the real impact of the industry on the European economic model … the beneficial effect of private equity on productivity and innovation suggests a positive impact on economic growth. In cross-country data, there is a clear positive relationship between private equity investment activity and economic growth. However, no rigorous academic study has analysed whether private equity actually has an impact on the GDP growth of a country. The problem in undertaking such studies is to control for the reverse causality explanation – that growth causes private equity investment, rather than the other way around.'[28]

The South African Department of Trade and Industry ('DTI') published a working paper reviewing South Africa's company law and related common law, with the aim of reforming the South African 'company' in light of its role in the economy.[29] This policy document set out the basic approach that was intended to provide a framework for detailed technical consultation to ensure that South Africa

[23]Makhene, M. (2009), 'Alternative Growth: The Impact of Emerging Market Private Equity on Economic Development', Neumann Business Review, Spring 2009, at pages17-47.

[24]European Private Equity and Venture Capital Association ('EVCA'), (2013), 'Exploring the Impact of Private Equity on Economic Growth in Europe', A Report prepared for the EVCA by Frontier Economics, May 2013, at pages 14-18.

[25]Gatauwa, J.M. and Mwithiga, A.S. (2014), 'Private Equity and Economic Growth: A Critical Review of the Literature', Published by European Centre for Research Training and Development, June 2014, Volume 2, Number 3, at pages 1-10.

[26]Strömberg, P. (2009), 'The Economic and Social Impact of Private Equity in Europe: Summary of Research Findings', Stockholm School of Economics, Institute for Financial Research, September 2009, at page 6, available at SSRN 1429322.

[27]Strömberg, P. (2009), 'The Economic and Social Impact of Private Equity in Europe: Summary of Research Findings', Stockholm School of Economics, Institute for Financial Research, September 2009, at page 6, available at SSRN 1429322.

[28]Strömberg, P. (2009), 'The Economic and Social Impact of Private Equity in Europe: Summary of Research Findings', Stockholm School of Economics, Institute for Financial Research, September 2009 at pages 1-6 available at SSRN 1429322.

[29]Department of Trade and Industry (2004), 'South African Company Law for the 21st Century: Guidelines for Corporate Law Reform', Report presented by the Department of Trade and Industry, Pretoria, South Africa.

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has company law that is competitive and up-to-date. One of the key objectives of the South African Government noted in the policy document is encapsulated in the following quotation:

> '…a key role for government is to ensure that the regulatory framework within which enterprises operate promotes growth, employment, innovation, stability, [and] good governance…'[30]

This highlights a common assumption made by policymakers wanting to replicate the US model, namely that private equity spurs economic growth. It is usually put forward as an untested assumption.[31] The above mentioned Department of Trade and Industry policy document was part of the process whereby the Companies Act 61 of 1973 was replaced by the Companies Act 71 of 2008. The latter Act came into effect in 2011. An explanatory note issued by the Department of Trade and Industry re-affirms the objective of the developers of the Companies Act of 2008 encapsulated in the above quotation. The explanatory note states:

> 'The process of developing the Companies Act, No. 71 of 2008 began in earnest over five years ago. For guidance, the developers looked to *South African Company Law for the 21st Century: Guidelines for Corporate Law Reform* (May 2004), a policy document developed by the Department of Trade and Industry…The ultimate goal in repealing the Companies Act, No. 61 of 1973, was to ensure that the regulatory framework for enterprises of all types and sizes promoted growth, employment, innovation, stability, good governance, confidence and international competitiveness…'[32]

It is discussed throughout this thesis that these aforementioned fundamental characteristics of a regulatory framework are critical to the development of a successful private equity industry. It is evident that one of the fundamental objectives of the aforementioned working paper and the subsequent Companies Act 71 of 2008 is to advance economic transformation in the South African economy. This thesis will consistently discuss that private equity is a promoter *inter alia* of economic growth that directly affects the broader South African economy and this point is encapsulated in the aforementioned working paper and subsequent Companies Act 71 of 2008. These important policy considerations are acknowledged by the National Treasury of the South African Government in a policy document that states:

[30]Department of Trade and Industry (2004), 'South African Company Law for the 21st Century: Guidelines for Corporate Law Reform', Report presented by the Department of Trade and Industry, Pretoria, South Africa.
[31]Gatauwa, J.M. and Mwithiga, A.S. (2014), 'Private Equity and Economic Growth: A Critical Review of the Literature', Published by European Centre for Research Training and Development, June 2014, Volume 2, Number 3, at pages 1-10.
[32]The Department of Trade and Industry of South Africa, 'The Companies Act, No 71 of 2008: Explanatory Guide, Replacing the Companies Act, No 61 of 1973', at page 6. Accessed at www.cipc.co.za/Publications_files/Companies _Act_Guide.pdf, accessed in August 2014.

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> 'The financial services sector is at the heart of the South African economy and touches the life of each and every citizen. Financial services allow people to make daily economic transactions, save and preserve wealth to meet future aspirations and retirement needs, and insure against personal disaster … It enables economic growth, job creation, the building of vital infrastructure and sustainable development for South Africa and her people. It is, therefore, crucial that the sector is well regulated and stable. However, stability is not the only policy objective for the financial sector. The sector is characterised by high and opaque fees, and needs to be more transparent, competitive and cost effective.'[33]

The aforementioned National Treasury policy document acknowledges that the financial services sector is at the heart of the South African economy. This thesis will discuss that the private equity industry is a critical component of the financial services sector and that private equity *inter alia* enables economic growth and job creation. However, the thesis will also discuss *inter alia* that the financial services sector and in particular the private equity industry, needs to be more transparent and cost effective. Therefore, the discussions in this thesis must be viewed against the favourable outcomes from private equity, as well as the weaknesses of the private equity business model.

This analysis will focus on policy reform that will promote the development of the South African economy, by providing an effective regulatory environment that recognises the broader, social role of private equity investing. However, it is submitted that private equity is primarily about making profits and that it is not motivated by business development considerations. If the link between private equity and business development is viewed from a policy and regulatory-based logic then the two go hand in hand, especially when considering the role that private equity plays in enabling capital flows and catalysing growth of domestic businesses. In this regard, this thesis will discuss that private equity could make a considerable contribution to economic growth and business development.[34] Nevertheless, this analysis collates a diverse universe of regulations, research and information which is aimed at providing a structured yet critical analysis of the prevailing social, economic and regulatory issues brought about by private equity investing. On the one hand this critical legal analysis will rely on the analysis of legal precedents and regulations; research reports; economic data; formal and informal discussions with industry stakeholders; both locally and abroad. On the other hand this critical legal analysis aims to contribute towards the establishment of an efficient private equity framework that is unique to South Africa. This leads to the first contribution of this analysis: considering how legislation relating to private equity investing can be structured to promote business development.

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[33]Department of National Treasury of the South African Government (2011), 'A Safer Financial Sector to Serve South Africa Better', National Treasury Policy Document, 23rd February 2011, Pretoria, South Africa, at page 1.

[34]See South African Government, National Planning Commission (2013), 'National Development Plan 2030: Executive Summary', The Department of the Presidency of the South African Government, at pages 47-48.

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Much of the discussion in this analysis will centre on the regulatory environments in the UK, Canada, Australia and the US, simply because they have reached a sophisticated level of development, which is useful in understanding the salient features related to structuring of private equity funds and transactions. The reference to 'sophisticated level of development' refers to the considerable growth in the aforementioned private equity markets, coupled with consistent regulatory reforms in these private equity markets.[35] The aforementioned growth resulted in an increase awareness of the obvious weaknesses of the private equity business model such as limited liquidity, conflicts of interest, excessive fees charged by private equity firms and lack of transparency. The aforementioned jurisdictions have been at the forefront of consistent regulatory reforms, to *inter alia* address the aforementioned weaknesses. Nevertheless, these two crucial factors are important in understanding the salient features related to the structuring of private equity funds and transactions. This does not imply that, for example, the US regulatory system is more efficient than South Africa's. On the contrary, it will become evident that the US system is much more complex and cumbersome than that of South Africa and so, at times, unduly complicates the structuring of private equity transactions in the US. Nevertheless, it is well acknowledged that the US government had significantly contributed towards the development of the US private equity market via consistent regulatory reforms.[36]

During the 1950s and 1960s, the US Congress introduced legislation to promote the development of small business. The real growth in the US private equity market began in the late 1960s with an increase in the market for stock market listings,[37] which resulted in significant profitable realisations of private equity investments made in the 1960s.[38] During the late 1970s, regulatory and tax changes allowed US pension funds to invest in private equity for the first time, which resulted in the growth in the size of the US private equity market.[39] In addition, specific tax regimes exist in the US, Canada, Australia and UK which define taxation of private equity investment vehicles on a more specific basis. However, much of the regulatory developments in the US, Canada, Australia and UK have been directed towards mitigating the risks posed by private equity investing rather than promoting private equity investing.[40] For instance in the UK, a House of Commons Treasury Report listed several

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[35]There had been considerable growth in institutional investors making greater allocations to private equity in the aforementioned jurisdictions, as well as policy makers having simultaneously contributed significantly towards the development of these private equity markets via consistent regulatory reforms.

[36]Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', John Wiley and Sons, 2nd edition.

[37]A stock market listing and initial public offering ('IPO') which is interchangeable used, refers to the method whereby a company's shares are listed on a stock exchange and where the investor will be able to sell its shares to the public.

[38]Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', John Wiley and Sons, 2nd edition.

[39]Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', John Wiley and Sons, 2nd edition.

[40]Discussed in detail in chapter four.

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disadvantages of private equity investing relative to company shares traded on a stock exchange (publicly traded shares).[41]

The report summarised these disadvantages:

‘- Conflicts of interest, because private equity partners involved in the running of companies may have different priorities from other investors in the private equity fund;
- Shorter investment horizons, because the aim is usually to sell the company after a few years, rather than focusing on long-term growth;
- Lack of transparency, making them less accountable to the public and their workforces;
- Greater leverage, making companies more vulnerable to economic downturns and with the potential to pose risks to lenders and the financial system;
- Risk of job destruction through seeking to extract value;
- Risk to pensions, through selling assets and loading companies with debt.’[42]

The latter report, together with the Walker Report[43] on transparency and disclosure in the private equity industry were the precursor to much of the subsequent regulatory developments in the UK.[44] The above mentioned countries have recognised the contribution of private equity to economic growth and business development, but they have also been cognisant of the risks. For example, Black and Gilson argue that many countries have tried to replicate the US private equity market and have failed because of the absence in those countries of well developed stock markets that permit private equity firms to exit through stock market listings.[45] According to Cummings and MacIntosh, a stock market listing involves the sale of shares of a company to public investors, accompanied (but not always) by a listing on a stock exchange.[46] Black and Gilson argue that a well developed stock market is critical for the existence of a vibrant private equity market. [47] Lerner *et al* state that the more favourable the environment for stock market listing is as an exit route for private equity investments, the more favourable the environment is for private equity firms to raise more capital.[48] The authors further state that studies of the US market suggest that the most profitable private equity investments

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[41]House of Commons Treasury Committee, (2007), ‘Private Equity’, Tenth Report of Session 2006-07, Volume 1, Ordered by House of Commons, July 2007, at chapter 3, pages 11-18.
[42]House of Commons Treasury Committee, (2007), ‘Private Equity’, Tenth Report of Session 2006-07, Volume 1, Ordered by House of Commons, July 2007, at chapter 3, pages 11-18.
[43]Walker, D. (2007), ‘Walker Guidelines for Disclosure and Transparency in Private Equity’, in association with British Private Equity and Venture Capital Association (BVCA), November 2007, at pages 16-32.
[44]Discussed in chapters three and four.
[45]Black, B.S. and Gilson, R.J. (1998), ‘Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets’, Journal of Financial Economics, Volume 47, at pages 243-277.
[46]Cumming, D.J. and MacIntosh, J.G. (1999), ‘Venture Capital Exits in Canada and the United States,’ Working paper, University of Alberta and University of Toronto, at page 9.
[47]Black, B.S. and Gilson, R.J. (1998), ‘Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets’, Journal of Financial Economics, Volume 47, at pages 243-277.
[48]Lerner, J., Hardymon, F., and Leamon, A. (2012), ‘Venture Capital and Private Equity: A Casebook’, 5th edition, Wiley and Sons, ISBN 0470650915.

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have, on average, been exited by way of stock market listing.[49] Therefore, an important point is that policymakers need to understand the link between the stock market and the private equity market. This requires understanding of the contractual arrangements between entrepreneurs and private equity providers; especially the importance of the opportunity to enter into an implicit contract over control, which gives a successful entrepreneur the option to reacquire control from the private equity fund by using a stock market listing as the means by which the private equity firm exits from a portfolio investment.[50]

This analysis will extend the literature on private equity contracting by offering an explanation for two central characteristics of the US private equity market, namely: relatively rapid exit by private equity providers from investments in portfolio companies, and the common practice of exit through a stock market listing. This leads to the second contribution of this thesis: considering to what extent the South African laws impede the structure of the private equity industry, private equity funds and the contractual relationships that exist between the various parties related to a fund such as investors, the private equity firm and underlying portfolio investments.[51]

In chapter four, it will be highlighted that South Africa's capital markets are generally characterised by a lack of liquidity, especially for private equity investments.[52] This lack of liquidity negatively impacts the private equity industry because a private equity firm's success is gauged by the number of successful exits it has achieved.[53] While trade sales and secondary buyouts are important exit methods available to the South African market, it is submitted that the stock market listing method remains critical to the long term success of the local private equity industry. In chapter four[54] it will be argued that the sustained growth in the South African private equity market will be difficult to achieve unless there is an improvement in the demand for new listings because a critical characteristic of the private equity business model is the pre-determined, fixed life period of a private equity fund.[55] Private equity investments are by its very nature illiquid investments that cannot be sold as readily, say for instance, as listed shares trading on a stock exchange. This, coupled with

[49]Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', 5th edition, Wiley and Sons, ISBN 0470650915.
[50]Claessens, S., Klingebiel, D. and Schmukler, S.L. (2006), 'Stock market development and internationalization: Do economic fundamentals spur both similarly?' Journal of Empirical Finance, 13, at pages 316–350. See also generally paragraph 3 of chapter 1; and paragraph 3 of chapter 4.
[51]This statement in the dissertation is referring to the private equity industry in broad terms and not just private equity as a transaction. The dissertation will also discusses the legal, tax and regulatory framework within which the aforementioned industry participants raise funds that are earmarked for South African investments.
[52]KPMG and South African Venture Capital and Private Equity Association (SAVCA), (2014), 'Private Equity and Venture Capital Industry Performance Survey of South Africa covering the 2013 calendar year', Survey, 2014.
[53]Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', 5th edition, Wiley and Sons, ISBN 0470650915.
[54]See paragraph three of chapter four.
[55]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', 2nd edition, Elsevier Inc.

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the limited investment period highlights the crucial nature of private equity exiting, which involves the private equity firm ensuring the ultimate redemption of the investor's capital and investment returns.[56] The pre-determined, fixed life period of a private equity fund basically requires that the investment relationship of the parties thereto, namely between the private equity firm, the investors and the underlying investee companies has to be terminated after a period of time.[57] This creates the situation that the private equity firm and its investors are contractually 'forced' to exit from the underlying portfolio investee companies. Chapter four will also discuss private equity reforms in South Africa aimed at improving exit options such as the Venture Capital Company ('VCC') initiative which is the only specific tax incentive scheme in South Africa that encourages investment in unlisted companies.[58]

In addition, chapter three submits the basic proposition that private equity firms need to address the corporate governance issues of an underlying portfolio investee company from the day when they first meet with management to consider an investment, right up to the point when a complete exit from the investment has been executed.[59] The basis upon which the private equity firm determines the most appropriate timing to exit a portfolio investment can create a conflict of interest, for example where that investment is jointly owned by two or more funds operated by the same private equity firm.[60] Despite the recognition that joint holdings are likely to be owned by funds that are at different stages of their life cycle, it is generally considered preferable for the private equity firm to enter into such transactions on the basis that it will divest all funds of their investments simultaneously. The timing for divestment will normally be determined by reference to the fund which made the original investment or that has reached the end of its life first. However, this approach may still present the private equity firm with a conflict of interest in terms of choosing between divesting an investment at the end of one fund's life, set against the potential for a younger fund to benefit from receiving greater returns if the investment is held for a longer period.[61] Chapter three discusses a number of effective mitigants that a private equity firm and its investors can employ to manage the risk of conflict. These include the contractual negotiation and disclosure of exit criteria in fund agreements; the disclosure of proposed exit rationale to the funds' investors; disclosure to investors of actual divestments via

[56]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', 2nd edition, Elsevier Inc.
[57]Demaria, C. (2013), 'Introduction to Private Equity: Venture, Growth, LBO & Turn-Around Capital', John Wiley & Sons.
[58]The Venture Capital Company ('VCC') initiative is the only South African specific tax incentive scheme encouraging investment in unlisted companies, regulated by section 12J of the Income Tax Act 58 of 1962.
[59]Paragraph 2.2 of chapter three.
[60]Schell, J.M. (1999), 'Private equity Funds: Business, Structure and Operations', Law Journal Press, revised edition, at paragraphs 1-32 to 1-35, 2-2 to 2-39, 3-1 to 3-25. As discussed in chapter two hereof, Regulation 3(b) of 'March 2012 Regulations' places a positive obligation on every FSP to avoid a conflict of interest and where such conflict cannot be avoided, to mitigate against such conflicts. See also International Organization of Securities Commissions (IOSCO), (2009), 'Private Equity Conflicts of Interest', Report by the Technical Committee of the International Organization of Securities Commissions, November 2009, at pages 21-22.
[61]Muller, K. and Achleitner, A.K. (2008), 'Investing in Private Equity Partnerships: The Role of Monitoring and Reporting', Springer Science and Business Media, at pages 27-37.

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ongoing fund performance reporting; and the ability of the private equity firm to extend the fund's life beyond its original term to maximise investment returns.[62] To summarise, the two fundamental questions are:

- To what extent does the law regulate the structure of private equity funds and the relationships between the various parties related to a fund, that is: investors, the fund manager and underlying portfolio investments?
- Should the law relating to private equity funds be changed to promote business development?

In attempting to answer the above two fundamental questions, this thesis will analyse the South African legal and economic framework in which private equity operates.[63] It is submitted that the law does not promote business development and will highlight why regulatory reform of this industry is necessary. The analysis will show that private equity in South Africa is a major asset class and could have a positive impact on job creation and economic growth.[64] Despite the clear and demonstrable benefits for the South African economy, private equity also poses several dangers which investors and regulators alike must be cognisant of.[65] Therefore, the analysis will also address some of the related risks commonly associated with private equity investing such as conflicts of interest, lack of liquidity, lack of transparency and disclosure, high leverage and excessive fees charged by private equity firms. In addition, the analysis will make several recommendations *inter alia* the establishment of an appropriate legal and regulatory framework for local investment vehicles and the introduction of a specific tax incentive for risk capital investments.[66] Furthermore, the regulatory framework should encourage the involvement of institutional investors; and the framework should provide for mechanisms for exiting investments.

2. Private Equity Defined

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[62]See Schell, J.M. (1999), 'Private equity Funds: Business, Structure and Operations', Law Journal Press, revised edition, at paragraphs 1-32 to 1-35, 2-2 to 2-39, 3-1 to 3-25. As discussed in chapter two hereof, Regulation 4 of the 'March 2012 Regulation states that: 'The responsible person, manager, administrator, or advisor of a private equity fund must disclose to the fund any possible conflict of interest that may arise or any direct or indirect benefit it may obtain or may have obtained as a consequence of any transaction concluded by the private equity fund or in the acquisition or disposal of assets in the execution of the business of the private equity fund.'

[63]A common thread throughout the dissertation is the submission that private equity encourages economic activity and growth.

[64]The dissertation also discusses the development of the South African regulatory framework as a key driver to developing an efficient private equity industry.

[65]Strömberg, P. (2009), 'The Economic and Social Impact of Private Equity in Europe: Summary of Research Findings', Stockholm School of Economics, Institute for Financial Research, September 2009, at page 6.

[66]The dissertation discusses both the clear benefits and the disadvantages and real risks posed by the private equity industry on the South African economic framework.

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In the UK and much of continental Europe, the term private equity is used synonymously with that of venture capital.[67] The same applies in South Africa where the terms venture capital and private equity are used interchangeably.[68] Black and Gilson define venture capital as an investment by specialized venture capital organisations in high growth, high-risk, often high-technology firms that need capital to finance product development or growth and must, by the nature of their business, obtain this capital largely in the form of equity rather than debt.[69] Black and Gilson exclude 'buyout' financing that enables a mature firm's managers to acquire the firm from its current owners, even though in Europe, so-called venture capital firms often provide such financing.[70]

British Private Equity and Venture Capital Association (BVCA), defines private equity as providing:

> ' … long-term, committed share capital, to help unquoted companies grow and succeed. If you are looking to start up, expand, buy into a business, buy out a division of your parent company, turnaround or revitalise a company, private equity could help you to do this. Obtaining private equity is very different from raising debt or a loan from a lender, such as a bank. Lenders have a legal right to interest on a loan and repayment of the capital, irrespective of your success or failure. Private equity is invested in exchange for a stake in your company and, as shareholders, the investors' returns are dependent on the growth and profitability of your business.'[71]

The European Private Equity and Venture Capital Association (EVCA), defines private equity as:

> ' ... the provision of equity capital by financial investors over the medium or long term to non-quoted companies with high growth potential. Venture capital is, strictly speaking, a subset of private equity and refers to equity investments made for the launch, early development, or expansion of a business. It has a particular emphasis on entrepreneurial undertakings rather than on mature businesses. Private equity covers not only the financing required to create a business, but also includes financing in the subsequent development stages of its life cycle. When financing

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[67]Poser, T.B. (2002), 'The Impact of Corporate Venture Capital on Sustainable Competitive Advantage of the Investing Company', Inaugural Dissertation, Wissenschaftliche Hochschule für Unternehmensführung (WHU), Koblenz, Germany.
[68]KPMG and South African Venture Capital and Private Equity Association ('SAVCA') (2009), 'Venture Capital and Private Equity Industry Performance Survey of South Africa' covering the 2008 calendar year, at pages 9-10: '…Because the definitions of the terms 'venture capital' and 'private equity' vary from country to country, the figure below sets out the terminology used in this survey to avoid confusion…'. The survey broadly classified private equity into three sub-classes, namely: venture capital, development capital and buy-out funding. The survey defines the term 'private equity' as shareholder capital invested in private companies, as distinguished from publicly listed companies.
[69]Black, B.S. and Gilson, R.J. (1998), 'Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets', Journal of Financial Economics, Volume 47, at pages 243-277.
[70]Black, B.S. and Gilson, R.J. (1998), 'Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets', Journal of Financial Economics, Volume 47, at pages 243-277.
[71]British Private Equity and Venture Capital Association Report (2010), 'Guide to Private Equity', February 2010 at page 7.

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is required by a management team to buy an existing company from its current stakeholders, such a transaction is called a buyout. Private equity and venture capital may refer to different stages of the investment but the essential definition remains the same: it is the provision of capital, after a process of negotiation between the investment fund manager and the entrepreneur, with the aim of developing the business and creating value. For the sake of simplicity, from this point onwards, the term private equity will be used to cover both venture capital and buyout. Private equity firms have a main goal: seek out companies with the potential for growth and with the aim to put in place the capital, talent and strategy needed to permanently strengthen the company and raise its value. Private equity is often categorised under the umbrella of 'alternative investments', complementary to the stock and bond portfolios traditionally used by investors.'[72]

In the US, however, venture capital usually refers to the provision of funds for younger, early stage and developing businesses whereas private equity is mainly associated with the financing of leveraged buy-outs and buy-ins.[73] According to Lerner, the first question to ask when defining private equity is, 'what constitutes a private equity fund?'[74] He states that many start-up firms require substantial capital and a firm's founder may not have sufficient funds to finance projects alone and therefore must seek outside financing. Entrepreneurial firms that are characterised by significant tangible assets; expect years of negative earnings; and have uncertain prospects, are unlikely to receive bank loans or other debt financing.[75] Similarly, troubled firms that need to undergo restructuring may find it difficult to raise external financing. Private equity organisations finance these high-risk, potentially high-reward projects. They protect the value of their equity interests by undertaking careful due diligence before making the investments and retaining powerful oversight rights afterwards.[76] Typically, these private equity organisations do not primarily invest their own capital, but rather raise the bulk of their funds from institutional investors.[77] The formation process of a private equity fund starts with the investors, who are the sources of capital. This capital is typically pooled into a fund, which is managed by professional private equity firms.[78]

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[72]European Private Equity and Venture Capital Association Report, (2007), 'Guide on Private Equity and Venture Capital for Entrepreneurs', An EVCA Special Report, November 2007, at page 6, paragraph 3.1.
[73]Fenn, G.W, Laing, N. and Prowse, S. (1995), 'The Economics of the Private Equity Market', Washington, D.C.: Board of Governors of the Federal Reserve System.
[74]Lerner, J. (1999), 'Venture Capital and Private Equity: A Casebook', John Wiley and Sons, at page 520.
[75]See KPMG and South African Venture Capital and Private Equity Association (SAVCA) (2009), 'Venture Capital and Private Equity Industry Performance Survey of South Africa' covering the 2008 calendar year, at pages 9-10: '…Private equity funds are generally investment vehicles that invest primarily in enterprises which are not listed on a public stock exchange. An enterprise may seek private equity financing for a variety of applications, from increasing its working capital base in times of business expansion, developing new technologies and products to grow and remain competitive, making acquisitions of other businesses, to buying out certain shareholders to restructure the ownership and management of the business. Another vital application of private equity in South Africa is facilitating the introduction of BEE investment…'.
[76]Kumpf, S. (2013), 'Listed Private Equity: Investment Strategies and Returns', Volume 6 of Alternative Investments, Diplomica Verlag Publishers, at pages 17-20.
[77]Kumpf, S. (2013), 'Listed Private Equity: Investment Strategies and Returns', Volume 6 of Alternative Investments, Diplomica Verlag Publishers, at pages 17-20.
[78]Kumpf, S. (2013), 'Listed Private Equity: Investment Strategies and Returns', Volume 6 of Alternative Investments, Diplomica Verlag Publishers, at pages 17-20.

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The Emerging Markets Private Equity Association (EMPEA), states the following in respect of private equity:

> ' … is a critical source of financing for companies in emerging market economies, making possible positive development outcomes while simultaneously providing investors with the opportunity to achieve superior financial returns. The term private equity encompasses growth capital, venture capital, leveraged buyouts and management buyouts. Private equity funds greatly improve access to the funding that innovative small and medium-sized enterprises (SMEs) require to grow their businesses, leading to positive impacts such as employment, tax payments and increased service availability. Given the core facets of the PE model – active ownership, often of minority stakes, in private businesses seeking not only capital but also enhanced governance or more professionalized management, over a period of several years – private equity investors seek clarity and consistency around securities law and minority investor protections, as well as fair and equivalent treatment for all providers of capital regardless of mode of investment or country of origin.'[79]

The Australian Private Equity and Venture Capital Association Limited (AVCAL), defines private equity:

> 'In its broadest sense, private equity is equity investment in a business not quoted on a public exchange. This would include, for instance, equity investment in a private family company. Private equity is more often used in a second, narrower sense to describe investment in unlisted businesses with the aim of building and improving them over a period of years and then selling them at an increased price. Private equity investment of this type is frequently categorised according to the stage of development of the company being invested in. The following categories are often used: seed investment; early stage investment; expansion stage investment; and buyout investment. An even narrower definition of private equity arises from these categories. Expansion and buy-out stage investments are often termed 'private equity' investment whereas seed and early stage investments are termed 'venture capital' investment. Private equity and venture capital have many common features despite the different development stages of the businesses invested in. Both involve equity investment typically over a 3 to 5 year investment period in unquoted companies that are considered to have significant growth potential. Both involve active involvement by the investor in the governance and management of the investee business and

[79] Emerging Markets Private Equity Association (EMPEA) definition of private equity. Available at http://empea.org/resources/facts-about-pe/, accessed in April 2015.

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both contemplate, at the time of investment, the subsequent sale of the investment rather than the indefinite retention of it.'[80]

The South African Venture Capital and Private Equity Association (SAVCA), defines private equity as:

' … shareholder capital invested in private companies, as distinguished from publicly listed companies. Private equity funds are generally investment vehicles that invest primarily in enterprises which are not listed on a public stock exchange. An enterprise may seek private equity financing for a variety of applications, from increasing its working capital base in times of business expansion, developing new technologies and products to grow and remain competitive, making acquisitions of other businesses, to buying out certain shareholders to restructure the ownership and management of the business. Another vital application of private equity in South Africa is facilitating the introduction of BEE investment.'[81]

In South Africa, a significant amendment to Regulation 28 of the Pensions Fund Act 24 of 1956, defines a private equity fund as follows:

'Private Equity Fund' means a managed pool of capital that –

(a) has as its main business the making of equity, equity orientated or equity related investments in unlisted companies to earn income and capital gains;
(b) is not offered to the public as contemplated in the Companies Act, 2008 (No. 71 of 2008);
(c) is managed by a person licensed as a discretionary Financial Services Provider as defined in the Code of Conduct for Administrative and Discretionary Financial Service Providers, 2003, or if a foreign private equity fund managed by a person licensed as a Category I Financial Services Provider that is authorised to render financial services on securities and instruments as defined in the Determination of Fit and Proper Requirements for Financial Services Providers, 2008; and
(d) is subject to conditions as may be prescribed;'[82]

Following on from the above mentioned amendment to the Pensions Fund Act 24 of 1956, the South African Registrar of Pension Funds published a notice prescribing the conditions with which pension

[80]Australian Private Equity and Venture Capital Association Limited, (2007), 'Private Equity in Australia', Submission to the Senate Standing Committee on Economics, May 2007, at page 8, paragraph 5.1.
[81]KPMG and South African Venture Capital and Private Equity Association, (2014), 'Private Equity and Venture Capital Industry Performance Survey of South Africa covering the 2013 calendar year', Survey, 2014, at page 10.
[82]Regulation 28 means the Pensions Fund Act, 24 of 1956: Amendment of Regulation 28 of the Regulations made under Section 36 of the Act (Government Notice 183 of 4 March 2011 which took effect on 1 July 2011).

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funds must comply when investing in private equity funds.[83] Similarly private equity funds will have to comply with the prescribed conditions in order to qualify to hold money and assets belonging to pension funds. A pension fund may only invest in a private equity fund which is a member of a private equity fund industry body recognised by the Registrar of Pension Funds and which is structured in one of the following ways:

i. A *bewind* trust that provides that the pension fund is the beneficiary. The trustees of the trust will manage and control the assets of the trust whilst the effective rights of ownership of the assets will vest in the beneficiaries and not the trustees;
ii. An *en commandite* partnership provided that the pension fund is the limited partner (*en commandite* partner) in the partnership. As the limited partner, the pension fund cannot be held liable to creditors of the partnership for more than its capital contribution to the partnership;
iii. A company provided that the assets and liabilities of the company are limited to the assets and liabilities arising from investments made by the private equity fund;
iv. A foreign private equity fund, provided that such a fund is a limited partnership, an open-ended investment company or a company in which the assets and liabilities are limited to the assets and liabilities arising from the investments made by the private equity fund.

It seems that the Registrar of Pension Funds aims to ensure that pension funds enjoy the benefits of limited liability against the claims of creditors. In addition, pension funds are required to invest in private equity funds on condition that any person rendering a financial service, whether discretionary or otherwise, to that private equity fund, is a discretionary Financial Services Provider ('FSP') or a representative of such an FSP.[84] The notice provides a number of factors that pension funds must consider before investing in a private equity fund and this will be discussed in greater detail in paragraph 4.1 of chapter two. Gilligan and Wright provide an all encompassing, but succinct definition of private equity:

> 'Private equity is risk capital provided in a wide variety of situations, ranging from finance provided to business start-ups to the purchase of large, mature quoted companies, and everything in between. Buy-outs are examples of private equity investments in which investors and a management team pool their own money, usually together with borrowed money, to buy a business from its current owners.'[85]

[83]'March 2012 Regulations' means the regulations dated 15 March 2012 entitled 'Pensions Fund Act, 1956: Amended Regulation 28 of the Regulations made under Section 36 of the Act: Conditions for Investment in Private Equity Funds Approval in terms of Section 5(2)(e) of the Act' (Government Notice 1 of 15 March 2012).
[84]The Financial Advisory and Intermediary Services Act, 37 of 2002 (the 'Act') and its Regulations.
[85]Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at page 1.

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Taking into account the comments above, private equity can be defined to be investment in usually unlisted enterprises, which is in the form of pure equity, shareholder loans or subordinated debt, with the objective of increasing the value of the company over the medium to long term. Furthermore, venture capital is distinct from buyouts because of the phase of the underlying company's life and the risk profile of the investment.[86] The latter distinction is discussed in paragraphs 3.1, 3.2 and 3.3 of this chapter.

According to Missankov *et al*,[87] private equity investment may be further categorised according to the stage of development of the underlying company and the specific transaction which is being financed. This is typically referred to as the sub-classes of the private equity universe which include early stage venture capital, late stage venture capital, leveraged buyouts and management buyouts.[88] Each of these sub-classes offers a unique trade-off of risk and return and has its own distinct capital cycle. Cumming and Johan, state that:

> 'The key characteristics of private equity investing can be highlighted as being that it requires equity participation; there is value added through active and ongoing involvement with the companies in which they invest; and that the investment objectives are of a long-term nature.'[89]

Private equity providers become co-owners of these companies and share risk and returns to the extent in which they participate in them. Their investment returns depend directly on the growth and profitability of the investee firm. The private equity providers realize their returns through selling their shares in investee companies. Successful investments are usually exited through trade sales or offerings on the stock market, as mentioned earlier.[90]

In South Africa, the main providers of formal private equity are captive and independent private equity firms.[91] The distinction between captive and independent private equity firms is that

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[86]Missankov, I., Van Dyk, R., Van Biljon, A., Hayes, M., and Van der Veen, W., (2006), 'Is Private Equity a Suitable Investment for South African Pension Funds', Presented at the Convention of the Actuarial Society of South Africa October, 2006, at pages 9-17.

[87]Missankov, I., Van Dyk, R., Van Biljon, A., Hayes, M., and Van der Veen, W., (2006), 'Is Private Equity a Suitable Investment for South African Pension Funds', Presented at the Convention of the Actuarial Society of South Africa October, 2006, at pages 9-17.

[88]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', 2nd edition, Elsevier Inc. See also Goldman, Sachs and Co. and Frank Russell Capital Inc. (1996), 'Survey of Alternative Investments by Pension Funds, Endowments and Foundations', New York: Goldman, Sachs and Co. and Frank Russell Capital Inc. Leveraged buy-outs, financial distress and mezzanine financing are more fully discussed in paragraph three of this chapter.

[89]At page 18 earlier, quoting Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', 2nd edition, Elsevier Inc.

[90]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', 2nd edition, Elsevier Inc.

[91]KPMG and South African Venture Capital and Private Equity Association, (2014), 'Private Equity and Venture Capital Industry Performance Survey of South Africa covering the 2013 calendar year', Survey, 2014, at page 16.

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independent firms manage funds on behalf of third parties and captives manage on-balance sheet investments that were funded by a parent organisation.[92] Increasingly, some of these captives also raise funds from other institutional investors. They are known as semi-captives.[93] Nevertheless, the majority of private equity providers are independent private equity firms.[94] These firms raise their funds for investment from external sources, mainly institutional investors such as banks, insurance companies and pension funds. Unlike captive funds, independent funds are usually closed ended.[95] This means that once a fund has been raised, it is closed out, following which no further commitments are accepted from third parties. Independent private equity managers usually earn income from a combination of a management fees based on total commitments plus an enhanced carried interest, which is based on the performance of the fund relative to a benchmark.[96] For institutional investors, fixed-life funds managed through independent and semi-captive private equity firms are the primary vehicles for investing in private equity. In South Africa, the legal structures commonly used for these fixed life closed-end funds are either a *bewind* trust or an *en commandite* partnership (limited liability partnership).[97]

3. The Types of Private Equity

Fenn, Liang and Prowse,[98] defined the organized private equity market as having three major players and an assortment of minor players. Firstly, there are the private equity firms which are regarded as the financial intermediaries between institutional investors and the underlying portfolio investee company in which the fund managers invest. Secondly, there are the investors, such as pension funds, wealthy private individuals, banks and insurance companies, which invest in the private equity fund and which act as providers of capital.[99] Thirdly, there is the underlying portfolio investee

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[92]According to the annual KPMG and SAVCA (2013) survey, captive firms are 'those funds making investments mainly on behalf of a parent or group, typically an insurance company, bank or institutional asset manager, often from an indeterminate pool of money'. KPMG and South African Venture Capital and Private Equity Association (SAVCA), (2013), 'Private Equity and Venture Capital Industry Performance Survey of South Africa covering the 2012 calendar year', Survey, 2013.
[93]KPMG and South African Venture Capital and Private Equity Association (SAVCA), (2013), 'Private Equity and Venture Capital Industry Performance Survey of South Africa covering the 2012 calendar year', Survey, 2013. Captive funds are for the purpose of this survey further classified into the captive funds of government, financial services (including banks and insurance companies) and other captive funds (including corporates). A further category of funds were included in the 2011 survey for investment holding companies. An investment vehicle that acts as a holding company by owning shares of other companies. Investment holding companies typically do not have committed investable sources of capital from third parties (as the case with independents) and typically are able to have longer term investment holding periods.
[94]KPMG and South African Venture Capital and Private Equity Association, (2013), 'Private Equity and Venture Capital Industry Performance Survey of South Africa covering the 2012 calendar year', Survey 2013.
[95]KPMG and South African Venture Capital and Private Equity Association, (2014), 'Private Equity and Venture Capital Industry Performance Survey of South Africa covering the 2013 calendar year', Survey, 2014, at page 16.
[96]Kumpf, S. (2013), 'Listed Private Equity: Investment Strategies and Returns', Volume 6 of Alternative Investments, Diplomica Verlag Publishers, at pages 17-20.
[97]Discussed in chapter two.
[98]Fenn, G.W, Laing, N. and Prowse, S. (1995), 'The Economics of the Private Equity Market', Washington, D.C.: Board of Governors of the Federal Reserve System.
[99]Fenn, G.W, Laing, N. and Prowse, S. (1995), 'The Economics of the Private Equity Market', Washington,

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company into which the fund managers invest and later exit.[100] These underlying portfolio investee companies are regarded as issuers of private equity and are categorised by investment stage into leveraged buyouts, management buyouts, growth equity and venture capital.[101] These issuers of equity seek to raise finance based on their capital requirements. In the case of buyout transactions, the institution proposing to lend the money (debt finance) would typically be a bank or banks.[102]

3.1 Leveraged Buyout

As mentioned in the aforementioned introductory paragraph 3 and paragraph 2 of this chapter, 'private equity' is a generic term used to identify a suite of alternative investing methods, which includes leveraged buyouts (also referred to as LBOs). Leveraged buyout itself is a generic phrase that refer to the use of leverage to acquire a company.[103] Kaplan and Stromberg states:

> 'In a leveraged buyout, a company is acquired by a specialised investment firm using a relatively small portion of equity and a relatively large portion of outside debt financing. The leveraged buyout investment firms … refer to themselves … as private equity firms. In a typical leveraged buyout transaction, the private equity firm buys majority control of an existing or mature firm. This arrangement is distinct from venture capital firms that typically invest in young or emerging companies, and typically do not obtain majority control.'[104]

D.C.: Board of Governors of the Federal Reserve System.

[100]Fenn, G.W, Laing, N. and Prowse, S. (1995), 'The Economics of the Private Equity Market', Washington, D.C.: Board of Governors of the Federal Reserve System.

[101]It must be noted that this thesis will not discuss all the various categories of private equity finance, but will only undertake a critical analysis of the salient features of the predominant categories, namely leveraged buyouts, management buyouts, growth equity and venture capital. For instance, mezzanine capital is regarded as a form of private equity finance; however it is beyond the scope of this thesis to discuss the salient features of mezzanine finance. Mezzanine financings are typically structured as either debt or preference shares. See generally Thompson, J. (2013), 'Alternative Financing Instruments for SMEs and Entrepreneurs: the Case of Mezzanine Finance', Organisation for Economic Co-operation and Development (OECD), Centre For Entrepreneurship, SMEs and Local Development, Final Report, February 2013, at page 4. See generally Robinson, A.D., Fert, I. and Webb, D.N. (2011), 'Mezzanine Finance: Overview', Practical Law Company, Simpson Thacher and Bartlett LLP, at page 6. Investopedia defines mezzanine finance as: 'A hybrid of debt and equity financing that is typically used to finance the expansion of existing companies. Mezzanine financing is basically debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full. It is generally subordinated to debt provided by senior lenders such as banks and venture capital companies.' Available at www.investopedia.com/terms/m/mezzaninefinancing.asp, accessed in April 2015. Due to the unique nature of mezzanine investments, it does not form part of the typical classification of what would constitute a debt provider, on the one hand, and an equity investor on the other hand. See Berman, A. (2013), 'Mezzanine Debt and Preferred Equity in Real Estate in Alternative Investments: Instruments, Performance, Benchmarks and Strategies', John Wiley and Sons, at chapter 9.

[102]Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at page 2.

[103]Available at www.investopedia.com/articles/financial-theory/08/leveraged-buyouts.asp, accessed in June 2017.

[104]Kaplan, S.N. and Stromberg, P. (2008), 'Leveraged Buyouts and Private Equity', Journal of Economic Perspective, University of Chicago Graduate School of Business, Volume 22, No. 4, at page 1.

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A leveraged buyout takes place when a private equity firm acquires a controlling stake in a company's equity and where a significant part of the purchase price is financed through borrowing. In turn the assets of the acquired company are used as security for the borrowed capital.[105] The equity component of the purchase price pertaining to a leveraged buyout transaction can be provided by multiple private equity funds that co-invest to come up with the needed equity for a purchase.[106] Similarly, multiple lenders may syndicate to provide jointly the debt required to fund the transaction.[107] Not all companies are suitable targets for leveraged buyouts because of the importance of debt and the ability of the acquired company to make regular loan payments after the completion of a leveraged buyout.[108] For example, a significant part of the purchase price in a leverage buyout is typically financed through borrowing and sometimes the assets of the target company wanting to be acquired are not sufficient to be used as security for the capital that needs to be borrowed.

Some of the potential features that make companies possible targets for leveraged buyouts would be low levels of debt; valuable assets such as property and trade debtors that could be used as security for secured debt; undervalued share price; and the potential for management to improve cashflows.[109] According to Rachidi, the key attributes of what the South African private equity industry considers to make companies attractive targets for leveraged buyouts are:

> '(in order of priority) strong and partner-able management, steady and predictable cashflow, viable exit strategy and strong market position ... Therefore in order of significance this ranking describes the valued attributes about or of the entity that is suitable for an LBO type investment.'[110]

In addition, Rachidi argues that a lender's priority was primarily towards the cash flow generative capability of the target company.[111] Acquisition debt in a leveraged buyout is usually non-recourse to the private equity firm and to the private equity fund that the firm manages. Non-recourse debt is

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[105]Pilger, D. (2012), 'Leveraged Buyouts: An Introductory Practical Guide to LBOs', Harriman House Publishers, at chapter 1.
[106]Pilger, D. (2012), 'Leveraged Buyouts: An Introductory Practical Guide to LBOs', Harriman House Publishers, at chapter 1.
[107]Pilger, D. (2012), 'Leveraged Buyouts: An Introductory Practical Guide to LBOs', Harriman House Publishers, at chapter 1.
[108]Pilger, D. (2012), 'Leveraged Buyouts: An Introductory Practical Guide to LBOs', Harriman House Publishers, at chapter 1.
[109]Pignataro, P. (2013), 'Leveraged Buyouts: A Practical Guide to Investment Banking and Private Equity', John Wiley and Sons Publishers, at chapter 1.
[110]Rachidi, M. (2010), 'Attributes of a good Leveraged Buyout 'LBO' Target Company: The South African Private Equity's Perspective', Graduate School of Business, University of Cape Town, December 2010, at pages 3.
[111]Rachidi, M. (2010), 'Attributes of a good Leveraged Buyout 'LBO' Target Company: The South African Private Equity's Perspective', Graduate School of Business, University of Cape Town, December 2010, at pages 3. It must be noted that the primary aim of Rachidi's study was to gather opinions from the local private equity industry and to a limited extent contrast this with opinions from debt providers of leveraged buyout transactions. The study have a specific focus on the target company and was positioned at the due diligence stage of the leveraged buyout process.

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a secured loan that is secured by security but for which the borrower is not personally liable.[112] However, if the borrower defaults, the lender can take the security but the lender's recovery is limited to the security provided; and if the security is insufficient to cover the outstanding loan balance, the difference between the value of the security and loan value becomes a loss for the lender.[113] In addition, unlike in a hedge fund, where debt raised to purchase certain securities is also securitised by the fund's other securities, the acquisition debt in a leveraged buyout is restricted only to the company purchased in a particular leveraged buyout transaction.[114] Therefore, a leveraged buyout transaction's financial structure is particularly attractive to a private equity fund's investors, affording them the benefits of leverage but restricting the recourse of that leverage.[115] The first significant benefit of this type of transaction is that the private equity investors via the private equity fund only need to provide a fraction of the capital for the acquisition.[116] Secondly, if the internal rate of return on the investment is greater than the weighted average interest rate on the acquisition debt (in addition to accounting for the exit proceeds), returns to the private equity fund will be greatly enhanced. [117] In addition, a leveraged buyout typically increases a company's capitalisation which often serves to revitalise a mature company which in turn may enable the company to improve its market position.[118] According to Pilger, there is also a tax advantage associated with acquiring a company through debt financing rather than an outright purchase because the cost of servicing the debt is deductible.[119]

There are also disadvantages associated with leveraged buyouts, for instance such transactions have been characterised as leading to the downsizing of operations and employees losing their employment.[120] For example, a leveraged buyout could be unsuccessful and the company could

[112]Available at https://en.wikipedia.org/wiki/Nonrecourse_debt. accessed in July 2016.
[113]Available at https://en.wikipedia.org/wiki/Nonrecourse_debt. accessed in July 2016.
[114]Sismangil, H.E. (2014), 'Creditor Protection in Private Equity-Backed Leveraged Buyout and Recapitalisation Practices: A Comparative Analysis of Company and Insolvency Law Mechanisms in England, Germany and Turkey, Volume 72 of Berliner Juristische Universitätsschriften – Zivilrecht', John Wiley and Sons Publishers, at pages 1-58.
[115]Sismangil, H.E. (2014), 'Creditor Protection in Private Equity-Backed Leveraged Buyout and Recapitalisation Practices: A Comparative Analysis of Company and Insolvency Law Mechanisms in England, Germany and Turkey, Volume 72 of Berliner Juristische Universitätsschriften – Zivilrecht', John Wiley and Sons Publishers, at pages 1-58.
[116]Sismangil, H.E. (2014), 'Creditor Protection in Private Equity-Backed Leveraged Buyout and Recapitalisation Practices: A Comparative Analysis of Company and Insolvency Law Mechanisms in England, Germany and Turkey, Volume 72 of Berliner Juristische Universitätsschriften – Zivilrecht', John Wiley and Sons Publishers, at pages 1-58.
[117]Sismangil, H.E. (2014), 'Creditor Protection in Private Equity-Backed Leveraged Buyout and Recapitalisation Practices: A Comparative Analysis of Company and Insolvency Law Mechanisms in England, Germany and Turkey, Volume 72 of Berliner Juristische Universitätsschriften – Zivilrecht', John Wiley and Sons Publishers, at pages 1-58.
[118]Tripathi, P. (2012), 'Leveraged Buyout Analysis', Journal of Law and Conflict Resolution, National Law School of India University, Bangalore India, December 2012, Volume 2, 4(6), at page 90.
[119]Pilger, D. (2012), 'Leveraged Buyouts: An Introductory Practical Guide to LBOs', Harriman House Publishers, at chapter 1. See paragraph 3.1.1 of this chapter hereinafter.
[120]Sismangil, H.E. (2014), 'Creditor Protection in Private Equity-Backed Leveraged Buyout and Recapitalisation Practices: A Comparative Analysis of Company and Insolvency Law Mechanisms in England,

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face bankruptcy if the company's cash flow and the sale of assets are not sufficient to meet the interest payments of the debt.[121] According to Tripathi, much of the criticism regarding leveraged buyouts is as result of conflicts of interest between the management and the shareholders.[122] For instance, management negotiating the sale of the company to themselves are engaged in self-dealing while on the other hand these managers have a fiduciary duty to their shareholders to sell the company at the highest possible price.[123] Despite the potential conflict of interests, a leveraged buyout transaction through the management team can also benefit the shareholders. Tripathi argues:

> 'The insider managers know how to deal with the transaction and protect the interest of the company as well as the shareholders. From this the shareholders may be willing the insider managers rather than the outsiders to rejuvenate the company.'[124]

In paragraphs 2(a) and 2(b) of chapter three the fiduciary duties of directors and conflicts of interests are discussed in greater detail, however it is important to highlight such potential conflicts of interest as part of the this discussion.

Leveraged buyouts emerged as a popular form of private equity finance in the 1980s and Jensen predicted that the leveraged buyout organisation would become the dominant corporate organisational form.[125] He argued that the private equity firm itself combined concentrated ownership shareholding in its portfolio companies, high-powered incentives for the private equity firm's team of professionals and an efficient organisation with minimal overhead costs.[126] The private equity firm then applied performance-based managerial compensation, highly leveraged capital structures and active governance to the companies in which it invested.[127] His argument was that these structures were superior to those of the common public corporation with widespread shareholders, low leverage and weak corporate governance. Kaplan and Stromberg argued that Jensen's predictions seemed to have been premature because by the early 1990s, the high-yield[128] bond market crashed following

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Germany and Turkey, Volume 72 of Berliner Juristische Universitätsschriften – Zivilrecht', John Wiley and Sons Publishers, at pages 1-58.

[121]Sismangil, H.E. (2014), 'Creditor Protection in Private Equity-Backed Leveraged Buyout and Recapitalisation Practices: A Comparative Analysis of Company and Insolvency Law Mechanisms in England, Germany and Turkey, Volume 72 of Berliner Juristische Universitätsschriften – Zivilrecht', John Wiley and Sons Publishers, at pages 1-58.

[122]Tripathi, P. (2012), 'Leveraged Buyout Analysis', Journal of Law and Conflict Resolution, National Law School of India University, Bangalore India, December 2012, Volume 2, 4(6), at page 89.

[123]Tripathi, P. (2012), 'Leveraged Buyout Analysis', Journal of Law and Conflict Resolution, National Law School of India University, Bangalore India, December 2012, Volume 2, 4(6), at page 89.

[124]Tripathi, P. (2012), 'Leveraged Buyout Analysis', Journal of Law and Conflict Resolution, National Law School of India University, Bangalore India, December 2012, Volume 2, 4(6), at page 87.

[125]Jensen, M. (1989), 'Eclipse of the Public Corporation', Harvard Business Review, September, at 61-74.

[126]Jensen, M. (1989), 'Eclipse of the Public Corporation', Harvard Business Review, September, at 61-74.

[127]Jensen, M. (1989), 'Eclipse of the Public Corporation', Harvard Business Review, September, at 61-74.

[128]High yield bond (non-investment grade bond, speculative grade bond or junk bond) is a bond that is rated below investment grade at the time of purchase. These bonds have a higher risk of default or other adverse credit events, but typically pay higher yields than better quality bonds in order to make them attractive to investors.

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the demise of the investment bank, Drexel Burnham Lambert;[129] several high-profile leveraged buyouts resulted in default and bankruptcy; and leveraged buyouts of public companies[130] all but disappeared.[131] It was during the 1980s that many private equity investments were termed 'corporate raids', especially those leveraged buyouts that involved the hostile takeover of a company.[132] These transactions were characterised by asset stripping, large scale retrenchments and/or major corporate restructuring activities.[133] According to Vincent, a notable example of an investor to be labelled a corporate raider was Carl Icahn.[134] Carl Icahn[135] developed a reputation as a corporate raider after his hostile takeover of Trans World Airlines ('TWA')[136] in 1985.[137] The takeover started when Icahn bought more than 20 percent of TWA's shares in 1985 and then delisted TWA from the stock exchange making a significant profit via a payment of $469 million to himself. This was at the same time that TWA was saddled with $540 million in debt. Thereafter Icahn sold the airline's London routes for $445 million in 1991.[138] The latter sale in part contributed to the demise of TWA because the London routes were very valuable and the airline ultimately went bankrupt.[139] According to Bruck, many of the corporate raiders were former clients of Michael Milken, whose investment banking firm, Drexel Burnham Lambert (as mentioned above) helped raise pools of capital with which corporate raiders could make hostile takeovers and provided high-yield debt financing of such buyouts.[140]

Following the aforementioned, major corporate and accounting scandals in the US affecting Enron, Tyco International, Adelphia, Peregrine Systems and WorldCom, prompted regulatory changes for publicly traded companies, more specifically the introduction of the Sarbanes-Oxley Act of 2002.[141]

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[129]Drexel Burnham Lambert was the investment bank most responsible for the boom in private equity during the 1980's due to its leadership in the issuance of high-yield debt. Drexel reached an agreement with the government in which it pleaded *nolo contendere* (no contest) to six felonies, three counts of stock parking and three counts of stock manipulation. It also agreed to pay a fine of $650 million, which at the time, the largest fine ever levied under securities laws. Milken left the firm after his own indictment in March 1989. On February 13, 1990 after being advised by United States Secretary of the Treasury Nicholas F. Brady, the U.S. Securities and Exchange Commission, the New York Stock Exchange and the Federal Reserve, Drexel Burnham Lambert officially filed for Chapter 11 bankruptcy protection. See Stewart *Den of Thieves* (1991).
[130]So called public-to-private transactions.
[131]Kaplan, S.N. and Stromberg, P. (2008), 'Leveraged Buyouts and Private Equity', Journal of Economic Perspective, University of Chicago Graduate School of Business, Volume 22, No. 4.
[132]Gaughan, P.A. (2010), 'Mergers, Acquisitions & Corporate Restructurings', John Wiley & Sons, 5th Ed, at pages 291-334.
[133]Gaughan, P.A. (2010), 'Mergers, Acquisitions, & Corporate Restructurings', John Wiley & Sons 5th Ed, at pages 291-334.
[134]Vincent, J.K (2013), 'Profiting from Hedge Funds: Winning Strategies for the Little Guy', John Wiley & Sons, at chapter 7.
[135]Carl Celian Icahn is an American businessman, activist shareholder and investor. He is the majority shareholder of Icahn Enterprises, a diversified holding company.
[136]Trans World Airlines ('TWA') was a major American airline from 1925 until 2001.
[137]Vincent, J.K (2013), 'Profiting from Hedge Funds: Winning Strategies for the Little Guy', John Wiley & Sons at chapter 7.
[138]Vincent, J.K. (2013), 'Profiting from Hedge Funds: Winning Strategies for the Little Guy', John Wiley & Sons at chapter 7.
[139]Vincent, J.K (2013), 'Profiting from Hedge Funds: Winning Strategies for the Little Guy', John Wiley & Sons at chapter 7.
[140]Bruck, C. (2013), 'Predator's Ball', Simon and Schuster Publishers, part 3, chapter 10.
[141]De Vay, D.L. (2006), 'The Effectiveness of the Sarbanes-Oxley Act of 2002 in Preventing and Detecting Fraud in Financial Statements', Universal Publishers, at pages 1-27.

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The Sarbanes-Oxley Act of 2002 is formally known as the Public Company Accounting Reform and Investor Protection Act of 2002 and commonly called Sarbanes-Oxley.[142] These scandals, which cost investors billions of dollars when the share prices of affected companies collapsed, shook public confidence in the US securities markets. Named after sponsors US Senator Paul Sarbanes and US Representative Michael G. Oxley, the Sarbanes-Oxley Act of 2002 was approved by the House by a vote of 334-90 and by the Senate 99-0.[143] The legislation set new or enhanced standards for all US public company boards, management and public accounting firms. However, it does not apply to privately held companies.[144] The Sarbanes-Oxley Act of 2002 contains eleven titles, or sections, ranging from additional corporate board responsibilities to criminal penalties, and requires the Securities and Exchange Commission (SEC) to implement rulings on requirements to comply with the Sarbanes-Oxley Act of 2002.[145] The Sarbanes-Oxley Act of 2002 created a new, quasi-public agency, the Public Company Accounting Oversight Board (PCAOB) charged with overseeing, regulating, inspecting and disciplining accounting firms in their roles as auditors of public companies.[146] The Sarbanes-Oxley Act of 2002 also covers issues such as auditor independence, corporate governance, internal control assessment, and enhanced financial disclosure.[147]

Nevertheless, the passage of the Sarbanes-Oxley Act in the US during July 2002 had a profound impact on the leveraged buyout and private equity markets because it added to growth of the leveraged buyout market. It resulted in a large number of US companies recognising the benefits of avoiding increasingly burdensome regulations that were imposed on public companies based on the Sarbanes-Oxley Act of 2002.[148] By ‘going private’ the companies were not subject to the increased financial, disclosure and corporate governance requirements and the costs of remaining public in the prevailing regulatory environment, which was exacerbated by the Sarbanes-Oxley Act of 2002.[149] The reference to a company ‘going private’ is with regard to a private equity transaction as discussed in the thesis, with the common structure being a leveraged buyout.

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[142]It is a US federal law enacted on 30th July 2002.
[143]Fernando, A.C. (2009), ‘Corporate Governance: Principles, Policies and Practices’, Pearson Publishers, at pages 3-40.
[144]Fernando, A.C. (2009), ‘Corporate Governance: Principles, Policies and Practices’, Pearson Publishers, at pages 3-40.
[145]Fernando, A.C. (2009), ‘Corporate Governance: Principles, Policies and Practices’, Pearson Publishers, at pages 3-40.
[146]Stephen, S.K. (2008), ‘The Impact of the Sarbanes-Oxley Act of 2002 on the US Financial Markets’, The University of Texas at Arlington, ProQuest Publishers, at pages 1-11.
[147]Stephen, S.K. (2008), ‘The Impact of the Sarbanes-Oxley Act of 2002 on the US Financial Markets’, The University of Texas at Arlington, ProQuest Publishers, at pages 1-11.
[148]Kaplan, S.N. and Stromberg, P. (2008), ‘Leveraged Buyouts and Private Equity’, Journal of Economic Perspective, University of Chicago Graduate School of Business, Volume 22, No. 4, at page 1.
[149]Kaplan, S.N. and Stromberg, P. (2008), ‘Leveraged Buyouts and Private Equity’, Journal of Economic Perspective, University of Chicago Graduate School of Business, Volume 22, No. 4, at page 1.

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In the mid-2000s, public-to-private transactions re-emerged. One such transaction was the purchase of Manchester United Football Club by the American Glazer family by way of a leveraged buyout.[150] In 2005 the Glazer family took their shareholding of the club to seventy five percent allowing them to delist it from the London Stock Exchange. In the same year the Glazer family increased their share to ninety eight percent which was enough for a compulsory buyout of all remaining shareholders.[151] The debt taken on by the Glazers to finance the club was £660 million which accrued interest payments of £62 million per annum. The loans were secured against the clubs assets.[152] In 2010 the clubs debts had increased to in excess of £716 million and it had to refinance the debt through a bond issue of £504 million. This allowed the club to pay off most of the £509 million it owed to the lending banks.[153]

Less than twenty years after the previous crash, the global economy experienced a second leveraged buyout boom.[154] In 2006 and 2007, a record amount of capital was committed to private equity, both in nominal terms and as a fraction of the overall stock market.[155] Hence, Jensen's prediction seemed more relevant than ever. In July 2007, turmoil that had been affecting the mortgage markets spilled over into the leveraged finance and high-yield debt markets.[156] The

[150] House of Commons Culture, Media and Sport Committee, (2011), 'Football Governance: Report, Together with Formal Minutes', House of Commons Papers Series, The Stationery Office Publishers, at pages 63-67.
[151] House of Commons Culture, Media and Sport Committee, (2011), 'Football Governance: Report, Together with Formal Minutes', House of Commons Papers Series, The Stationery Office Publishers, at pages 63-67.
[152] House of Commons Culture, Media and Sport Committee, (2011), 'Football Governance: Report, Together with Formal Minutes', House of Commons Papers Series, The Stationery Office Publishers, at pages 63-67.
[153] House of Commons Culture, Media and Sport Committee, (2011), 'Football Governance: Report, Together with Formal Minutes', House of Commons Papers Series, The Stationery Office Publishers, at pages 63-67.
[154] As 2005 ended and 2006 began, new 'largest buyout' records were set and surpassed several times with nine of the top ten buyouts at the end of 2007 having been announced in an 18-month window from the beginning of 2006 through the middle of 2007. In 2006, private equity firms bought 654 US companies for $375 billion, representing 18 times the level of transactions closed in 2003. Additionally, US based private equity firms raised $215.4 billion in investor commitments to 322 funds, surpassing the previous record set in 2000 by 22 percent and 33 percent higher than the 2005 fundraising total. The following year, despite the onset of turmoil in the credit markets in the summer, saw yet another record year of fundraising with $302 billion of investor commitments to 415 funds. See Samuelson, R.J., (2007), 'The Private Equity Boom', The Washington Post, March 15, 2007. In South Africa 2007 was a year of 'mega- transactions', such as Bain Capital's Edcon buy-out, Actis and Ethos' Alexander Forbes Limited buy-out, Brait, Old Mutual and Sanlam's buy-out of Consol Limited and Brait and the Mine Workers Investment Company's Primedia Limited buy-out. Many of the mega-transactions were concluded in 2007 but a number of large transactions were announced but not successfully concluded, such as Shoprite Holdings Limited, Iliad Africa Limited and Gold Reef Resorts Limited. Reported private equity investments in South Africa increased by 270% from R6.9 billion during 2006 to R25.5 billion during 2007. The total number of investments increased by 34 from 806 to 840 during the same period, representing a 4% increase. See KPMG and South African Venture Capital and Private Equity Association, (SAVCA), (2007), 'Private Equity and Venture Capital', Survey, 2007, at page 26.
[155] As 2005 ended and 2006 began, new 'largest buyout' records were set and surpassed several times with nine of the top ten buyouts at the end of 2007 having been announced in an 18-month window from the beginning of 2006 through the middle of 2007. In 2006, private equity firms bought 654 US companies for $375 billion, representing 18 times the level of transactions closed in 2003. Additionally, US based private equity firms raised $215.4 billion in investor commitments to 322 funds, surpassing the previous record set in 2000 by 22 percent and 33 percent higher than the 2005 fundraising total. The following year, despite the onset of turmoil in the credit markets in the summer, saw yet another record year of fundraising with $302 billion of investor commitments to 415 funds. See Samuelson, R.J., (2007), 'The Private Equity Boom', The Washington Post, March 15, 2007.
[156] Fleischer, C. (2013), 'Predicting Leveraged Buyout Success', GRIN Verlag Publishers, at pages 1-8.

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markets had been highly robust during the first six months of 2007, and covenant light debt was widely available to finance large leveraged buyouts.[157] However, by July 2007 there was a notable slowdown in issuance levels in the high yield and leveraged loan markets with only few issuers accessing the market.[158] As 2007 ended and 2008 began, it was clear that lending standards had tightened and the era of mega-buyouts had come to an end.[159] However, in 2008, with the turmoil in the debt markets, private equity appeared to have declined again.[160]

A major criticism to emerge from the above discussion of the historical development of leveraged buyouts has been the reliance on unrealistic forecasts of the target company's revenues by private equity firms. This overpricing of the target firm and its assets by leveraged buyout firms have led to financial distress after acquisition, often resulting in the inability to repay the debt.[161] This also poses a risk to a country's revenue base because leveraged buyout transactions lead to a substantial

[157]Moody's Investor Services Report, (2013), 'Covenants Signs of a 'Covenant Bubble' Suggest Future Risks for Investors: Quest for yield could leave creditors vulnerable in a downturn', May 2013, at pages 1-8. Cov-lite ('covenant light') is financial jargon for loan agreements which do not contain the usual protective terms and conditions for the benefit of the lending party. Although traditionally banks have insisted on a wide range of contractual terms and conditions which allow them to intervene if the financial position of the borrower or the value of underlying assets deteriorates, from around the year 2006 the increasing strength of private equity firms and the decreasing opportunities for traditional corporate loans made by banks fuelled something of a 'race to the bottom' with syndicates of banks competing with each other to essentially offer ever less invasive terms to borrowers in relation to leveraged buyouts. Cov-lite lending is seen as more risky because it removes the early warning signs lenders would otherwise receive through traditional contractual terms and conditions. Against this, it have been countered that cov-lite loans simply reflected changes in bargaining power between borrowers and lenders, and followed from the increased sophistication in the loans market where risk is quickly dispersed through syndication or credit derivatives. However, this spreading have been shown to be false. According to the above mentioned Moody's Investors Services Report (at page 1): 'Robust issuance of covenant-lite loans and high-yield bonds with weak investor protections suggest a 'covenant bubble' that could leave fixed-income investors vulnerable in a credit cycle downturn. The quest for yield is driving looser covenant terms that may not reflect debt issuers' underlying credit fundamentals. In a distressed situation, these looser covenants would limit creditors' rights. As strong issuance narrows credit spreads, investors may not be fully compensated for the risks they are taking on.'

[158]Uncertain market conditions led to a significant widening of yield spreads which led many companies and investment banks to put their plans to issue debt on hold. However, the expected rebound in the market did not materialize and the lack of market confidence prevented transactions from pricing. By the end of September 2007, the full extent of the credit situation became obvious as major lenders including Citigroup and UBS AG announced major write downs due to credit losses. The leveraged finance markets came to a near standstill.

[159]Fleischer, C. (2013), 'Predicting Leveraged Buyout Success', GRIN Verlag Publishers, at pages 1-8.

[160]Sismangil, H.E. (2014), 'Creditor Protection in Private Equity-Backed Leveraged Buyout and Recapitalisation Practices: A Comparative Analysis of Company and Insolvency Law Mechanisms in England, Germany and Turkey, Volume 72 of Berliner Juristische Universitätsschriften – Zivilrecht', John Wiley and Sons Publishers, at pages 1-58.

[161]Andrade, G., and SN. Kaplan, (1998), 'How costly is financial (not economic distress)? Evidenced from Highly Leveraged Transactions that became distressed', Journal of Finance, 53, 1443-1494. Certain US courts have found that leveraged buyout debt constitutes a fraudulent transfer under US insolvency law if it is determined to be the cause of the acquired firm's failure, (US Bankruptcy Code, 11 U.S.C. § 548(2); Uniform Fraudulent Transfer Act, § 4). This is because the company usually gets no direct financial benefit from the transaction but incurs the debt for it nevertheless. However, the Bankruptcy Code includes a so-called 'safe harbor' provision, preventing bankruptcy trustees from recovering settlement payments to the bought-out shareholders (US Bankruptcy Code, 11 U.S.C. § 546(e)). In 2009, the US Court of Appeals for the Sixth Circuit in the case *QSI Holdings, Inc. v. Alford, --- F.3d ---, Case No. 08-1176 (6th Cir. July 6, 2009)*, held that such settlement payments could not be avoided, irrespective of whether they occurred in a leveraged buyout of a public or private company. See paragraph 3.1.2 of this chapter hereinafter with regard to financial assistance by a company in terms of section 44 and section 4 of the Companies Act 71 of 2008.

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interest deduction which in turn leads to a loss of revenue for the government. From a South African perspective these criticisms lead to two important legal questions. Firstly, what is the legal position of the deductibility of interest where borrowed funding is used with regard to leveraged buyouts in South Africa? However, at the outset it must be noted that it is not the intention of this thesis to discuss all the South African tax implications of leveraged buyouts, as well as the tax treatment of dividends and underlying portfolio interests.[162] Secondly, in the context of a leveraged buyout, are there rules preventing the target company from giving financial assistance for the purpose of assisting a purchase of shares in the target company? If so, how does this affect the ability of a target company in a buyout to give security to lenders? In addressing the first question, paragraph 3.1.1 below will discuss an important South African case study, namely the proposed buyout of Shoprite Holdings by Brait Private Equity in 2006.[163]

3.1.1 Tax Issues with regard to Leveraged Buyouts in South Africa

The characteristics of a leveraged buyout in South Africa are similar to a leveraged buyout in most developed countries, such as the US and the UK. Typically the private equity firm or group of firms planning a leveraged buyout would form a new company to serve as a special purpose vehicle ('SPV') to buy the target company. The private equity firm(s) would arrange for the SPV to borrow most of the acquisition finance and provide the remainder of the acquisition finance as equity finance. The SPV would arrange the borrowed funds in tranches ranging from senior debt, senior subordinated debt and junior subordinated debt.[164] Levin argues that in order to obtain each successively more junior layer of debt financing the SPV must offer a progressively higher interest rate and/or a progressively larger equity interest to each more subordinated layer.[165] A key feature of the leveraged buyout transaction is that the private equity firm(s) and the investors in the private equity fund are not liable for the borrowed money raised to fund the buyout.[166] It is only the SPV and/or the target company that would be liable to the lender for the borrowed funds.[167]

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[162]However, in the context of a private equity fund, brief reference is made in paragraph 3.1.3(e) of chapter two to *African Life Investment Corporation (Pty) Ltd v SIR* (1969) 4 SA 259 (A), *CIR v Nussbaum* 1996 (4) SA 1156 (A), 58 SATC 283, 1996 Taxpayer 150, and *ITC 1412* (1983) 48 SATC 157. The brief discussion relates to the proceeds from the realisation of the shares in the investee company which can be said to be of a capital nature resulting in the return to the investors being liable to the lower capital gains tax.

[163]The proposed buyout of Shoprite Holdings by Brait Private Equity in 2006 is a case study of two South African companies which was subject to the South African regulatory regime. The transaction was ultimately not concluded.

[164]Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', Aspen Publishers, 2003 edition, at pages 1-9 to 1-10.

[165]Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', Aspen Publishers, 2003 edition, at pages 1-9 to 1-10.

[166]Pignataro, P. (2013), 'Leveraged Buyouts: A Practical Guide to Investment Banking and Private Equity', John Wiley and Sons Publishers, at chapter 1.

[167]Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', Aspen Publishers, 2003 edition, at pages 1-9 to 1-10.

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The private equity firm would also secure key management, either sourced from within the target company or recruited to manage the target company once the leveraged buyout is completed.[168] The private equity firm usually incentivises management, for example by way of share options in the underlying portfolio investee companies. This is an important part of private equity investing and is discussed in greater detail in chapter four.[169] The management of the target company could also be the originator of a leveraged buyout and would approach a private equity firm to secure the equity finance for the acquisition. This is typically referred to as a management buyout and is discussed in paragraph 3.2 of this chapter.

Nevertheless, one of the key tax features of a leveraged buyout in South Africa which would have been evident of the proposed buyout of Shoprite Holdings by Brait, would have been to optimize the interest deductions for the interest resulting from the high leverage used in the transaction. In terms of the transaction, a SPV[170] was formed which would have been funded with approximately R9,4 billion of debt borrowed from several local and international banks.[171] The equity finance of approximately R2,5 billion to the SPV was largely provided by Brait, but also included key management and re-investing shareholders. Approximately 79 percent of the SPV's acquisition funding was made up of debt. The SPV was a wholly owned subsidiary of Shoprite Checkers and Shoprite Checkers in turn being a wholly owned operating subsidiary of Shoprite Holdings.[172] Thereafter, Shoprite Checkers would dispose of its business to the SPV in exchange for approximately R11,9 billion in debentures in the SPV and R700 million in equity in the SPV. The South African Revenue Service ('SARS') was critical of the proposed leveraged buyout because of the high gearing created by the transaction.[173] SARS was of the view that the substantial interest deductions would lead to a loss of revenue by the State. The introduction of debt into the SPV would have resulted in significant interest charges to the target company. The criticisms by SARS were extensively covered by the local press:

> 'SA Revenue Service (Sars) Commissioner Pravin Gordhan accuses the dealmakers of 'robbing not only the fiscus of tax revenue, but all South Africans' … attacking transactions which 'show complete and reckless disregard for tax morality'. Although he didn't give names, those in the

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[168]Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', Aspen Publishers, 2003 edition, at pages 1-9 to 1-10.

[169]Paragraph 2.2 of chapter four discusses the taxation of share options in investee companies.

[170]The SPV was referred to as New Opco in the proposed Shoprite buyout.

[171]For more detailed outline of the transaction, see Shoprite Holdings Limited Cautionary Announcement (2006), 'Internal re-organisation of Shoprite, *in specie* distribution, delisting, liquidation and further cautionary announcement', Available at www.rhp.co.za/sites/default/files/xSHOPRITE.pdf, accessed in April 2015.

[172]For more detailed outline of the transaction, see Shoprite Holdings Limited Cautionary Announcement (2006), 'Internal re-organisation of Shoprite, *in specie* distribution, delisting, liquidation and further cautionary announcement'.

[173]Hogg, A. (2007), 'Taxman adds pressure to block Shoprite delisting', Moneyweb article, 15th January 2007, Available at www.moneyweb.co.za/archive/taxman-adds-pressure-to-block-shoprite-delisting/, accessed in April 2015.

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know believe Gordhan was referring to the proposed Shoprite transaction. Advisers Brait have put together a complex structure designed primarily to avoid having to pay tax of R1,4bn on the transaction …'[174]

The deductibility of this interest expenditure against the income of the target company would typically be determined in terms of the general deductions contained in section 11(a) of the Income Tax Act 58 of 1962. To determine the tax liability of a taxpayer, it is required to establish the 'taxable income', which is the amount remaining after deducting all allowable deduction and allowances from the income of a taxpayer.[175] Section 11(a) reads:

'11. General deductions allowed in determination of taxable income.—For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived – (a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature.'

Consideration must be giving to section 23(g) of the Income Tax Act 58 of 1962, which prohibits the deduction of,

'any moneys claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purpose of trade'.

According to De Koker *et al*, whether or not expenses incurred by a taxpayer can be deducted from such taxpayer's gross income will depend on the results of an analysis of the general deduction formula, as contained in section 11(a) read with section 23(g) of the Income Tax Act 58 of 1962.[176] The key requirements of the general deduction formula are:

'a trade to be carried on; income to be derived from such trade; there be expenditure and losses; actually incurred; in the production of income; not of a capital nature'[177]

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[174]Hogg, A. (2007), 'Taxman adds pressure to block Shoprite delisting', Moneyweb article, 15th January 2007, Available at www.moneyweb.co.za/archive/taxman-adds-pressure-to-block-shoprite-delisting/, accessed in April 2015.

[175]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragragraph 7, at pages 136-163.

[176]De Koker, A.P., Williams, R.C. and Silke, A.S. (2014), 'Silke Tax Yearbook 2013-2014', Butterworths Publishers.

[177]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 7, at pages 136-163. For example, expenditure will only be deductible in terms of section 11(a) of the Income Tax Act 58 of 1962 if the expense results in income derived from carrying on a trade. In *ITC 1476*, 1989, 52 SATC 141 (T) it was held that "the carrying on of a trade involves an 'active step', something more than watching over existing investments that are not income-producing and are not intended or expected to be so". In this case for a specific period, the shares and investments did not produce dividends or income and were merely investments in other companies

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All these requirements must be met for an expense or loss to be deductible.[178] Failure to meet any of the requirements will result in a disallowance of the expenditure for taxation purposes.[179] In the context of the proposed buyout of Shoprite by Brait the transaction was structured to derive a deduction for interest incurred by forming a SPV to acquire the operating assets of Shoprite Checkers. Therefore, the simplistic answer to the determination as to whether or not expenses incurred by a taxpayer can be deducted from such taxpayer's gross, income will depend on the results of an analysis of the general deduction formula, as contained in section 11(a) read with section 23(g) of the Income Tax Act 58 of 1962. Nevertheless, section 24J of the Income Tax Act 58 of 1962 allows an interest deduction when income is derived from the carrying on of a trade and the interest was incurred in the production of income. Section 24J of the Income Tax Act 58 of 1962 has no requirement that interest must not be of a capital nature in order for the interest to be deductible.[180]

Section 24J of the Income Tax Act 58 of 1962 overrides the above mentioned general rule[181] as section 24J(1) includes premiums and discounts on financial instruments in the definition of interest. In addition, section 24J(3) requires all interest earned (as determined in terms of section 24J) to be included in the gross income of the lender irrespective of whether it is of a capital or revenue nature; and section 24J(2) provides that the interest amount on an instrument, determined in terms of section 24J must be deducted from the trade income of the borrower if the interest is incurred in the production of income.[182] Section 24J(2) of the Income Tax Act 58 of 1962 reads:

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to enable the speculation in immovable property. The company failed to prove that the company was carrying on a trade.

[178]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragragraph 7, at pages 136-163. In *ITC 770,* 1953, 19 SATC 216 the judge stated at 217 that the definition of trade is "obviously intended to embrace every profitable activity and which I think should be given the widest possible interpretation." From this case it can be deduced that "trade" involves an active step where the taxpayer is taking a chance by acquiring shares in companies. Undertaking a risk can be viewed as an act of carrying on a trade. Investing in other companies requires involvement in the investment from the taxpayer's position. A taxpayer's main purpose in acquiring shares is to receive maximum benefits in the form of dividends and/or capital gains on sale of the shares. In *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 8 SATC 13, at 247, Watermeyer AJP said: "Chance, in other words, increases the expenses, or makes additional expenses, but though chance causes them to arise they nevertheless remain expenses so closely linked to a necessary business operation that they can be regarded as part of the cost of performing such operation. In this case the potential liability is there all the time and is inseparable from the employment of drivers, that is to say, inseparable from the carrying on of the business."

[179]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragragraph 7, at pages 136-163.

[180]In *CIR v Shapiro* 1928 NPD 436 4 SATC 29, Matthews J stated 'the payment of interest on borrowed money obviously not being an outgoing of a capital nature, the contention was that it was an outgoing actually incurred during the year of assessment in the production of the taxpayer's income'.

[181]Namely, the general deduction formula, as contained in section 11(a) read with section 23(g) of the Income Tax Act 58 of 1962.

[182]Income Tax Act 58 of 1962.

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'(2) Where any person is the issuer in relation to an instrument during any year of assessment, such person shall for the purposes of this Act be deemed to have incurred an amount of interest during such year of assessment, which is equal to

(a) the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument; or
(b) an amount determined in accordance with an alternative method in relation to such year of assessment in respect of such instrument;

which must be deducted from the income of that person derived from carrying on any trade, if that amount is incurred in the production of the income;'

According to Haupt:

'Section 24J was introduced into the Act in 1995 to address what was considered by the Revenue Service to be a serious problem concerning the timing of interest and finance charges for income tax purposes. A taxpayer could, for example, have borrowed R100 in terms of an arrangement which provided for the repayment of R160 after three years. The R60 premium payable at the end of the contract was claimed as a section 11(a) deduction on day 1 on the basis that it represented an expense actually incurred. Section 24J addressed such problems by providing a basis for the determination of the time of accrual and incurral of interest. Whether or not such amounts were taxable or deductible had to be determined under the normal gross income rules and section 11(a). An amendment in the 2004 Revenue laws Amendment Act changed this. As a result of the amendment which came into operation on 1 January 2005 the section now deals with the gross income inclusion and section 24J deduction in respect of interest.'[183]

According to Stiglingh *et al*:

'At the time of its introduction, it was commonly accepted that s 24J merely aimed to regulate the timing of interest accruals and deductions and that it did not represent a charging section. Amounts were accordingly taxed by virtue of the fact that the constituted "gross income", or they qualified for deduction as a result of the application of s 11(a). In other words, s 24J was directed solely at the timing of accrual or incurral of interest. Subsequent amendments altered the principles outlined above:

- Section 24J(2) now specifically provides for the deduction of interest.

[183] Haupt, P. (2012), 'Notes on South African Income Tax', 31st edition, at pages 534-535. See also Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 23, at pages 726-774.

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- Section 24J(3) makes provision for the inclusion of amounts in gross income.

These amendments were deemed necessary by the legislature as taxpayers and the tax authorities contended that certain amounts of discount, premium and interest that were treated as interest under the provisions of s 24J were not taxable or deductible due to their capital nature.'[184]

Therefore section 24J of the Income Tax Act 58 of 1962 is the main section under which interest will be either deductible or included in income, as opposed to section 11(a) of the Income Tax Act 58 of 1962. For the sake of clarity, it must be reaffirmed at this point that it is not the intention of this thesis to discuss all the tax implications with regard to the deductibility of interest where borrowed funding is used, specifically all the fundamental concepts contained in section 24J of the Income Tax Act 58 of 1962.[185] Nonetheless, the substantive provisions of section 24J of the Income Tax Act 58 of 1962 are summarised succinctly by Stiglingh *et al*:

'- where there is any form of financial arrangement
- in terms of which one taxpayer (the borrower/issuer)
- undertakes to another (the lender/holder)
- to pay interest
- or to pay a premium (an amount greater that the amount that the borrower received when the instrument was issued) on an instrument that premium is in addition to the face value of the capital sum or because the instrument has been acquired at a discount on face value
- the following results ensue in terms of s24J:
    - in the hands of the taxpayer incurring the liability, the total financing cost to him over the total period of the arrangement is deemed to have been incurred on a day-to-day basis
    - in the hands of the recipient, there is an accrual of the interest on a day-to-day basis until he disposes of the instrument or until maturity of the instrument.'[186]

Furthermore, in calculating the interest expense incurred by issuers of financial instruments, the provisions of section 24J of the Income Tax Act 58 of 1962 apply to all 'instruments' as defined.[187] Section 24J(1) of the Income Tax Act 58 of 1962 defines 'instrument' as:

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[184] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 23, at page 728.

[185] Section 24J of the Income Tax Act 58 of 1962 is detailed, complex and contain numerous fundamental concepts and provisions. A detailed discussion of all such concepts and provisions is beyond the scope of this thesis.

[186] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 23, at page 734.

[187] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 23, at page 735.

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'…(c) any interest-bearing arrangement or debt; (d) any acquisition or disposal of any right to receive interest or the obligation to pay any interest, as the case may be, in terms of any other interest-bearing arrangement; or (e) any repurchase agreement or resale agreement ... but excluding any lease agreement (other than a sale and leaseback arrangement as contemplated in section 23G)or any policy issued by an insurer as defined in section 29A ...'

Nevertheless, to restate the abovementioned: the basis of section 24J(2) of the Income Tax Act 58 of 1962 is that the taxpayer can deduct the interest expense from income from carrying on trade, provided that the expenditure was incurred in the production of income. Therefore, if a taxpayer is carrying on a trade and is paying interest in respect of the acquisition of an asset which will produce income, that the interest should be deductible.[188] Section 24J of the Income Tax Act 58 of 1962 is a charging section on which a taxpayer can rely to claim a deduction and under which tax liability can arise.[189]

As mentioned above, it is not a requirement in section 24J of the Income Tax Act 58 of 1962 that the interest must not be of a capital nature. All that is required is that the interest be deductible against income from the carrying on of a trade and that it be incurred in the production of income.[190] In the proposed buyout of Shoprite, Brait introduced capital into the structure through the formation of a SPV that purchased operating assets. The transaction was structured to establish a link between the income and the interest to give rise to expenditure in the production of income. This was intended to satisfy the provisions of section 24J of the Income Tax Act 58 of 1962 that the interest expenditure would have been deductible from income derived from the carrying of trade and would have been incurred in the production of income.[191] In addition, Brait introduced capital into the structure through the formation of a SPV that purchased operating assets. The transaction was structured on the basis that as these assets were operating assets, there was an adequate link between the income and the interest to give rise to expenditure in the production of income. Therefore at the time of the proposed Shoprite buyout there was a sound argument based on the provisions of section 24J that the interest expenditure would have been deductible from income derived from the carrying of trade and would have been incurred in the production of income. However, subsequent to the proposed Shoprite

[188]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 23, at pages 726-774. See De Koker, A.P., Williams, R.C. and Silke, A.S. (2014), 'Silke Tax Yearbook 2013-2014', Butterworths Publishers.
[189]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 23, at pages 726-774. See Haupt, P. (2015), 'Notes on South African Income Tax', 34th edition, at pages 512-515.
[190]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 23, at pages 726-774. See Haupt, P. (2015), 'Notes on South African Income Tax', 34th edition, at pages 512-515.
[191]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 23, at pages 726-774. See Haupt, P. (2015), 'Notes on South African Income Tax', 34th edition, at pages 512-515.

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leveraged buyout in 2006, SARS introduced section 23K of the Income Tax Act 58 of 1962 in 2011 as an anti-avoidance provision.[192]

On the one hand the purpose of section 24J of the Income Tax Act 58 of 1962 is to determine the accrual and incurral of interest, while on the other hand the deduction of interest in relation to the direct acquisition of equity interests is subject to anti-avoidance provisions that were first introduced into the Income Tax Act in 2011.[193] These provisions, namely section 23K of the Income Tax Act 58 of 1962, initially applied to indirect acquisitions of equity interests but have been amended to extend their application to direct acquisitions of equity interests.[194] In addition, section 23K of the Income Tax Act 58 of 1962 required an application to SARS for a directive that covers a specific interest deduction. The provisions of section 23K of the Income Tax Act 58 of 1962 were only applicable to acquisition transactions where interest-bearing or debt arrangements were effected after 1 January 2013. The deduction was also only available for as long as the requirements stipulated above were met and the conditions as stipulated in the Section 23K directive were applicable. Subsequently, with effect from 1st April 2014 section 23K of the Income Tax Act 58 of 1962 was replaced by section 23N which now applies to transactions entered into on or after 1st July 2013.[195] Section 23N of the Income Tax Act 58 of 1962 set out the permanent rules to disallow 'excessive interest'.[196] The acquisition debt interest incurred by the new operating company must in any year of assessment and for a period of five years of assessment thereafter, not exceed forty percent of the higher of the adjusted taxable income determined (i) in the particular year of assessment; or (ii) in the year in which the re-organisation occurred.[197]

At the time of the proposed buyout of Shoprite by Brait, there were *inter alia* two separate (but related) tax considerations. On the one hand consideration had to be given to the deductibility of interest expenditure from income derived from the carrying of trade and that would have been incurred in the production of income. On the other hand consideration had to be given to the

[192]The proposed transaction with regard to the buyout of Shoprite by Brait was never concluded.
[193]Section 23K was inserted into the Income Tax Act 58 of 1962 by the Taxations Laws Amendment Act 24 of 2011.
[194]De Koker, A.P., Williams, R.C. and Silke, A.S. (2014), 'Silke Tax Yearbook 2013-2014', Butterworths Publishers.
[195]Standing Committee on Finance (SCOF): Report-Back Hearings on the Draft Taxation Laws Amendments Bill, 2013 and Tax Administration Laws Amendment Bill, 2013, Draft Response Document from National Treasury and SARS (Version as presented to Standing Committee on Finance on 11th September 2013).
[196]Standing Committee on Finance (SCOF): Report-Back Hearings on the Draft Taxation Laws Amendments Bill, 2013 and Tax Administration Laws Amendment Bill, 2013, Draft Response Document from National Treasury and SARS (Version as presented to Standing Committee on Finance on 11th September 2013).
[197]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 23, at pages 726-774. See Haupt, P. (2015), 'Notes on South African Income Tax', 34th edition, at pages 586-587. See also Standing Committee on Finance (SCOF): Report-Back Hearings on the Draft Taxation Laws Amendments Bill, 2013 and Tax Administration Laws Amendment Bill, 2013, Draft Response Document from National Treasury and SARS (Version as presented to Standing Committee on Finance on 11th September 2013). Section 23N provides for an adjustment to the allowable percentage of 'adjusted taxable income' to the extent that South Africa's repo rate is subject to an increase beyond ten percent.

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deductibility of interest on loans used to acquire shares. The first aforementioned consideration has been discussed. Next, the second consideration will be discussed. As stated previously in this paragraph, the proposed buyout of Shoprite by Brait was structured to derive a deduction for interest incurred by forming a SPV to acquire the operating assets of Shoprite Checkers rather than the equity of Shoprite Checkers.[198] If the transaction included the purchase of the equity of Shoprite Checkers, the interest deduction would not have been allowed on the basis that it was not incurred in the production of income but rather to acquire a dividend producing asset.[199] At the time of the proposed buyout of Shoprite by Brait, the position of SARS was that the interest on loans used to acquire shares may not be deducted because the taxpayer earns exempt dividend income and it would have been difficult to prove that the interest deduction is directly linked to the production of taxable income. Therefore, if the loan was raised to purchase shares, a deduction of the interest would have generally not been available.

Nevertheless, dividends are exempt from tax therefore expenditure incurred for the purpose of producing dividends is not deductible. The position of SARS at the time of the proposed Shoprite buyout was that on the one hand if the purpose of borrowing money was to apply the funds to earn income of a kind that is taxable under the Income Tax Act 58 of 1962, then the interest on the loan is a deductible expense for income tax purposes. On the other hand, dividends are exempt from tax therefore expenditure incurred for the purpose of producing dividends is not deductible.[200] Therefore the purpose of a loan must be determined at the time of the borrowing of the funds. The interest on loans to purchase shares requires that if interest paid on money borrowed by a company to acquire shares in another company is linked with the actual or prospective receipt by the company of dividends, it cannot be allowed as a deduction because almost all dividends constitute exempt income.[201] However, if it can be shown that the sole or main purpose of the acquisition of the shares is the production of income, and that any receipt or accrual of dividends on these shares is purely incidental to the main purpose; interest paid on money borrowed to acquire the shares would properly be allowable as a deduction. Therefore it does not necessarily follow that interest paid by a company on moneys borrowed to acquire shares may not be deducted from its income.[202]

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[198]Shoprite Holdings Limited Cautionary Announcement (2006), 'Internal re-organisation of Shoprite, *in specie* distribution, delisting, liquidation and further cautionary announcement', Available at www.rhp.co.za/sites/default/files/xSHOPRITE.pdf, accessed in April 2015.

[199]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 23, at pages 726-774. See Haupt, P. (2015), 'Notes on South African Income Tax', 34th edition, at pages 121, 364.

[200]*Sallies Limited v CSARS* 2007, 70 SATC 39.

[201]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 23, at pages 726-774. See Haupt, P. (2015), 'Notes on South African Income Tax', 34th edition, at pages 121, 364.

[202]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 23, at pages 726-774. See Haupt, P. (2015), 'Notes on South African Income Tax', 34th edition, at pages 121, 364.

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In *ITC1820*[203] the court had to decide whether the taxpayer was entitled to deduct the interest incurred by it in respect of an amount borrowed in order to acquire certain shares. The case was considered by the High Court and published as *Sallies Limited v CSARS.*[204] The court found in both, that Sallies had not incurred the interest expense in the production of income.[205] In *Sallies Limited v CSARS,*[206] the matter turned on whether the interest incurred by Sallies Limited on the loan which had been utilised to acquire the shares in Witkop Fluorspar Mine (Pty) Ltd, satisfied the criteria for deductibility laid down in the general deduction provisions of the Income Tax Act 58 of 1962, namely section 11(a) read with section 23(g). For income tax purposes, Sallies Limited claimed a deduction in respect of interest on the loan. SARS refused to allow the interest as a deduction. Sallies objected to the assessment and asserted its claim to a deduction. When the matter came before the Tax Court, the court ruled in favour of SARS. On further appeal to the High Court,[207] Judge Goldstein in his judgment, quoted from *CIR v Allied Building Society,*[208] where Ogilvie-Thompson JA stated:

> 'on the facts of that case, the ultimate use or destination of the borrowed money could not be elevated into a decisive factor in determining its deductibility under the Act. The dominant question was what was the true nature of the transaction and the most important factor in that inquiry was the purpose of the borrowing.'[209]

According to Judge Goldstein, the purpose of a loan must be determined at the time of the borrowing of the funds. The High Court in the Sallies case[210] held that Sallies Limited had not proved that it had acquired the shares in Witkop Fluorspar Mine (Pty) Ltd 'in the production of income' and the appeal failed and the interest was thus not deductible. Interest on loans to purchase shares states that if interest paid on money borrowed by a company to acquire shares in another company is linked with the actual or prospective receipt by the company of dividends, it cannot be allowed as a deduction, since almost all dividends constitute exempt income.[211] Nevertheless, it does not necessarily follow that interest paid by a company on moneys borrowed to acquire shares may not be deducted from its income.[212] If it can be shown that the sole or main purpose of the acquisition of the shares is the production of income, and that any receipt or accrual of dividends on these shares is purely incidental

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[203] *ITC1820*, 2007 69 SATC 163.
[204] *Sallies Limited v CSARS* 2007, 70 SATC 39.
[205] *Sallies Limited v CSARS* 2007, 70 SATC 39.
[206] *Sallies Limited v CSARS* 2007, 70 SATC 39.
[207] *Sallies Limited v CSARS* (Johannesburg High Court, case A3034/07; judgment delivered 30 November 2007).
[208] *CIR v Allied Building Society* 1963, 25 SATC 343.
[209] *CIR v Allied Building Society* 1963, 25 SATC 343, at page 1.3 C-H.
[210] *Sallies Limited v CSARS* (Johannesburg High Court, case A3034/07; judgment delivered 30 November 2007).
[211] Williams, R.C (1995), 'Income Tax in South Africa', Law and Practice, Juta.
[212] See for example *ITC 1124* (1968) 31 SATC 53(T), where the court held that the only connection was, at best, an indirect one, and consequently the payment of interest was only indirectly connected with the income-producing operations of the parent company. Since the parent company could not establish a sufficiently close connection between the interest and its income-producing operations its appeal failed.

to the main purpose, interest paid on money borrowed to acquire the shares would properly be allowable as a deduction.[213]

In *CIR v G Brollo Properties (Pty) Ltd*[214] the court summarised these principles as follows:

> 'In a case concerning the deductibility or otherwise of interest payable on money borrowed, the enquiry relates primarily to the purpose for which the money was borrowed. That is often the 'dominant' or 'vital' enquiry, although the ultimate user of the borrowed money may sometimes be a relevant factor. Where a taxpayer's purpose in borrowing money upon which it pays interest is to obtain the means of earning income, the interest paid on the money so borrowed is prima facie an expenditure incurred in the production of income … If, on the other hand, the purpose of the borrowing was for some other purpose than obtaining the means of earning income (e.g. to pay a dividend), the interest is not deductible'.[215]

In *CIR v Ticktin Timbers CC*[216] it was held that the purpose of the loan was to enable a dividend to be paid to Dr Ticktin. The court held that the interest was not deductible in the hands of the taxpayer. The facts of the aforementioned case were that Dr Ticktin's father sold his shareholding in a timber merchant company to four trusts for the benefit of his four sons. It was then decided that the equity of the business would be acquired by the one son, Dr Ticktin. The trust was dissolved. Dr Ticktin bought the shares owned by the other three trusts for R1,8 million and the company was converted to a close corporation. Dr Ticktin was the sole member of the close corporation.[217] The purchase price for the shares plus interest thereon remained payable to the trusts by Dr Ticktin. The close corporation then declared dividends which were not paid, but credited to Dr Ticktin's loan account in the books of the close corporation.[218] Interest would be charged by Dr Ticktin in respect of the close corporations' use of the money owed to him.[219] The court held that a close corporation cannot borrow

[213]See for example *CIR v Drakensberg Garden Hotel (Pty) Ltd* 1960 (2) SA 475(A), 23 SATC 251 in which a company, in order to obtain absolute control of hired premises from which it derived rent and business profits, thereby ensuring security of tenure and a continuance of its income, borrowed money in order to acquire the shares in another company owning the leased premises. The decision of the majority of the court was that as the purchase of the shares was not for the purpose of securing dividends, but to ensure the control by the company of its revenue-producing asset, the restriction limiting deductions to expenditure in the production of income did not apply. The majority further held that as the Special Court had found as a fact that the connection between the payment of interest and the production of the respondent's income was sufficiently close to warrant its deduction and as this was a finding which could not be held to be one at which no court could reasonably arrive, the appeal was dismissed. See also Williams, R.C (2009), 'Income Tax in South Africa: Cases and Materials', Law and Practice, Third Edition, Butterworths, at pages 458-461.
[214]*CIR v G Brollo Properties (Pty) Ltd* 1994 56 SATC 47.
[215]*CIR v G Brollo Properties (Pty) Ltd* 1994 56 SATC 47, at paragraphs 152J-153B.
[216]*CIR v Ticktin Timbers CC* 1999 61 SATC 399.
[217]Therefore, the taxpayer had been a company before the shares were bought by the present sole shareholder, namely Dr Ticktin who, upon acquiring them, had procured the conversion of the company into a close corporation.
[218]For the next five years, the close corporation declared all its profits each year to the sole member, Dr Ticktin.
[219]*CIR v Ticktin Timbers CC* 1999 61 SATC 399. See also Williams, R.C (2009), 'Income Tax in South Africa: Cases and Materials', Law and Practice, Third Edition, Butterworths.

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money to pay a dividend and then deduct the interest to arrive at its taxable income.[220] In addition, money borrowed by a close corporation to finance a dividend is not money borrowed in order to produce income and that the onus was on the close corporation to prove that the loan had been incurred in the production of income for such interest expense to be deductible in terms of section 11(a) of the Income Tax Act 58 of 1962.[221]

The court held that the question to be asked is: what is the purpose for which the money has been borrowed?[222] The answer is that the close corporation's purpose was to discharge the distribution debt.[223] The court will not look at why the loan is not being repaid which in this case might have been that the close corporation wished to retain capital for use in its business, making it look as if the expenditure is incurred in the production of income.[224] The purpose of structuring the transaction this way ensured that the close corporation assisted Dr Ticktin to pay the interest owed to the trusts.[225] The court held that the intention was to increase Dr Ticktin's income and not that of the close corporation. In addition, the loans that were created were not necessary, since there was an excess of cash available and only increased the close corporation's expenses.[226] Therefore the link between the loan and the dividend could not be sufficiently established.[227]

In *CSARS v BP South Africa (Pty) Ltd*[228] the taxpayer declared a dividend to its holding company and simultaneously entered into a loan agreement. At the time of declaring the dividend, the company had cash reserves in excess of the dividend and would have been able to continue with its normal business activities but required funding towards the end of the following year.[229] The court summarised the principles resulting from this case as follows:

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[220]It should be noted that during the years in question, the company tax rate was higher than the maximum marginal rate for individuals, so it was favourable from the tax point of view for income to be taxed in the hands of an individual. The sole member (Dr Ticktin) also needed funds from the close corporation in order to pay interest on loans he had incurred in order to purchase his membership in the close corporation. The net effect of this practice by the close corporation was that the interest the corporation paid on the balance of the loan account was part of the gross income of the member and a deductible expense by the close corporation.

[221]*CIR v Ticktin Timbers CC* 1999 61 SATC 399. The South African Revenue Service ('SARS') disallowed the expense in the hands of the close corporation on the grounds that it had been incurred in order to pay the dividend each year. The taxpayer argued that the two actions were separate and distinct; the corporation had every right to declare its profits as dividends, and also to finance its activities with loan capital.

[222]*CIR v Ticktin Timbers CC* 1999 61 SATC 399.

[223]*CIR v Ticktin Timbers CC* 1999 61 SATC 399.

[224]*CIR v Ticktin Timbers CC* 1999 61 SATC 399. See also Williams, R.C (2009), 'Income Tax in South Africa: Cases and Materials', Law and Practice, Third Edition, Butterworths, at pages 470-472.

[225]*CIR v Ticktin Timbers CC* 1999 61 SATC 399.

[226]*CIR v Ticktin Timbers CC* 1999 61 SATC 399.

[227]*CIR v Ticktin Timbers CC* 1999 61 SATC 399 at paragraph 263. See also Williams, R.C (2009), 'Income Tax in South Africa: Cases and Materials', Law and Practice, Third Edition, Butterworths, at pages 470-472.

[228]*CSARS v BP South Africa (Pty) Ltd* 2006 68 SATC 229; (5) SA559 (SCA).

[229]*CSARS v BP South Africa (Pty) Ltd* 2006 68 SATC 229; (5) SA559 (SCA).

(i) Firstly, determine the purpose for which the money was borrowed. If the purpose of the loan is to obtain the means of earning income, the interest paid on the loan is expenditure incurred in the production of income and thus deductible;

(ii) Secondly, consider the intention of the company for raising the loan. If a dividend is declared and a loan agreement is simultaneously entered into by a taxpayer, determine whether the dividend and the loan are interdependent and whether one can exist without the other.

(iii) Thirdly, consider whether the company has sufficient cash available to pay the dividend and to continue its normal business operations without an immediate need to procure finance by way of a loan; and

(iv) Lastly, consider whether the income-earning capacity of the taxpayer declaring the dividend has been increased by the loan funding obtained.[230]

Nevertheless, it is evident from the abovementioned listed principles that a dominant test applied by South African courts concerning the deductibility of interest payable on a loan is to establish the purpose of borrowing the money. In practice the general rule is that the interest on loans used to acquire shares may not be deducted because the taxpayer earns exempt dividend income and it is virtually impossible to prove that the interest deduction is directly linked to the production of taxable income.[231] Therefore, if the loan was raised to purchase shares, a deduction of the interest is generally not available.

The abovementioned general rule that the interest on loans used to acquire shares may not be deducted because the taxpayer earns exempt dividend income has led to the use of innovative transaction structures that allow for interest deductions. This led to the introduction of Section 24O of the Income Tax Act 58 of 1962 in 2013.[232] Section 24O of the Income Tax Act 58 of 1962 allows the taxpayer to deduct interest on the purchase of shares, if (i) the target company is an operating company, (namely the target company must be a business that provides goods or services for consideration and carries on that business on a continuous basis); or (ii) the target company is a controlling-group company of an operating company; and (iii) when after the transaction is concluded, the purchaser becomes a controlling-group company with at least a seventy percent interest; and (iv) only if the deductions are available in respect of wholly domestic acquisitions.[233]

[230] *CSARS v BP South Africa (Pty) Ltd* 2006 68 SATC 229; (5) SA559 (SCA). See also Williams, R.C (2009), 'Income Tax in South Africa: Cases and Materials', Law and Practice, Third Edition, Butterworths, at pages 475-484.

[231] De Koker, A.P., Williams, R.C. and Silke, A.S. (2014), 'Silke Tax Yearbook 2013-2014', Butterworths Publishers.

[232] Income Tax Act 58 of 1962. Which became effective from 1st January 2013.

[233] Income Tax Act 58 of 1962. See also South African Revenue Service (2013), 'Request For Public Comment For Incorporation Into The Forthcoming 2013 Tax Laws Amendment Bill: Proposed Limitation Against Excessive Interest Tax Deductions,' 29th April 2013.

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Section 23K of the Income Tax Act 58 of 1962 (as mentioned above) was extended to include acquisition transactions conducted under Section 24O of the Income Tax Act 58 of 1962.[234]

In terms of section 23K of the Income Tax Act 58 of 1962 where interest-bearing loan funding is used by the acquirer to fund the purchase of shares in a target company in terms of section 24O of the Income Tax Act 58 of 1962 the acquirer may not claim a deduction for the interest incurred by it on the loan funding, unless the Commissioner of the South African Revenue Service issues a directive that the interest may be deducted by the acquirer. In this regard, the Commissioner may only issue a section 23K directive if and to the extent that the Commissioner is satisfied that the issuing of that directive will not lead nor be likely to lead to a significant reduction of the aggregate taxable income of all parties who incur, receive or accrue interest in respect of and for all periods during which any amounts are outstanding in terms of the loan funding.[235]

The provisions of section 23K of the Income Tax Act 58 of 1962 were only applicable to acquisition transactions where interest-bearing or debt arrangements were effected after 1 January 2013. The deduction was also only available for as long as the requirements stipulated above were met and the conditions as stipulated in the Section 23K directive were applicable. Subsequently, with effect from 1st April 2014 section 23K of the Income Tax Act 58 of 1962 was replaced by section 23N which now applies to transactions entered into on or after 1st July 2013.[236] Section 23N of the Income Tax Act 58 of 1962 applies where an amount of interest is incurred by an acquiring company on loan funding raised for a section 24O acquisition or in respect of any debt used directly or indirectly for the purpose of redeeming, refinancing or settling the debt raised for a section 24O acquisition. Section 23N of the Income Tax Act 58 of 1962 set out the permanent rules to disallow 'excessive interest'.[237] The acquisition debt interest incurred by the new operating company must in any year of assessment and for a period of five years of assessment thereafter, not exceed forty percent of the

[234]See South African Revenue Service (2013), 'Request For Public Comment For Incorporation Into The Forthcoming 2013 Tax Laws Amendment Bill: Proposed Limitation Against Excessive Interest Tax Deductions,' 29th April 2013.
[235]National Treasury have indicated that although the provisions of section 23K of the Income Tax Act 58 of 1962 were designed to target the potential erosion of the tax base caused by interest deductions on excessive loan funding, these provisions were introduced as an interim measure only. National Treasury have also acknowledged that the process of obtaining a section 23K directive from the Commissioner is not viable as a permanent solution as it is a time consuming and discretionary process, and furthermore, taxpayers who require loan funding for a section 24O acquisition require decisive rules before entering into and concluding negotiations for such transactions.
[236]Standing Committee on Finance (SCOF): Report-Back Hearings on the Draft Taxation Laws Amendments Bill, 2013 and Tax Administration Laws Amendment Bill, 2013, Draft Response Document from National Treasury and SARS (Version as presented to Standing Committee on Finance on 11th September 2013).
[237]Standing Committee on Finance (SCOF): Report-Back Hearings on the Draft Taxation Laws Amendments Bill, 2013 and Tax Administration Laws Amendment Bill, 2013, Draft Response Document from National Treasury and SARS (Version as presented to Standing Committee on Finance on 11th September 2013).

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higher of the adjusted taxable income determined (i) in the particular year of assessment; or (ii) in the year in which the re-organisation occurred.[238]

This paragraph 3.1.1 discussed the position of SARS at the time of the the proposed Shoprite leveraged buyout transaction and SARS subsequent position. Nevertheless, leveraged buyouts such as the proposed Shoprite leveraged buyout structure are largely tax driven which made use of the provisions of the Income Tax Act 58 of 1962 applicable at the time to avoid liability to income tax. SARS criticised the aforementioned transaction, among others, on the basis that it was an abuse of the provisions of the Income Tax Act 58 of 1962, which led SARS to recommend several amendments to the Income Tax Act 58 of 1962 such as those discussed above.[239] It is submitted that that these amendments are aimed at limiting interest deductions. More importantly, these amendments are intended to ensure that interest deductions are incurred in terms of *bona fide* leveraged buyout transactions and not in terms of synthetically structured schemes aimed at avoiding the payment of tax. SARS is clearly concerned about the adverse effect that highly geared leveraged buyout transactions are having on the South African tax base.

3.1.2 Financial Assistance Rule

The Companies Act 71 of 2008 is the principal legislative enactment that regulates the merger and acquisition legislative framework in South Africa.[240] In addition, it regulates fundamental transactions, such as schemes of arrangement, amalgamation and mergers and disposals of all or the greater part of the assets or undertaking of a company.[241] However, it must be noted that it is not the intention of this discussion to provide a detailed legal analysis of the requirements of fundamental transactions, particularly as contained in Chapter 5 of the Companies Act 71 of 2008, including the related legislation and case law. The discussion is aimed at addressing the question as to whether there rules preventing the target company in a leveraged buyout transaction from giving financial

[238]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 23, at pages 726-774. See Haupt, P. (2015), 'Notes on South African Income Tax', 34th edition, at pages 586-587. See also Standing Committee on Finance (SCOF): Report-Back Hearings on the Draft Taxation Laws Amendments Bill, 2013 and Tax Administration Laws Amendment Bill, 2013, Draft Response Document from National Treasury and SARS (Version as presented to Standing Committee on Finance on 11th September 2013). Section 23N provides for an adjustment to the allowable percentage of 'adjusted taxable income' to the extent that South Africa's repo rate is subject to an increase beyond ten percent.

[239]SARS can recommend/suggest amendments but ultimately National Treasury decides on policy considerations which when adopted go through the normal legislative processes.

[240]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', 2nd edition, Juta and Co, Cape Town, chapter 15, at pages 674-675.

[241]Although the Companies Act 71 of 2008 does not define the phrase 'fundamental transaction', it provides three types of fundamental transactions in Part A of Chapter 5. These transactions, which fundamentally alter a company, compromise: an amalgamation; a disposal of all or greater part of the assets or the undertaking of a company; and a scheme of arrangement. Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', 2nd edition, Juta and Co, Cape Town, chapter 15, at page 674.

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assistance for the purpose of assisting a purchase of shares in the target company? If so, how does this affect the ability of a target company in a buyout to give security to lenders?

In simplistic terms, financial assistance in the context of a leveraged buyout arises when the bank(s) or other lenders of the debt take security on the assets of the target company. The bank(s) or lenders would not lend without security provided by the target company. The acquired company is therefore assisting in the raising of the acquisition finance to complete the acquisition.[242] Cumming and Zambelli state that:

> 'Leveraged buyouts involve the acquisition of the equity capital of a target firm by another company ('newco') through the adoption of a large amount of debt relative to the asset value of the acquired firm. The newco obtains debt financing under the expectation that the acquired company will repay it. As a result, the target pays the economic price of its own acquisition.'[243]

In South Africa, the target company would have to satisfy the procedural requirements of section 44 of the Companies Act 71 of 2008 before the target company would be allowed in the context of a leveraged buyout to assist in financing the purchase of its own shares by third parties.[244] In terms of section 44 of the Companies Act 71 of 2008 a company may give financial assistance for the purchase or subscription of its securities if certain requirements are met.[245] Financial assistance is not defined except where section 44(1) of the Companies Act 71 of 2008 states that financial assistance does not mean lending of any money by a company whose primary business is the lending of the money. Section 44(1) of the Companies Act 71 of 2008 reads:

> 'In this section, 'financial assistance' does not include lending money in the ordinary course of business by a company whose primary business is the lending of money'.

The Companies Act 71 of 2008 does not contain a precise definition of financial assistance. Prior to the introduction of the Companies Act 71 of 2008, the courts used certain tests to determine if financial assistance had been given by a company. For instance, the courts applied the impoverishment test in the case *Gradwell* (*Pty*) *Ltd v Rostra Printers Ltd*.[246] This test involved asking if a company had become poorer as a result of what was done for the purpose of, or in connection

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[242] Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at page 86.
[243] Cumming, D.J. and Zambelli, S. (2010), 'Illegal buyouts', Journal of Banking and Finance, 34(2) July 2010 at 441-456.
[244] Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', 2nd edition, Juta and Co, Cape Town, at pages 328-329.
[245] Set out in section 44(3) and section 44(4) of the Companies Act 71 of 2008.
[246] *Gradwell* (*Pty*) *Ltd v Rostra Printers Ltd* & *Another* 1959 (4) SA 419 (A).

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with, the purchase of or subscription for the company's shares.[247] In *Gradwell (Pty) Ltd v Rostra Printers Ltd,*[248] Schriener JA stated:

> 'The question whether it was to give financial assistance would depend not on how it obtained the money by loan, secured or not, by realising assets or otherwise but on what it was to do with the money when available.'[249]

The impoverishment test was also analysed by Miller JA in *Lipschitz NO v UDC Bank Ltd*,[250] where he stated that:

> 'the concern is not only at preventing actual loss of company funds but also at the exposure of company funds to possible risk'.[251]

In *Gardner v Margo*,[252] Van Heerden JA stated:

> 'Moreover, financial assistance within the meaning of s 38(1) is given only when the direct object of the transaction is to assist another financially the s 38 prohibition is not contravened when the direct object of the transaction is merely to give another that to which he or she is already entitled'.[253]

However, section 44(2) of the Companies Act 71 of 2008 provides that financial assistance includes assistance by way of a loan, guarantee, the provision of security or otherwise, to any person for the purpose of, or in connection with, the subscription of any option, or any securities, issued or to be issued by the company or a related or inter-related company, or for the purchase of any securities of the company or a related or inter-related company.[254] However, this excludes lending money in the ordinary course of business by a company whose business is lending of money. Furthermore, section 44(2) of the Companies Act 71 of 2008 reads:

> 'Except to the extent that the Memorandum of Incorporation of a company provides otherwise, the board may authorise the company to provide financial assistance by way of a loan, guarantee, the provision of security or otherwise to any person for the purpose of, or in connection with, the subscription of any option, or any securities, issued or to be issued by the company or a related

[247] *Gradwell (Pty) Ltd v Rostra Printers Ltd & Another* 1959 (4) SA 419 (A) at 425E.
[248] *Gradwell (Pty) Ltd v Rostra Printers Ltd & Another* 1959 (4) SA 419 (A).
[249] *Gradwell (Pty) Ltd v Rostra Printers Ltd & Another* 1959 (4) SA 419 (A) at 425E.
[250] *Lipschitz NO v UDC Bank Ltd* 1979 (1) SA 789 (A).
[251] *Lipschitz NO v UDC Bank Ltd* 1979 (1) SA 789 (A) at 797H-798A.
[252] *Gardner v Margo* 2006 SCA 36 (SA).
[253] *Gardner v Margo* 2006 SCA 36 (SA) at pages 28-29.
[254] The word 'securities' is widely defined in section 1 and includes shares, debt instruments as well as debentures.

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or inter-related company, or for the purchase of any securities of the company or a related or inter-related company, subject to subsections (3) and (4).'[255]

The question whether financial assistance exists in any given case for the purpose of section 44 of the Companies Act 71 of 2008 will be determined based on the extensive case law that has been built up around the meaning of the words 'or otherwise' in section 38 of the Companies Act 61 of 1973. However, as stated above it is not the intention of this discussion to provide a detailed legal analysis of the capital maintenance rule in terms of section 38 of the Companies Act 61 of 1973 and relevant case law.[256]

Section 44(2) of the Companies Act 71 of 2008 affords authority to the board of directors of the target company to provide financial assistance.[257] However the authority to provide financial assistance is subject to the fulfillment of the requirements of section 44(3) and section 44(4) of the Companies Act 71 of 2008. Section 44(3) and section 44(4) of the Companies Act 71 of 2008 reads:

'3. Despite any provision of a company's Memorandum of Incorporation to the contrary, the board may not authorise any financial assistance contemplated in subsection (2), unless—
(a) the particular provision of financial assistance is—
(i) pursuant to an employee share scheme that satisfies the requirements of section 97; or
(ii) pursuant to a special resolution of the shareholders, adopted within the previous two years, which approved such assistance either for the specific recipient, or generally for a category of potential recipients, and the specific recipient falls within that category; and
(b) the board is satisfied that—
(i) immediately after providing the financial assistance, the company would satisfy the solvency and liquidity test; and
(ii) the terms under which the financial assistance is proposed to be given are fair and reasonable to the company.

[255]Section 44 of the Companies Act 71 of 2008 applies to 'securities' as stipulated by the Securities Services Act, 36 of 2004 (which was repealed by the Financial Markets Act 19 of 2012), which includes 'shares, bonds, and debentures' and this is different to section 38 of the Companies Act 61 of 1973, which only applied to shares.
[256]The leading South African cases pertaining to the definition of 'financial assistance' are: *Gardner and Another v Margo* 2006 (6) SA 33 (SCA); *Gradwell (Pty) Ltd v Rostra Printers Ltd* 1959 (4) SA 419 (A); *Lewis v Oneanate (Pty) Ltd* 1992 (4) SA 811(A); *Lipschitz v UDC Bank Ltd* 1979 (1) SA 789 (A) 51. The leading English cases are: *England Anglo Petroleum Ltd and another v TFB (Mortgages) Ltd* 2008 1 BCLC; *Arab Bank Plc v Mercantile Holdings Ltd* 1994 2 All ER 74; *Belmont Finance Corp v William Furniture (No.2) Ltd* 1980 1 All ER 393 (CA); *Brady v Brady* 1989 AC 755 (HL) at 780; *Chaston v SWP Group Plc* 2003 1 BCLC 675 (CA); *Charterhouse Investment Trust Ltd v Tempest Diesels Ltd* 1986 BCLC1; *Selangor United Rubber Estates Ltd v Craddock (No.3)* 1968 1 WLR 1555; *Spink (Bournemouth) Ltd v Spink* 1936 Ch 544; Trevor v Whitworth 1887 12 App Cas 409 (HL) 416; *Victor Battery Co Ltd v Curry's Ltd* 1946 Ch 242.
[257]Section 44(2) reads 'Except to the extent that the Memorandum of Incorporation of a company provides otherwise, the board may authorise …'.

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4. In addition to satisfying the requirements of subsection (3), the board must ensure that any conditions or restrictions respecting the granting of financial assistance set out in the company's Memorandum of Incorporation have been satisfied.'[258]

A target company in the context of a leveraged buyout can provide financial assistance to any other person for the purpose of acquiring or subscribing to any shares in the target company, including providing security to lenders, provided the conditions for financial assistance mentioned above are met. Cassim *et al* summarises the conditions for financial assistance as follows:[259]

> 'Irrespective of what the Memorandum of Incorporation may say, financial assistance is prohibited unless the requirements set out in s 44(3) and (4) are met. The requirements are:[260]
>
> - the particular provision of financial assistance must be pursuant to an employee share scheme that satisfies the requirements of s 97,[261] or pursuant to a special resolution of the shareholders, adopted within the previous two years, which approved such assistance either for the specific recipient, or generally for category of potential recipients, and the specific recipient falls within that category;[262]
> - the board must be satisfied that immediately after providing the financial assistance, the company would satisfy the solvency and liquidity test;
> - the board must be satisfied that the terms under which the financial assistance is proposed to be given are fair and reasonable to the company;[263] and
> - the board must ensure that any conditions or restrictions respecting the granting of financial assistance set out in the company's Memorandum of Incorporation have been satisfied.'

In terms of the first requirement listed above,[264] the financial assistance must either be pursuant to a section 97 employee share scheme, or to a special resolution adopted within the previous two years that approved such assistance for a specific recipient or generally for a category of potential recipients.[265] Yeats and Jooste argue that the resolution approving financial assistance generally for a category of potential recipients may prove problematic.[266] Cassim *et al* state:

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[258]The conditions with respect to the granting of financial assistance stipulated in the Memorandum of Incorporation must be satisfied before any decision is made. Section 44(4) of the Companies Act 71 of 2008 requires a board to ensure that all conditions in the Memorandum of Incorporation are complied with.
[259]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', 2nd edition, Juta and Co, Cape Town, at pages 328.
[260]Section 44(4) of the Companies Act 71 of 2008.
[261]Section 44(3)(a)(i) of the Companies Act 71 of 2008.
[262]Section 44(3)(a)(ii) of the Companies Act 71 of 2008.
[263]Section 44(3)(b) of the Companies Act 71 of 2008.
[264]Section 44(3)(a) of the Companies Act 71 of 2008.
[265]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', 2nd edition, Juta and Co, Cape Town, at page 329.
[266]Yeats, J. and Jooste, R. (2009), 'Financial assistance a new approach', SALJ 126(3), at page 579.

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> 'Needless to say, the special resolution requirement will have administrative and cost implications for companies (especially large public companies and listed companies). A pragmatic board may therefore decide to propose a suitably drafted resolution at, for example, the annual general meeting every two years. The question then arises whether a category or categories of potential recipients may be so widely framed so as to effectively give the board the discretion whether to provide the assistance or not without consulting the shareholders again. So, for example, would it satisfy the requirements of s 44(3) and (4) if the shareholders resolve that the company may provide financial assistance to any person if, in the opinion of the directors, the provision of such financial assistance would serve to further the BEE objectives of the company? This possibility would largely remove the protection ostensibly afforded to shareholders by the resolution requirement, because in these circumstances the board will be able to provide financial assistance without obtaining shareholder approval. However, nothing that appears from the section militates against such an interpretation, nor is there anything in the Act that prevents the passing of a number of such 'boilerplate' resolutions, widely framed, in respect of a number of different categories of recipients every two years as a matter of course.'[267]

In addition, section 44(3)(b)(ii) of the Companies Act 71 of 2008, requires that the board of the target company may not authorise any financial assistance unless it is satisfied that 'the terms under which the financial assistance is proposed to be given are fair and reasonable to the company'. According to Yeats and Jooste,[268] the language in this section with regard to a board being satisfied has raised a lot of debate as to the actual meaning of the word. These authors are of the view that the wording will bring a lot of ambiguity in the interpretation of the section 44(3)(b)(ii).[269] Cassim *et al* state:[270]

> 'It will be recognised that this requirement makes the Act tougher to negotiate than s 38 of the 1973 Act. As a result of the exception to s 38 introduced by the amendment in 2006, as long as there was a special resolution and the solvency and liquidity criteria were met, there was no contravention of s 38 even if the terms under which the assistance was given were not fair and reasonable to the company. As has been said[271] the change is to be welcomes, although it is not clear what is meant by 'the terms under which the assistance is proposed' being 'fair and reasonable to the company'. Does it mean that, viewed from a commercial perspective, the transaction, whatever it might be, will benefit the company? In other words, must there be a reasonable *quid pro quo*? Or does it simply mean that the company is provided with 'fair and

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[267]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', 2nd edition, Juta and Co, Cape Town, at page 329.
[268]Yeats, J. and Jooste, R. (2009), 'Financial assistance a new approach', SALJ 126(3), at page 579.
[269]Yeats, J. and Jooste, R. (2009), 'Financial assistance a new approach', SALJ 126(3), at page 579.
[270]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', 2nd edition, Juta and Co, Cape Town, at pages 330 and 332.
[271]Yeats, J. and Jooste, R. (2009), 'Financial assistance a new approach', SALJ 126(3), at page 579.

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reasonable' security? If the latter, and this needs to be clarified …the only rationale for the inclusion of the 'fair and reasonable' criterion is s 44(3)(b)(ii) seems to be the possible liability of a director to the company or its shareholders created in s 44(6) of the Act.'[272]

As discussed above, an important characteristic of leveraged buyouts is the substantial amounts of debt applied in the structure. The target company typically provides security to the lenders for such debt. Importantly, the target company must be satisfied that immediately after the transaction the company will remain solvent and will be liquid for the duration of the transaction.[273] The solvency and liquidity test referred to in section 44(3)(b)(i) of the Companies Act 71 of 2008 is governed by the provisions of section 4 of the Companies Act 71 of 2008. Section 4 of the Companies Act 71 of 2008 reads:

'1. For any purpose of this Act, a company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of the company at that time -

(a) the assets of the company, as fairly valued, equal or exceed the liabilities of the company, as fairly valued; and

(b) it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of -

(i) 12 months after the date on which the test is considered; or

(ii) in the case of a distribution contemplated in paragraph (a) of the definition of 'distribution' in section 1, 12 months following that distribution.

2. For the purposes contemplated in subsection (1) -

(a) any financial information to be considered concerning the company must be based on-

(i) accounting records that satisfy the requirements of section 28; and

(ii) financial statements that satisfy the requirements of section 29;

(b) subject to paragraph (c), the board or any other person applying the solvency and liquidity test to a company -

(i) must consider a fair valuation of the company's assets and liabilities, including any reasonably foreseeable contingent assets and liabilities, irrespective of whether or not arising as a result of the proposed distribution, or otherwise; and

(ii) may consider any other valuation of the company's assets and liabilities that is reasonable in the circumstances; and

(c) unless the Memorandum of Incorporation of the company provides otherwise, when applying the test in respect of a distribution contemplated in paragraph (a) of the definition of 'distribution' in section 1, a person is not to include as a liability any amount that would

[272] See Yeats, J. and Jooste, R. (2009), 'Financial assistance a new approach', SALJ 126(3), at page 579.
[273] Section 44(3)(b)(i) of the Companies Act 71 of 2008.

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be required, if the company were to be liquidated at the time of the distribution, to satisfy the preferential rights upon liquidation of shareholders whose preferential rights upon liquidation are superior to the preferential rights upon liquidation of those receiving the distribution.'

The solvency and liquidity test prohibits a target company from providing financial assistance (in the context of this discussion) if, after considering all reasonably foreseeable financial circumstances, the target company is, or would after providing financial assistance be unable to pay its debts as they become due in the course of business.[274] The solvency and liquidity test prohibits a company from providing financial assistance if after considering all reasonably foreseeable financial circumstances at that time, the consolidated assets of the company fairly valued would after the payment, be less than the consolidated liabilities of the company.[275] On the other hand, it would also be prudent for lenders such as banks to consider diligently whether they are convinced that the board of the target company is satisfied before accepting security from the company, because if it emerges that the board of the target company was not satisfied then that security will be invalidated.[276]

According to Makapela, the introduction of section 44 of the Companies Act 71 of 2008 has brought a reduction of the absolute restrictions.[277] According to Makapela:[278]

'… the Act makes strong recommendations for directors to take fiduciary responsibility to ensure that they are not acting recklessly when recommending that the company provides financial assistance. This means that the directors must also consider any liabilities that may arise, including any contingent liabilities.'[279]

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[274]Section 4(1)(b) of the Companies Act 71 of 2008.
[275]Section 4(1)(a) of the Companies Act 71 of 2008.
[276]Section 44(5) of the Companies Act 71 of 2008, discussed below. It must be noted that it is not within the scope of this discussion to clarify all the key points around the Turquand rule which exists in both common law and in terms of section 20(7) of the Companies Act 71 of 2008. Basically, the Turquand rule relates to the presumption of the authority of an agent of a company. For a more detailed discussion on the Turquand rule, see the judgment of *One Stop Financial Services (Pty) Ltd v Neffensaan Ontwikkelings (Pty) Ltd and Another*, 2015 ZAWCHC 89, which clarified several key points around the Turquand rule. See also section 20(7) of the Companies Act 71 of 2008, which have somewhat codified the Turquand rule. The general rule is that if an agent is unauthorised, he/she does not validly bind the principal and no valid contract is concluded with the principal. This rule would have prejudicial effects in the context of the daily operations of companies contracting. Therefore there have existed a common law rule whereby a third party may presume that an agent of the company have followed all internal procedures and secured the all internal approvals before concluding a contract on the company's behalf. See *Royal British Bank v Turquand*, 1856, 6 E and B 327.
[277]As was the case in terms of section 38 of the Companies Act 61 of 1973.
[278]Makapela, L. (2010), 'Capital Rules in the New Companies Act 71 of 2008', University of Pretoria, Faculty of Law, April 2010, at page 23.
[279]Section 44 of the Companies Act 71 of 2008 does not contain criminal liability provision. A punitive sanction appears possible in the form of a fine of an administrative nature flowing from a failure to comply with the compliance notice issued by the Companies Intellectual Property Commission established in terms of section 185 of the Companies Act 71 of 2008.

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In terms of section 44(5) of the Companies Act 71 of 2008, a board decision to provide financial assistance is void to the extent that the provision of that assistance would be inconsistent either with section 44 of the Companies Act 71 of 2008 or any conditions or restrictions in respect of the granting of financial assistance set out in the Memorandum of Incorporation of the company.[280] Section 44(5) of the Companies Act 71 of 2008 reads:

> 'A decision by the board of a company to provide financial assistance contemplated in subsection (2), or an agreement with respect to the provision of any such assistance, is void to the extent that the provision of that assistance would be inconsistent with -
> (a) this section; or
> (b) a prohibition, condition or requirement contemplated in subsection (4).'

Section 44(6) of the Companies Act 71 of 2008 read with section 77(3)(e)(iv) of the Companies Act 71 of 2008, provides that a director is liable for any loss, damages or costs sustained by the company as a direct or indirect result of the director having been present at a meeting, or participated in the making of a decision adopted by written consent of a majority of the directors, and failing to vote against the provision of financial assistance as contemplated in section 44 of the Companies Act 71 of 2008, despite knowing that the provision of such financial assistance was inconsistent with the requirements of the section, or the company's Memorandum of Incorporation.[281] Section 44(6) of the Companies Act 71 of 2008 reads:

> 'If a resolution or an agreement is void in terms of subsection (5) a director of the company is liable to the extent set out in section 77(3)(e)(iv) if the director –
> (a) was present at the meeting when the board approved the resolution or agreement, or participated in the making of such a decision in terms of section 74; and
> (b) failed to vote against the resolution or agreement, despite knowing that the provision of financial assistance was inconsistent with this section or a prohibition, condition or requirement contemplated in subsection (4).'

According to Van Der Linde, section 38 of the Companies Act 61 of 1973 was based on a system of share capital maintenance which required that the company had to maintain the level of funding contributed by its shareholders.[282] The Companies Act 71 of 2008 has done away with the maintenance of share capital rule and replaced it with the solvency and liquidity test as contained in

[280] Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', 2nd edition, Juta and Co, Cape Town, at page 332.
[281] Yeats, J. and Jooste, R. (2009), 'Financial assistance a new approach', SALJ 126(3), at page 584.
[282] Van Der Linde, K. (2009), 'The solvency and liquidity approach in the Companies Act 2008', TSAR(2) at pages 224-238.

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section 4 of the Companies Act 71 of 2008.[283] The purpose of Section 44 of the Companies Act 71 of 2008 is also to preserve a company's capital in the interest of creditors and shareholders.[284] The solvency and liquidity tests provide safeguards for minority shareholders and creditors of the company.[285] The solvency and liquidity test discussed above has two elements. The solvency element tests whether a company's assets exceed its liabilities and thus requires an examination of the balance sheet. The liquidity element tests whether a company is able to satisfy its debts as they become due and payable and thus requires an examination of the cash flow statement. According to Van Der Linde, both these elements are considered to be essential because they address two different concerns.[286] The solvency element is aimed at ensuring that a creditor is not prejudiced by the company stripping itself of material assets or incurring excessive liabilities. The liquidity element is aimed at ensuring that creditors will be paid on time.[287] A major shortcoming of the maintenance of capital rule was that it did not address the liquidity element at all despite including some of the characteristics of the solvency element.[288]

It is submitted that the legal position with regard to the deductibility of interest on loans used in leveraged buyouts is set out in permanent rules to disallow 'excessive interest'.[289] As mentioned earlier in this chapter, SARS has been critical of the high levels of debt used in leveraged buyout transactions, which led SARS to recommend several amendments to the Income Tax Act 58 of 1962 such as those discussed above. Secondly, the introduction of section 44 of the Companies Act 71 of 2008 read together with section 4 of the Companies Act 71 0f 2008 has placed considerable onus on the board of directors of the target company to decide whether or not to authorise any proposed financial assistance transactions, for instance permitting a company to give financial assistance for the purchase of its shares by a third party subject to adequate safeguards for the creditors and minority shareholders. The Companies Act 71 of 2008 provides a flexible procedure that a company could follow in order to allow the granting of financial assistance in the case of a leveraged buyout. In the situation where a private equity firm(s) via a SPV seeks to acquire a controlling interest in the shares of a target company; it is financial assistance if the private equity firm(s) via the SPV intends

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[283] Van Der Linde, K. (2009), 'The solvency and liquidity approach in the Companies Act 2008', TSAR(2) at pages 224-238.
[284] See Moloi, G. (2013), 'Financial Assistance and Balancing of Stakeholder Interests in Terms of Section 44 of the South African Companies Act 71 of 2008', University of the Witwatersrand, Faculty of Commerce, Law and Management, School of Law, at pages 1-90.
[285] Davis, D., Geach, W., Mongalo, T., Butler, D., Loubser, A., Coetzee, and Burdette, D. (2014), 'Companies and other Business Structures in South Africa', 3rd Edition, Oxford University Press, South Africa.
[286] Van Der Linde, K. (2009), 'The solvency and liquidity approach in the Companies Act 2008', TSAR(2) at pages 224-238.
[287] Van Der Linde, K. (2009), 'The solvency and liquidity approach in the Companies Act 2008', TSAR(2) at pages 224-238.
[288] Erasmus, N. (2010), 'Capital Rules Under the Companies Act 71 of 2008, with Emphasis on Financial Assistance', University of Pretoria Faculty of Law, April 2010, at pages 6-17.
[289] For example Section 23N of the Income Tax Act 58 of 1962. See Standing Committee on Finance (SCOF): Report-Back Hearings on Draft Taxation Laws Amendments Bill, 2013 and Tax Administration Laws Amendment Bill, 2013, Draft Response Document from Treasury and SARS (presented to Standing Committee on Finance on 11th September 2013).

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gaining control of the company and to use the assets of the company as security for securing payment of the price for the shares.

3.2 Management Buyout

A special form of acquisition is a management buyout (commonly referred to as a 'MBO') which occurs when a company's managers buy or acquire a large part of the company. A management buyout is similar in all major legal aspects to any other acquisition of a company.[290] The characteristics of a private equity backed leveraged buyout is very much the same as a private equity backed management buyout. For example, a private equity firm or group of private equity firms form a SPV, whose equity is privately held by the management and private equity fund, with the objective of acquiring the target company. In addition, both leveraged buyouts and management buyouts are predominantly financed by the use of high levels of debt as previously discussed.

The distinctive feature between a leveraged buyout and a management buyout is that the group of investors in the management buyout includes members of the management of the target company. However, in the proposed buyout of Shoprite Holdings by Brait as discussed in paragraph 3.1 of this chapter, management was part of the leveraged buyout as investors in the SPV. The fact that members of the management of the target company are part of the transaction does not make a leveraged buyout a management buyout. What distinguishes a management buyout is that that the incumbent management of the target company acquires a substantially greater portion of the SPV's and in turn the target company's equity, than it previously had.[291]

Robbie and Wright, define a management buyout as:

> 'An MBO involves members of the incumbent management team acquiring a significant equity stake as individuals with institutional support in order to control the company.'[292]

In addition, it is the incumbent management of the target company that usually initiates a management buyout. For example, often the target company's management instead of the private equity firm(s) originate the transaction and the target company's management would approach a private equity firm(s) to provide the equity finance for the acquisition of the target company.[293]

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[290]Harris, R., D. Siegel, and M. Wright, (2005), 'Assessing the impact of management buyouts on economic efficiency: plant-level evidence from the United Kingdom', The Review of Economics and Statistics 87, at pages 148-153.
[291]Amihud, Y. (2002), 'Leveraged Management Buyouts: Causes and Consequences', Beard Books Publishers, at pages 3-5.
[292]Robbie, K. and Wright, M. (1996), 'Management buy-ins: entrepreneurship, active investors and corporate restructuring', Manchester University Press, at pages 4-19.
[293]Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', Aspen Publishers, 2003 edition, at pages 1-9 to 1-10.

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According to Levin, this often happens where the target company's owner shareholders have offered to sell the target company to the existing management provided they can secure the acquisition finance.[294] According to Amihud, it is this feature of management buyouts that gives these transactions their name.[295]

A basic chronological description of a management buyout transaction would be that the incumbent management of the target company will not usually have the money available to buy the company outright themselves.[296] They would first seek to borrow the acquisition finance from a bank, provided the bank was willing to accept the risk. Management buyouts are frequently seen as too risky for a bank to finance the purchase through a loan alone.[297] If a bank is unwilling to lend, the management will commonly look to private equity investors to fund the buyout.[298] A high proportion of management buyouts are financed in this way. The private equity investors will invest money in return for a proportion of the shares in the company, though they may also grant a loan to the management.[299] The exact financial structure will depend on the backer's desire to balance the risk with its return, with debt being less risky but less profitable than capital investment.[300] Although the management may not have resources to buy the company, private equity firm will require that the managers each make as large an investment as they can afford in order to ensure that the management is locked in by an overwhelming vested interest in the success of the company.[301] Private equity backers are likely to have different goals to the management. They aim to achieve the maximum return and make an exit after a specific time period (for example 5 years) whereas the management will typically take a long-term view.[302]

A management buyout of a target company could also be facilitated through vendor finance, which occurs when the management and the original owner of the company agree on a transaction

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[294]Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', Aspen Publishers, 2003 edition, at pages 1-9 to 1-10.
[295]Amihud, Y. (2002), 'Leveraged Management Buyouts: Causes and Consequences', Beard Books Publishers, at page 3.
[296]Ahlers, O. (2014), 'Bargaining power in family firm buyouts: Does family influence make a difference?', Family Firms and Private Equity, Springer Fachmedien Wiesbaden, at pages 129-157.
[297]Ahlers, O. (2014), 'Bargaining power in family firm buyouts: Does family influence make a difference?', Family Firms and Private Equity, Springer Fachmedien Wiesbaden, at pages 129-157.
[298]Jensen, M. and K. J. Murphy., (1990), 'Performance Pay and Top Management Incentives', Journal of Political Economy, 98, at pages 225-264.
[299]Appelbaum, E., Batt, R. and Clark, I. (2013), 'Implications of financial capitalism for employment relations research: evidence from breach of trust and implicit contracts in private equity buyouts', British Journal of Industrial Relations 51, No. 3, at pages 498-518.
[300]Appelbaum, E., Batt, R. and Clark, I. (2013), 'Implications of financial capitalism for employment relations research: evidence from breach of trust and implicit contracts in private equity buyouts', British Journal of Industrial Relations 51, No. 3, at pages 498-518.
[301]Appelbaum, E., Batt, R. and Clark, I. (2013), 'Implications of financial capitalism for employment relations research: evidence from breach of trust and implicit contracts in private equity buyouts', British Journal of Industrial Relations 51, No. 3, at pages 498-518.
[302]Kaplan, S. N., (1989a), 'The Effects of Management Buyouts on Operating Performance and Value', Journal of Financial Economics, 24, at pages 217-254.

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whereby the seller finances the buyout.[303] The price paid at the time of sale will be nominal, with the real price being paid over the following years out of the profits of the company.[304] According to Axelson *et al*, this represents a disadvantage for the vendor, which must wait to receive its money after it has lost control of the company.[305] It is also dependent on the returned profits being increased significantly following the acquisition, in order for the deal to represent a gain to the seller in comparison to the pre-sale situation. This will usually only happen in very particular circumstances.[306] The vendor may nevertheless agree to vendor financing for tax reasons, as the consideration could be classified as capital gain rather than as income.[307] It may also receive some other benefit such as a higher overall purchase price than would be obtained by a normal purchase.[308] The advantage for the management is that they do not need to become involved with private equity or a bank and will be left in control of the company once the consideration has been paid.[309]

The remainder of the discussion will focus on the practical consequences that follow from the managers of the company being the 'buyers' of the company in the case of a management buyout. For example, the due diligence process will in all probability be limited as the buyers already have knowledge of the company.[310] In addition, the seller will only give the most basic warranties because the management will know more about the company than the sellers do.[311] A criticism of management buyouts is that they create a conflict of interest because they give managers an incentive to mismanage the company, depressing its share price and then profiting handsomely by implementing effective management after the successful management buyout.[312] According to Cumming *et al*, this is based on the view that asymmetric information possessed by management may offer them an unfair advantage relative to current owners.[313] According to Green, the impending possibility of a management buyout may lead to principal-agent problems and downward

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[303]Ahlers, O. (2014), 'Bargaining power in family firm buyouts: Does family influence make a difference?', Family Firms and Private Equity, Springer Fachmedien Wiesbaden, at pages 129-157.
[304]The timescale for the payment is typically 3-7 years.
[305]Axelson, U., Jenkinson, T., Strömberg, P. and Weisbach, M.S. (2013), 'Borrow cheap, buy high? The determinants of leverage and pricing in buyouts', The Journal of Finance 68, No. 6, at pages 2223-2267.
[306]Axelson, U., Jenkinson, T., Strömberg, P. and Weisbach, M.S. (2013), 'Borrow cheap, buy high? The determinants of leverage and pricing in buyouts', The Journal of Finance 68, No. 6, at pages 2223-2267.
[307]Depends on the fiscal regulations of the relevant jurisdiction.
[308]Kaplan, S. N., (1989a), 'The Effects of Management Buyouts on Operating Performance and Value', Journal of Financial Economics, 24, at pages 217-254.
[309]Kaplan, S. N., (1989a), 'The Effects of Management Buyouts on Operating Performance and Value', Journal of Financial Economics, 24, at pages 217-254.
[310]Arcot, S., Fluck, Z, Gaspar, J.M. and Hege, U. (2015), 'Fund managers under pressure: Rationale and determinants of secondary buyouts', Journal of Financial Economics 115, No. 1, at pages 102-135.
[311]Fox, I. and Marcus, A. (1992), 'The causes and consequences of leveraged management buyouts', Academy of Management Review 17, No. 1, at pages 62-85.
[312]Cumming, D.J., Siegel, D.S. and Wright, M. (2007), 'Private equity, leveraged buyouts and governance', Journal of Corporate Finance 13, No. 4, at pages 439-460.
[313]Cumming, D.J., Siegel, D.S. and Wright, M. (2007), 'Private equity, leveraged buyouts and governance', Journal of Corporate Finance 13, No. 4, at pages 439-460. Information asymmetry transactions with the study of decisions in transactions where one party have more or better information than the other. This creates an imbalance of power in transactions which can sometimes cause the transactions to go awry.

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manipulation of the share price prior to the sale.[314] In addition, Kaplan states that such adverse information disclosure could include accelerated and aggressive loss recognition, public launching of questionable projects[315] and adverse earnings surprises.[316] Naturally, such corporate governance concerns would exist whenever current senior management is able to benefit personally from the sale of their company or its assets. According to Easterwood *et al* corporate valuation (for the purpose of a management buyout) is often subject to considerable ambiguity, and since it can be influenced by inside information, questions could arise challenging the validity of management buyouts and consider them to represent potentially a form of insider trading.[317] In terms of this view, management buyouts have been criticised as 'robbing shareholders of wealth that is rightfully theirs'.[318] Wright *et al* argue that in order to control such agency risks the structuring of a management buyout should include the introduction of significant equity incentives for the incumbent management involved, together with substantial external funding and active monitoring by investors, such the private equity firm.[319]

Despite the potential conflicts of interest that exist between the incumbent management and the shareholders, a management buyout can still achieve its benefits if the division of the gains between the managers and other stakeholders is equitable.[320] In addition, the managers of a company must

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[314]Green, S. (1992), 'The Impact of Ownership and Capital Structure on Managerial Motivation and Strategy in Management Buy-Outs: A Cultural Analysis', Journal of Management Studies 29, No. 4, at pages 513-535. The principal-agent problem treats the difficulties that arise under conditions of incomplete and asymmetric information when a principal hires an agent, such as the problem that the two may not have the same interests, while the principal is, presumably, hiring the agent to pursue the interests of the former. Various mechanisms can be used to try to align the interests of the agent with those of the principal, such as profit sharing, efficiency wages, legislation and performance measurement.

[315]See Wright, M.S., Weir, C. and Burrows, A. (2007), 'Irrevocable commitments, going private and private equity', European Financial Management 13, No. 4, at pages 757-775. This paper discusses public to private buy-outs and mechanisms to ensure bid success. Using a hand-collected dataset of 155 public to private buy-outs, the study examines the determinants of irrevocable commitments. Irrevocable commitments involve undertakings given by existing shareholders to agree to sell their shares to the bidder before the bid to take the company private is announced. In terms of the findings, the level of irrevocable commitments in management buy-outs increased by the bid premium, as well as the reputation of the private equity backer and board shareholdings. The level of irrevocable commitments is reduced by rumours of a takeover bid and bid value. Therefore the evidence shows that management and the private equity firms' activity prior to the bid's announcement can have an important impact on the process of going private.

[316]Kaplan, S. N., (1989a), 'The Effects of Management Buyouts on Operating Performance and Value', Journal of Financial Economics, 24, at pages 217-254.

[317]Easterwood, J.C., Singer, R.F., Seth, A. and Lang, D.F. (1994), 'Controlling the conflict of interest in management buyouts', The Review of Economics and Statistics, at pages 512-522.

[318]Booth, R.A. (1985), Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty', New York University Law Review 60, at page 630.

[319]Wright, M.S., Robbie, K., Thompson, S. and Starkey, K. (1994), 'Longevity and the life cycle of MBOs', Strategic Management Journal 15, at pages 215-27.

[320]Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies 26, No. 2, at pages 368-402. See also *Fourie NO v Newton* 2010 JOL 26517 (SCA), where Cloete JA states at paragraph 41: 'It seems to me that the evidence about the conclusion of the amended retailer agreement ('ARA') shows businessmen with conflicting interests finding a mutually beneficial commercial solution to their differences, rather than a reckless carrying on of the business of Consolidated'.

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fulfill their fiduciary duties to the company and their responsibility to those they manage.[321] Fiduciary duties are discussed in chapter three as part of a broader discussion on corporate governance in relation to private equity. The notion of a compromise between the corporate governance issues raised above and the investment benefits which result from a management buyout is therefore critical when structuring a management buyout.[322] Robbie and Wright argue that:

> 'If wider gains can only be achieved through a buy-out, then management need to be incentivized adequately, otherwise their willingness to undertake the risks involved in such transactions will be reduced and the benefits will be lost.'[323]

The complexity of the manager and shareholder relationship has been extensively dealt with by local and foreign courts. In this discussion, an important 1985 US Delaware Supreme Court case is *Smith v Van Gorkom*[324] which is often called the 'Trans Union case'. The case involved a proposed leveraged buyout of TransUnion by Marmon Group which was controlled by Jay Pritzker.[325] The defendant Jerome Van Gorkom, who was the TransUnion's chairman and CEO, chose a proposed price of $55 per share without consultation with outside financial experts. He only consulted with the company's CFO and that consultation was to determine a per share price that would work for a leveraged buyout. Van Gorkom and the CFO did not determine an actual total value of the company.[326] The court was highly critical of this decision, writing that 'the record is devoid of any competent evidence that $55 represented the per share intrinsic value of the Company'. The proposed buyout was subject to Board approval. At the Board meeting, a number of items were not disclosed, including the problematic methodology that Van Gorkom used to arrive at the proposed price.[327] Also, previous objections by management were not discussed. The Board approved the proposal. The Court found that the directors were grossly negligent, because they quickly approved the merger without substantial inquiry or any expert advice. For this reason, the board of directors breached the duty of care that it owed to the corporation's shareholders. As such, the protection of the business judgment rule was unavailable. The Court stated:

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[321]Chrisman, J.J., Chua, J.H., Steier, L.P., Wright, M. and D'Lisa, N.M. (2012), 'An agency theoretic analysis of value creation through management buy-outs of family firms', Journal of Family Business Strategy 3(40) at pages 197-206.
[322]Chrisman, J.J., Chua, J.H., Steier, L.P., Wright, M. and D'Lisa, N.M. (2012), 'An agency theoretic analysis of value creation through management buy-outs of family firms', Journal of Family Business Strategy 3(40) at pages 197-206.
[323]Robbie, K. and Wright, M. (1996), 'Management buy-ins: entrepreneurship, active investors and corporate restructuring', Manchester University Press, at page 7.
[324]*Smith v Van Gorkom* 488 A.2d 858 Delaware 1985.
[325]Bainbridge, S.M. (2008), 'Smith v Van Gorkom', UCLA School of Law, Law-Econ Research Paper, May 2008, at 08-13.
[326]Bainbridge, S.M. (2008), 'Smith v Van Gorkom', UCLA School of Law, Law-Econ Research Paper, May 2008, at 08-13.
[327]Bainbridge, S.M. (2008), 'Smith v Van Gorkom', UCLA School of Law, Law-Econ Research Paper, May 2008, at 08-13.

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> 'The rule itself 'is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.' ... Thus, the party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one.'[328]

Furthermore, the court rejected the defendant's argument that the substantial premium paid over the market price indicated that it was a good deal. [329] In so doing, the court noted the irony that the board stated that the decision to accept the offer was based on their expertise, while at the same time asserting that it was proper because the price offered was a large premium above market value.[330] The decision also clarified the directors' duty of disclosure, stating that corporate directors must disclose all facts germane to a transaction that is subject to a shareholder vote.[331]

According to Applebaum *et al*,[332] the general agency view postulates that the decision rights of a company should be entrusted to a manager (agent) to act in shareholders' (principal) interests at all times.[333] In the context of a management buyout there are various conflicts of interest that can impact manager's decisions to act in shareholders' interests.[334] According to Chrisman *et al*, agency costs mainly occur when ownership is separated or when managers have objectives other than enhancing shareholder value.[335] On the one hand you have the shareholders that legally own shares of the company. These shareholders typically concede control rights to managers. On the other hand the managers are responsible for making decisions about company policy and strategy.[336] In the case of management buyouts, the incumbent management may even venture into fraud by manipulating financial figures to optimize the target company's valuation.[337] In chapter three it will be argued that corporations should respect the rights of shareholders and help shareholders to exercise those rights and it will be submitted that disclosure and transparency are intimately intertwined with these goals.

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[328] *Smith v Van Gorkom* 488 A.2d 858 Delaware 1985, at page 872.
[329] *Smith v Van Gorkom* 488 A.2d 858 Delaware 1985.
[330] See Aguir, I., Burns, N., Mansi, S.A. and Wald, J.K. (2014), 'Liability protection, director compensation, and incentives', Journal of Financial Intermediation 23, No. 4, at pages 570-589.
[331] Macey, J.R. (2001), 'Smith v Van Gorkom: Insights About CEOs, Corporate Law Rules, and the Jurisdictional Competition for Corporate Charters', Northwestern University Law Review 96, at page 607.
[332] Appelbaum, E., Batt, R. and Clark, I. (2013), 'Implications of financial capitalism for employment relations research: evidence from breach of trust and implicit contracts in private equity buyouts', British Journal of Industrial Relations 51, No. 3, at pages 498-518.
[333] This expectation is often problematic because managers like directors must exercise his/her duties with unfettered discretion and in accordance with the degree of care required of a person in his/her position. For instance, they cannot without the consent of the company, fetter their discretion in relation to the exercise of their duties and powers. Discussed in greater detail in paragraph 2.2 of chapter 3.
[334] Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies 26, No. 2, at pages 368-402.
[335] Chrisman, J.J., Chua, J.H., Steier, L.P., Wright, M. and D'Lisa, N.M. (2012), 'An agency theoretic analysis of value creation through management buy-outs of family firms', Journal of Family Business Strategy 3, No. 4, at pages 197-206.
[336] Bainbridge, S.M. (2008), 'Smith v Van Gorkom', Van Gorkom, UCLA School of Law, Law-Econ Research Paper, May 2008, at 08-13.
[337] Bainbridge, S.M. (2008), 'Smith v Van Gorkom', Van Gorkom, UCLA School of Law, Law-Econ Research Paper, May 2008, at 08-13.

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3.3 Venture Capital

Black and Gilson define venture capital as an investment by specialized venture capital organisations in high growth, high-risk, often high-technology firms that need capital to finance product development or growth and must, by the nature of their business, obtain this capital largely in the form of equity rather than debt.[338] Venture capital is also defined as money provided by investors to start-up firms and small businesses with perceived long-term growth potential. This is a very important source of funding for start-ups that do not have access to capital markets. It typically entails high risk for the investor, but it has the potential for above-average returns.[339]
According to Levin, venture capital start-up transactions can be categorised into:

> '(1) seed money and (2) early stage. Seed money refers to financing a potential business which requires substantial research, development, and/or other threshold activities before the entrepreneur can begin revenue-generating activities. Early-stage venture capital, on the other hand, refers to financing an entrepreneur who has passed the seed-money stage and is ready actually to begin (or has recently begun) revenue-generating activities. Start-up transactions can further be broken down into high tech, low tech, and no tech, depending on the degree of cutting edge technology necessary for the business to succeed. Businesses financed by venture capital/private equity investors can range from high-tech bio-tech engineering company to a low-tech manufacturing enterprise to a no-tech retail or fast food chain.' [340]

Lerner defines venture capital as a broad subcategory of private equity that refers to equity investments made in less mature companies for the launch, early development, or expansion of a business.[341] Venture capital investment is commonly found in the application of new technology and new products that have yet to be proven. It is often sub-divided by the company's stage of development, ranging from early stage capital used for the launch of start-up companies to late stage and growth equity, which is often used to fund expansion of existing business that are generating revenue but may not be profitable or generating cashflow to fund future growth as yet.[342] A venture capital fund is a pooled investment vehicle that primarily invests the financial capital of third-party investors in enterprises that are too risky for the standard capital markets or bank loans.[343] It typically

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[338]Black, B.S. and Gilson, R.J. (1998), 'Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets', Journal of Financial Economics, Volume 47, at pages 243-277.
[339]Sourced and available at www.investopedia.com/terms/v/venturecapital.asp#ixzz3YUnzbSZR, accessed in April 2015.
[340]Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', (Aspen Publishers), 2003 edition, at page 1-7. See also Levin, J.S. and Rocap, D.E. (2012), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', Wolters Kluwer Law and Business Publishers, 2012 edition.
[341]Lerner, J. (2000), 'Something Ventured, Something Gained', Harvard Business School, July 24, 2000.
[342]Lerner, J. (2000), 'Something Ventured, Something Gained', Harvard Business School, July 24, 2000.
[343]Metrick, A. and Yasuda, A. (2011), 'Venture capital and other private equity: a survey', European Financial

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looks at investing in new companies with limited operating history that are too small to raise capital in the public markets and are too immature to secure a bank loan or complete a debt offering. The venture capitalists usually get a significant portion of the company's ownership for the high risk that they assume.[344] Rosiello *et al* state that although venture capital is most often closely associated with fast-growing technology and biotechnology fields, venture funding has been used for other more traditional businesses.[345] It is also associated with job creation, the knowledge economy and used as a proxy measure of innovation within an economic sector or geography. Entrepreneurs often develop products and ideas that require substantial capital during the formative stages of their companies' life cycles.[346] Many entrepreneurs do not have sufficient funds to finance projects themselves, and must therefore seek outside financing.[347]

Historically, one of the first steps toward a professionally-managed venture capital industry was taken in the US by means of the passage of the Small Business Investment Act of 1958. The 1958 Act officially allowed the US Small Business Administration ('SBA') to license private 'Small Business Investment Companies' ('SBICs') to help the financing and management of the small entrepreneurial businesses in the US.[348] This led to the common form of private equity fund emerging in the 1960s, which is still in use today. Such venture capital firms organized limited partnerships to hold investments in which the investment professionals served as general partner and the investors, who were passive limited partners, put up the capital.[349] The compensation structure also emerged with limited partners paying an annual management fee of between 1 and 2 percent of the value of the fund[350] and a carried interest typically representing up to 20 percent of the profits of the partnership.[351] With the passage of the US Employee Retirement Income Security Act ('ERISA') in 1974, corporate pension funds were prohibited from holding certain risky investments including many

Management 17.4, at pages 619-654.

[344]Cumming, D.J. and Dai, N. (2011), 'Fund size, limited attention and valuation of venture capital backed firms', Journal of Empirical Finance 18(1), at pages 2-15.

[345]Rosiello, A., Avnimelech, G. and Teubal, M. (2011), 'Towards a systemic and evolutionary framework for venture capital policy, Springer Berlin Heidelberg, at pages 195-216.

[346]Rosiello, A., Avnimelech, G. and Teubal, M. (2011), 'Towards a systemic and evolutionary framework for venture capital policy, Springer Berlin Heidelberg, at pages 195-216.

[347]Lerner, J. (1996), 'The Government as a Venture Capitalist: The Long Run Impact of the SBIR Program', NBER Working Paper 5753.

[348]Lerner, J. (1996), 'The Government as a Venture Capitalist: The Long Run Impact of the SBIR Program', NBER Working Paper 5753.

[349]Private equity funds are typically limited partnerships with a fixed term of 10 years. At inception, institutional investors make an unfunded commitment to the limited partnership, which is then drawn over the term of the fund. A private equity fund is raised and managed by investment professionals of a specific private equity firm (the general partner). Typically, a single private equity firm will manage a series of distinct private equity funds and will attempt to raise a new fund every 3 to 5 years as the previous fund is fully invested.

[350]There are various methodologies applied in calculating management fees and this is discussed under paragraph 4.1 of chapter 1, but the underlying premise is that the remuneration/fee structure is typically agreed between the investors and the private equity firm upfront.

[351]Carried interest is a share of the profits of the fund's investments (typically 20 percent), paid to the private equity funds' management company as a performance incentive. The remaining 80 percent of the profits are paid to the fund's investors.

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investments in privately held companies.[352] In 1978, the US Labor Department relaxed certain of the ERISA restrictions, under the 'prudent man rule', thus allowing corporate pension funds to invest in the asset class and providing a major source of capital available to venture capitalists.[353] The venture capital industry originated in the US, and US venture capital firms have traditionally been the largest participants in venture capital transactions and the majority of venture capital has been deployed in US companies.[354] However, non-US venture investment is growing and the number and size of non-US venture capitalists is expanding.[355] Venture capital has been used as a tool for economic development in both developed and various developing regions. In many developing regions, with less developed financial sectors, venture capital plays a role in facilitating access to finance for small and medium enterprises ('SMEs') that in most cases would not qualify to receive bank loans.[356]

This discussion on venture capital is restricted to its pertinent characteristics and will follow with a description of a typical venture capital transaction and highlight some of the important legal considerations with regard to venture capital investing. This discussion of venture capital will not discuss the regulatory and policy developments aimed at promoting venture capital investing, as well as developments aimed at investor protection. These are discussed in chapter four, with specific reference to venture capital investing in the US, UK, Australia, Canada and South Africa. For example, chapter four will discuss some of the developments in Canada that are worth noting such as Canadian technology companies that have attracted interest from international venture capitalist because of the generous tax incentive through the Scientific Research and Experimental Development ('SR and ED') investment tax credit programme.[357] The basic incentive available to any Canadian corporation performing research and development ('R and D') is a non-refundable tax credit that is equal to 20 percent of 'qualifying' R and D expenditures such as labour, material, R and D contracts, and R and D equipment.[358] An enhanced 35 percent refundable tax credit is available to certain small Canadian-controlled private corporations ('CCPCs'). Since the CCPC rules require a minimum of 50 percent Canadian ownership in the company performing R and D, foreign investors who would like to benefit from the larger 35 percent tax credit must accept a minority position in the

[352] Popov, A. (2014), 'Venture Capital and Industry Structure: Evidence from Local US Markets', Review of Finance, 18(3), at pages 1059-1096.
[353] Lerner, J. (1996), 'The Government as a Venture Capitalist: The Long Run Impact of the SBIR Program', NBER Working Paper 5753. See also Popov, A. (2014), 'Venture Capital and Industry Structure: Evidence from Local US Markets', Review of Finance, 18(3), at pages 1059-1096.
[354] Poser, T.B. (2002), 'The Impact of Corporate Venture Capital on Sustainable Competitive Advantage of the Investing Company', Inaugural Dissertation, Wissenschaftliche Hochschule für Unternehmensführung (WHU), Koblenz, Germany. See also Popov, A. (2014), 'Venture Capital and Industry Structure: Evidence from Local US Markets', Review of Finance, 18(3), at pages 1059-1096.
[355] Poser, T.B. (2002), 'The Impact of Corporate Venture Capital on Sustainable Competitive Advantage of the Investing Company', Inaugural Dissertation, Wissenschaftliche Hochschule für Unternehmensführung (WHU), Koblenz, Germany.
[356] Kirschner, S. (2008), 'Venture Capital's Grandfather', The Boston Globe, April 6, 2008.
[357] Parsons, M., and Phillips, N. (2007), 'An evaluation of the federal tax credit for scientific research and experimental development', Canada Department of Finance, Working Paper, September 2007, at 1-68.
[358] Johan, S., Schweizer, D. and Zhan, F. (2014), 'The Changing Latitude: Labor-Sponsored Venture Capital Corporations in Canada', Corporate Governance: An International Review, 22(2), at pages 145-161.

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company, which might not be desirable.[359] The SR and ED programme does not restrict the export of any technology or intellectual property that may have been developed with the benefit of SR and ED tax incentives.[360] Canada also has a fairly unique form of venture capital investment vehicle in the form of the Labour Sponsored Venture Capital Corporations ('LSVCC'). These funds, also known as Retail Venture Capital or Labour Sponsored Investment Funds ('LSIF'), are generally sponsored by labour unions and offer tax breaks from government to encourage retail investors to purchase the funds.[361] Generally, these Retail Venture Capital funds only invest in companies where the majority of employees are in Canada.

A typical venture capital investment is structured so that the venture capitalist gets convertible or redeemable preference shares in the underlying investee company.[362] For instance, the preference shares give the venture capitalist a preference over the ordinary shareholders in the event of a liquidation or merger.[363] These preference shares often include the right after a fixed period of time and at the discretion of the investor, to be redeemed at a fixed price.[364] For instance, investors usually build into the preference shares they purchase, preferences that entitle them to receive a predetermined amount which would typically include the investment amount plus the accrued dividend[365] before other shareholders in the event the company is liquidated.[366] In certain instances, the preference shares may also be convertible into ordinary shares at the option of the holder or automatically convertible by the occurrence of a certain event.[367] For example, the preference shares could convert to ordinary shares in the event of the company being listed on a stock exchange. This would be to simplify the capital structure of the company and facilitate the listing.[368]

A hypothetical venture capital transaction could occur where for example an entrepreneur or group of entrepreneurs ('entrepreneur') intends to start a business.[369] The entrepreneur may have a new

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[359]Johan, S., Schweizer, D. and Zhan, F. (2014), 'The Changing Latitude: Labor-Sponsored Venture Capital Corporations in Canada', Corporate Governance: An International Review, 22(2), at pages 145-161.
[360]Williamson, I. (2007), 'Your guide to arranging bank and debt financing for your own business in Canada', 2007-2008 edition, Productive Publications.
[361]Johan, S., Schweizer, D. and Zhan, F. (2014), 'The Changing Latitude: Labor-Sponsored Venture Capital Corporations in Canada', Corporate Governance: An International Review, 22(2), at pages 145-161.
[362]Richardson, C. (2013), 'Richardson's Growth Company Guide 5.0: Investors, Deal Structures, Legal Strategies', Read Janus LLC, at pages 1-18 and 367-393.
[363]Discussed later hereinafter.
[364]Richardson, C. (2013), 'Richardson's Growth Company Guide 5.0: Investors, Deal Structures, Legal Strategies', Read Janus LLC, at pages 1-18 and 367-393.
[365]These same preference shares typically include provisions that entitle the investor to receive dividends before dividends are issued to holders of ordinary shares.
[366]Richardson, C. (2013), 'Richardson's Growth Company Guide 5.0: Investors, Deal Structures, Legal Strategies', Read Janus LLC, at pages 1-18 and 367-393.
[367]Richardson, C. (2013), 'Richardson's Growth Company Guide 5.0: Investors, Deal Structures, Legal Strategies', Read Janus LLC, at pages 1-18 and 367-393.
[368]A brief description of preference shares is provided below.
[369]Several of the key feature of this hypothetical example have been referenced and adapted from Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', (Aspen Publishers), 2003 edition, at pages 2-3 to 2-56; and Levin, J.S. and Rocap, D.E. (2012), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', Wolters Kluwer Law and Business Publishers, 2012 edition.

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high-tech invention or a low-tech improvement on an existing product, or the entrepreneur may have a new low-tech approach to the manufacture or marketing of an established product or service.[370] The entrepreneur's concept may require substantial research, development, and/or other activities before the proposed business will be ready to begin actual sales of goods or services, for which the entrepreneur is seeking money.[371] Alternatively, the entrepreneur may have passed the seed money stage and may now need early-stage venture capital to begin producing goods or providing services.[372] In either event, the entrepreneur has approached a venture capital firm (venture capitalist) seeking R2 million to start the proposed new business or to enhance a business which the entrepreneur already commenced. In this regard, the entrepreneur and the venture capitalist have decided to form Venco, which will be registered as a private company in terms of the Companies Act 71 of 2008.

The entrepreneur makes the following proposal to the venture capitalist in terms of their contribution to, ownership of, and control positions in, Venco. The proposal is simplistic in that it is all based on an ordinary share transaction. In terms of this proposal the venture capitalist provides the R2 million investment for 40 percent of the ordinary shares of Venco. The entrepreneurs provide the ideas, experience and future services in exchange for 60 percent of the ordinary shares of Venco. In addition, the entrepreneur sees no need for any additional contractual arrangements among the entrepreneur, venture capitalist and Venco; for example the control of Venco's board of directors.[373]

The above mentioned proposal is not acceptable to the venture capitalist for several reasons. Firstly, Venco as a private company registered under the laws of South Africa, will be subject to income tax in terms of the Income Tax Act 58 of 1962. The venture capitalist would want at least a portion of its R2 million investment in Venco to be debt in order that the venture capitalists return on the amount so invested will be tax deductible to Venco as an interest expense and hence will reduce Venco's corporate level income tax.[374] Secondly, if Venco is successful and is profitably sold several years later, the venture capitalist wants a preference for most of its R2 million investment and wants only the profits to be shared. In terms of the entrepreneurs above mentioned proposal this would be 40 percent to the venture capitalist and 60 percent to the entrepreneur. For example, if Venco is sold after 5 years for R10 million, which would be R8 million more than the R2 million invested, the venture capitalist should not receive R4 million (40 percent of R10 million), but rather should receive its R2

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[370]Levin, J.S., Ginsburg, M.D. and Rocap, D.E. (2008), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', Wolters Kluwer Law and Business Publishers, 2008 edition.
[371]Levin, J.S. and Rocap, D.E. (2012), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', Wolters Kluwer Law and Business Publishers, 2012 edition.
[372]Levin, J.S., Ginsburg, M.D. and Rocap, D.E. (2008), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', Wolters Kluwer Law and Business Publishers, 2008 edition.
[373]See Rosenbusch, N., Brinckmann, J. and Müller, V. (2013), 'Does acquiring venture capital pay off for the funded firms? A meta-analysis on the relationship between venture capital investment and funded firm financial performance', Journal of Business Venturing 28, No. 3, at pages 335-353.
[374]See discussion on tax implications of leveraged buyouts in paragraph 3.1 of this chapter.

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million investment (perhaps plus an interest yield) plus a percentage of the remaining profit, namely R8 million profit less a possible interest yield on the venture capitalist's investment. However, if Venco is not successful and liquidates before Venco has spent all of the venture capitalists R2 million investment, the venture capitalist wants a preference for most of its R2 million investment. It would be fair to state that the venture capitalist would not want to only receive 40 percent of what remains of the R2 million investment. For example, if Venco's project becomes unfeasible and Venco prematurely liquidates after spending only R200,000 (while Venco still has R1,8 million), the entire R1,8 million, rather than only R720,000 (40 percent of R1,8 million), should go to the venture capitalist.[375]

Thirdly, the venture capitalist would want more than 40 percent of Venco's ordinary shares because the venture capitalist is supplying 100 percent of Venco's funding and the venture capitalists money is worth the full R2 million. Furthermore, the venture capitalist believes in this hypothetical scenario that the entrepreneur's services and ideas are not that novel, therefore the venture capitalist wants a higher return than it would expect to realise from only owning 40 percent of Venco's ordinary shares.[376] Finally, the venture capitalist also wants the entrepreneur to take investment risk and invest enough money in Venco to show commitment to Venco. In terms of these above mentioned considerations, the venture capitalist presents a counter proposal to the one proposed by the entrepreneur.

In terms of the venture capitalist proposal, the R2 million will be structured as a R1 million subordinated debenture, and R880,000 of cumulative convertible preference shares and R120,000 of ordinary shares, of which 60 percent will be to the venture capitalist (60 shares at R2,000 per share) and 40 percent to the entrepreneur (40 shares at R2,000 per share).[377]

	Entrepreneur	**Venture Capitalist**
Subordinated debentures		R1 million
Cumulative convertible preference shares		R880,000
Ordinary shares		
60% Venture Capitalist		R120,000
40% Entrepreneur	R80,000	
Total	R80,000	R2 million

There are several reasons why the venture capitalist has proposed this more complex capital structure. Firstly, the venture capitalists has a senior claim to Venco's first R1,880,000 (plus accrued

[375]See Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', (Aspen Publishers), 2003 edition, at page 2-8.
[376]See Smolarski, J. and Kut, C. (2011), 'The impact of venture capital financing method on SME performance and internationalization', International Entrepreneurship and Management Journal 7, No. 1, at pages 39-55.
[377]See Weakley, S.L. (2014), 'Sales and Mergers of California Businesses', CEB Publishers, at pages 2-41. See also Levin, J.S., Ginsburg, M.D. and Rocap, D.E. (2008), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', Wolters Kluwer Law and Business Publishers, 2008 edition.

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interest on the debenture and accrued preferred dividends on the preference shares) of distributions and any excess available for distribution by Venco will be distributed 60 percent to venture capitalist and 40 percent to entrepreneur.[378] A portion of the venture capitalists R1,880,000 senior claim is structured as debt (debenture), which will allow Venco a deduction for interest on debt that accrued to the venture capitalist on the debenture and the venture capitalist return of capital treatment on the redemption of the debenture.[379] The remainder of the venture capitalists senior claim is structured as preference shares, so that Venco's debt:equity ratio will not be excessive, in order to maximize the likelihood that the debenture will be treated as debt for tax purposes. The deduction of interest expense on borrowed money has been already discussed under the discussion of leveraged buyouts earlier. Secondly, where the entrepreneur has a substantial personal investment in Venco's ordinary shares, the entrepreneur will be less likely to abandon Venco should the development of Venco's business not progress as expected.[380] In terms of the venture capitalists proposed structure, the entrepreneur will pay R80,000 in cash to Venco to purchase the entrepreneurs 40 ordinary shares. Therefore, the entrepreneur will pay in cash the same price per ordinary share as the venture capitalist would, namely R2,000 per share. At the outset, Venco has assets of R2,080,000, namely R2 million from the venture capitalist and R80,000 from entrepreneur. After subtracting Venco's R1,880,000 in senior obligations, Venco's aggregate ordinary shares appears to be worth R200,000. This is R2,000 for each of Venco's 100 outstanding ordinary shares.[381]

Preference shares and debentures are two important elements of the capital structure of the venture capital transaction discussed above. Cassim *et al* in defining preference shares, state:

> 'Where the rights of classes of shares differ on the basis of rights to priority with regard to dividends and/or return of capital, the class or classes that enjoy preference right are referred to as 'preference' shares. The shares that enjoy no preferred rights are referred to as 'ordinary' shares … They have some preference or priority over ordinary shares.'[382]

In general, preference shares have preference in dividend payments. The preference does not assure the payment of dividends, but the company must pay the stated dividends on preference shares before paying any dividends on ordinary shares.[383] Preference shares may

[378]See Levin, J.S., Ginsburg, M.D. and Rocap, D.E. (2008), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', Wolters Kluwer Law and Business Publishers, 2008 edition.
[379]See Levin, J.S. and Rocap, D.E. (2012), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', Wolters Kluwer Law and Business Publishers, 2012 edition.
[380] Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', (Aspen Publishers), 2003 edition, at pages 2-10 and 2-11.
[381] See also Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', (Aspen Publishers), 2003 edition, at pages 2-10 and 2-11.
[382]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', 2nd edition, Juta and Co, Cape Town, at page 216.
[383]Bundgaard, J. (2014), 'Debt-flavoured Equity Instruments in International Tax Law', Intertax, 42(6), at pages 416-426.

be cumulative or non cumulative. Cumulative preference shares requires that if a company fails to pay a dividend or pays less than the stated rate, it must make up for it at a later time.[384] Dividends accumulate with each passed dividend period which for example may be quarterly, semi-annually or annually.[385] When a dividend is not paid in time, it has 'passed' and all passed dividends on a cumulative class of share make up a dividend in arrears.[386] A class of share without this feature is known as a non cumulative and any dividends passed are lost if not declared.[387] In addition, there is diversity in preference shares. Additional types of preference shares include for example participating preference shares that gives the holder the right to receive dividends equal to the normally specified rate that preferred dividends receive as well as an additional dividend based on some predetermined condition.[388] The additional dividend paid to the preference shareholders is commonly structured to be paid only if the amount of dividends that ordinary shareholders receive exceeds a specified per-share amount.[389] Furthermore, in the event of liquidation, participating preference shareholders can also have the right to receive the share purchasing price back as well as a pro-rata share of any remaining proceeds that the ordinary common shareholders receive.[390] Another type of preference share is cumulative convertible preference share. Cumulative convertible preference share is a type of preference share where the dividend payable accumulates, if not paid. After a specified date, these shares will be converted into equity capital of the company.[391]

A case worth mentioning in this regard is the Australian case *Beck v Weinstock.*[392] In terms of company law in Australia, a 'preference share' is a share that carries a preference or priority over another class of share. A company can issue preference shares or convert ordinary shares into preference shares only if the rights attached to the preference shares are set out in the company's constitution, or if they have been approved by a special resolution of the company.[393] However, in the Australian Court of Appeal case *Beck v Weinstock*[394] Chief Justice French held that neither the

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[384]Bundgaard, J. (2014), 'Debt-flavoured Equity Instruments in International Tax Law', Intertax, 42(6), at pages 416-426.
[385]Bundgaard, J. (2014), 'Debt-flavoured Equity Instruments in International Tax Law', Intertax, 42(6), at pages 416-426.
[386]Andres, C., Betzer, A., Van den Bongard, I., and Goergen, M. (2014), 'Dividend policy, corporate control and the tax status of the controlling shareholder', Corporate Control and the Tax Status of the Controlling Shareholder, July 2014.
[387]Andres, C., Betzer, A., Van den Bongard, I., and Goergen, M. (2014), 'Dividend policy, corporate control and the tax status of the controlling shareholder', Corporate Control and the Tax Status of the Controlling Shareholder, July 2014.
[388]Whitehead, I. (2014), 'What's in a Name-History, Language and Preference Shares in Beck v Weinstock', Sydney Law Review, 36, at 369.
[389]Whitehead, I. (2014), 'What's in a Name-History, Language and Preference Shares in Beck v Weinstock', Sydney Law Review, 36, at 369.
[390]Whitehead, I. (2014), 'What's in a Name-History, Language and Preference Shares in Beck v Weinstock', Sydney Law Review, 36, at 369.
[391]Whitehead, I. (2014), 'What's in a Name-History, Language and Preference Shares in Beck v Weinstock', Sydney Law Review, 36, at 369.
[392]*Beck v Weinstock* 2013 HCA 15.
[393]Section 254A and section 254G(2) of the Corporations Act 2001 (Cth).
[394]*Beck v Weinstock* 2013 HCA 15.

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Corporations Act 2001 (Cth)[395] nor the New South Wales (NSW) Companies Act 1961 defined the term 'preference share'. These Acts used the term in a generic sense to encompass shares defined by a variety of priority rights and issued for a variety of purposes.[396] The facts of the case was that LW Furniture was an incorporated company with its articles of association providing for fourteen different classes of shares from 'A' to 'N' worth one dollar each. Classes 'A' to 'D' were described as 'preference' shares with 'C' being redeemable preference shares.[397] The rest were classified as ordinary shares. The 'C' class shares gave the holder preference to the return of capital over the holder of any ordinary shares but otherwise had no preferential rights. Eight class 'C' shares were issued to Mrs Hedy Weinstock with the intention of reducing death and estate duties payable on the death of Leo Weinstock. The directors of LW Furniture were Mr and Mrs Weinstocks children, Mr Amiram Weinstock and Mrs Tamar Beck.[398] Mrs Weinstock died in 2004 and Amiram purported to pass a resolution redeeming, for one dollar each, the eight 'C' class shares which his mother had held at her death. Tamar, as executor of the estate of Mrs Weinstock claimed that the 'C' class shares were not redeemable because they were not preference shares within the meaning of the Corporations Act 2001 (Cth) and the New South Wales (NSW) Companies Act 1961.[399]

French CJ concluded that the historic use of the preference share as a means of raising original capital supported the argument that preference shares could be issued in the absence of issued ordinary shares. Chief Justice French held:

> 'Once it is accepted that preference shares were able to be issued … to raise part of the original capital of a company, the historical rationale for the proposition that a share issued, absent the issue of ordinary shares, could not be designated as a 'preference share' within the meaning of the 1961 Act and the 2001 Act, is weakened to the point of extinguishment.'[400]

In this case Chief Justice French and Judge Gageler delivered separate judgments, while Judge Hayne, Judge Crennan and Judge Keifel delivered a joint judgment. The central issue for Judge Hayne, Judge Crennan and Judge Keifel was 'what was meant in the 1961 Act by 'preference share''.[401] These three judges held that as long as a company's constitution expressly authorised the issue of shares that carried some preferential right over other shares that could be issued, then those

[395]Corporations Act 2001 (Cth) is an act of the Commonwealth of Australia that sets out the laws dealing with business entities in Australia at federal and interstate level. It focuses primarily on companies, although it also covers some laws relating to other entities such as partnerships and managed investment schemes.
[396]*Beck v Weinstock* 2013 HCA 15 at 36 and 39.
[397]Whitehead, I. (2014), 'What's in a Name-History, Language and Preference Shares in Beck v Weinstock', Sydney Law Review, 36, at 369.
[398]Whitehead, I. (2014), 'What's in a Name-History, Language and Preference Shares in Beck v Weinstock', Sydney Law Review, 36, at 369.
[399]Whitehead, I. (2014), 'What's in a Name-History, Language and Preference Shares in Beck v Weinstock', Sydney Law Review, 36, at 369.
[400]*Beck v Weinstock* 2013 HCA 15 at 31.
[401]*Beck v Weinstock* 2013 HCA 15 at 74.

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shares were 'preference shares'.[402] They held that there was no basis for implying into the Companies Act 1961 any additional requirement that the company concerned should have already issued shares that had inferior rights to the preference shares.[403] Judge Hayne, Judge Crennan and Judge Keifel held:

> 'The disputed shares had rights which preferred the holder of these shares over the holder of any ordinary share in the Company. That no ordinary shares were ever issued does not deny that the disputed shares were preference shares. The company's articles of association provided that the disputed shares were liable to be redeemed. They were redeemable preference shares.'[404]

The Australian Court of Appeal unanimously agreed that it was an essential quality of a preference share that it confers an advantage over another class of share.[405] Subsequently, the 'C' class shares were not preference shares since no ordinary shares had ever been issued and thus, there were no other shares on issue over which they had preference. The Court of Appeal held that the power conferred on the directors to issue new shares from available nominal capital could be exercised at all times.[406] In addition, there was nothing in the Companies Act 1961 that required a preference share to be given preference or priority over some other issued share. The emphasis in the Companies Act 1961 is the definition of the rights of shareholders in the memorandum and articles of association. If a company's memorandum and articles provided a share carried rights in respect of repayment of capital, voting, priority of payment of a dividend, and so forth, then the shares would be a preference share. Therefore, they were redeemable preference shares.[407]

Nevertheless, as mentioned earlier, the two important methods of raising capital for a company are to issue debt or equity securities.[408] According to Cassim, the Companies Act 71 of 2008 defines debt instruments to include all securities other than shares whether issued in terms of a security document or not, but excluding promissory notes and loans.[409] In South Africa, a debt instrument is governed by section 43 of the Companies Act 71 of 2008. Section 43(1)(a) and section 43(1)(b) of the Companies Act 71 of 2008 reads as follows:

> '(a) debt instrument' –

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[402] *Beck v Weinstock* 2013 HCA 15 at 67 and 74.
[403] *Beck v Weinstock* 2013 HCA 15 at 70.
[404] *Beck v Weinstock* 2013 HCA 15 at 75.
[405] *Beck v Weinstock* 2013 HCA 15 at 31-44.
[406] *Beck v Weinstock* 2013 HCA 15 at 31-44.
[407] *Beck v Weinstock* 2013 HCA 15 at 74-94.
[408] Cassim, F.H.I. (2011), 'The Practitioners Guide to the Companies Act 71 of 2008', Chapter 10: Corporate Finance: Shares and Distributions, Juta and Company Ltd, at page 115.
[409] Cassim, F.H.I. (2011), 'The Practitioners Guide to the Companies Act 71 of 2008', Chapter 10: Corporate Finance: Shares and Distributions, Juta and Company Ltd, at page 115.

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(i) includes any securities other than the shares of a company, irrespective of whether or not issued in terms of a security document, such as a trust deed; but

(ii) does not include promissory notes and loans, whether constituting an encumbrance on the assets of the company or not; and

(b) 'security document' includes any document by which a debt instrument is offered or proposed to be offered, embodying the terms and conditions of the debt instrument including, but not limited to, a trust deed or certificate.'

Section 1 of the Companies Act 71 of 2008 defines 'securities' as follows:

'means any shares, debentures or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company.'

According to Cassim *et al*, neither the Companies Act 61 of 1973 nor the Companies Act 71 of 2008 defines what a debenture is.[410] In the case *Edmonds v Blaina Furnaces*,[411] Justice Chitty stated the following:

'The term debenture has not, so far as I am aware, ever received any precise legal definition. it is, comparatively speaking, a new term … The term itself imports a debt - an acknowledgment of a debt … Generally, if not always, the instrument imports an obligation or covenant to pay. This obligation or covenant is in most cases at the present day accompanied by some charge or security. So that there are debentures which are secured, and debentures which are not secured.'

In the case *English Scottish Trust v Brunton,*[412] Justice Bowen held that a debenture could be:

'(1) A simple acknowledgment under seal of the debt; (2) an instrument acknowledging the debt and charging the property of the company with repayment; (3) an instrument acknowledging the debt, charging the property of the company with repayment, and further restricting the company from giving any prior charge.'[413]

The law in regard to debentures is often set within the terms of the debenture itself such as, for example, the rate of interest if any.[414] Cassim *et al*, state that:

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[410]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', 2nd edition, Juta and Co, Cape Town, at pages 231-233.

[411]*Edmonds v Blaina Furnaces* (1887) 36 Chancery Division 215.

[412]*English Scottish Trust v Brunton* (1892) 2 QB 700.

[413]*English Scottish Trust v Brunton* (1892) 2 QB 700.

[414]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', 2nd edition, Juta and Co, Cape Town, at page 233.

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> 'Every document creating or acknowledging a debt of a company is not necessarily a debenture ... A debenture holder is a particular kind of creditor.[415] The holder of the company for the amount of the loan and interest, whose rights are defined by the terms of the issue read with the provisions of the Act.'[416]

In terms of section 43(2)(a) of the Companies Act 71 of 2008, the board of a company may authorise the company to issue a secured or unsecured debt instrument at any time, except to the extent provided otherwise by the company's Memorandum of Incorporation; and and section 43(2)(b) states that it must determine whether each such debt instrument is secured or unsecured. In terms of section 43(4) of the Companies Act 71 of 2008, every security document must clearly indicate, on its first page, whether the relevant debt instrument is secured or unsecured. There is no restriction on the manner in which a debt instrument is secured. Section 43(3)(a) and section 43(3)(b) of the Companies Act 71 of 2008, states that:

> '(3) Except to the extent that a company's Memorandum of Incorporation provides otherwise, a debt instrument issued by the company may grant special privileges regarding -
> (a) attending and voting at general meetings and the appointment of directors; or
> (b) allotment of securities, redemption by the company, or substitution of the debt instrument for shares of the company, provided that the securities to be allotted or substituted in terms of any such privilege, are authorised by or in terms of the company's Memorandum of Incorporation in accordance with section 36.'

In addition to ordinary shares, preference shares and debentures usually form part of a typical venture capital transaction. When venture capitalists negotiate the purchase of such securities, they typically negotiate to attach varying degrees of rights thereto. This varies from transaction to transaction as discussed above.

Other rights typically associated with venture capital investing would be voting rights negotiated by the venture capitalist supplemented with rights to participate in developing or approving the company's business plan; to participate in certain board of director committees' and to receive regular financial reports from company management.[417] The rights to approve certain types of major transactions or changes in company direction are also common. In practice, venture capital investors who do not join a company's board of directors often request a separate agreement giving them rights to attend board meetings and confer with management and to receive various reports, such

[415] *Randfontein Estates Gold Mining Co Ltd v Custodian of Enemy Property* 1923 AD 576 at 580.
[416] Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', 2nd edition, Juta and Co, Cape Town, at page 233.
[417] Richardson, C. (2013), 'Richardson's Growth Company Guide 5.0: Investors, Deal Structures, Legal Strategies', Read Janus LLC, at pages 1-18 and 367-393.

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as financial statements and related information.[418] Other rights typically negotiated between the venture capitalist and entrepreneur would be preemptive rights and first refusals on the company's ordinary shares.[419] These rights are usually supplemented with first refusal agreements that entitle the venture capitalist to purchase shares sold by management at the price management negotiates with a willing outside buyer.[420]

According to Conti, founders and management of the investee company are usually required to enter into agreements that require their full time attention to the company's business and protect its trade secrets.[421] These agreements typically also prevent the founders and managers from going into competition with the company. Such agreements can provide powerful incentives to keep management from leaving the business to engage in competitive enterprises.[422] Conti also argues that company employees are usually required to sign confidentiality and proprietary rights agreements as a condition to the closing of a venture capital financing transaction.[423] It is common practice for most companies to have these agreements in place to protect the company's trade secrets and insure the company's rights to inventions created by company employees.[424] These agreements frequently include provisions preventing employees from soliciting customers or other employees away from the company.[425]

Once the investee company and the venture capitalist agree on the terms and conditions of the venture capitalist investment in the company (Venco in the case of the hypothetical example), the respective parties' lawyers will prepare and finalise the definitive agreements reflecting the transaction.[426] The main agreement will be the share purchase agreement, which typically contains the price of the shares to be sold and the number of shares to be purchased; representations and warranties of the company; the covenants of the company; conditions to concluding of the transaction; and cross referencing to related agreements, which contain additional negotiated rights

[418]Smolarski, J. and Kut, C. (2011), 'The impact of venture capital financing method on SME performance and internationalization', International Entrepreneurship and Management Journal 7, No. 1, at pages 39-55.
[419]Smolarski, J. and Kut, C. (2011), 'The impact of venture capital financing method on SME performance and internationalization', International Entrepreneurship and Management Journal 7, No. 1, at pages 39-55.
[420]Smolarski, J. and Kut, C. (2011), 'The impact of venture capital financing method on SME performance and internationalization', International Entrepreneurship and Management Journal 7, No. 1, at pages 39-55.
[421]Conti, R. (2014), 'Do non-competition agreements lead firms to pursue risky R&D projects?', Strategic Management Journal, 35(8), at pages 1230-1248.
[422]Conti, R. (2014), 'Do non-competition agreements lead firms to pursue risky R&D projects?', Strategic Management Journal, 35(8), at pages 1230-1248.
[423]Conti, R. (2014), 'Do non-competition agreements lead firms to pursue risky R&D projects?', Strategic Management Journal, 35(8), at pages 1230-1248.
[424]Marx, M. (2011), 'The firm strikes back non-compete agreements and the mobility of technical professionals', American Sociological Review, 76(5), at pages 695-712.
[425]Marx, M. (2011), 'The firm strikes back non-compete agreements and the mobility of technical professionals', American Sociological Review, 76(5), at pages 695-712.
[426]Rosenbusch, N., Brinckmann, J. and Müller, V. (2013), 'Does acquiring venture capital pay off for the funded firms? A meta-analysis on the relationship between venture capital investment and funded firm financial performance', Journal of Business Venturing 28, No. 3, at pages 335-353.

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for the venture capitalist, such as those discussed above.[427] The financing agreements prepared by venture capital investors are detailed and include extensive representations by the company and, sometimes, individual management members respecting all aspects of the company's operations.[428] Representations and warranties from the company are almost always present as part of a venture capital investment. A breach of the company's representations and warranties usually result affords investors various remedies laid out in the agreement.[429] Examples of common representations that companies are expected to make include the exact outstanding capitalisation of the company; that the company's financial statements are true and correct in all basic respects and have been prepared in accordance with generally accepted accounting procedures; that the company has no liabilities other than those reflected in its most recent balance sheet or occurring in the ordinary course of business since the date of the last balance sheet; that the company owns all of the assets it claims to own, without liens or encumbrances except those disclosed; that the company's intellectual property and products don't infringe the rights of others; that the company is in compliance with all relevant laws that govern its operations; and in the case of early-stage companies, venture capitalists may insist that the founders make the representations and warranties personally.[430]

Despite all of the above mentioned risk mitigating techniques employed by venture capitalist, venture capitalists are not totally immune to litigation. In the case *Trados Inc. Shareholder Litigation*,[431] the court highlighted the implications for private equity and venture capital firms both as investors and as directors of portfolio companies. In this case the court held that management directors, the directors appointed by the venture capitalist and one seemingly independent director with strong ties to another venture capitalist were personally interested in a merger transaction that triggered payments on the preference shares to the venture capital investors while paying ordinary shareholders nothing.[432] In addition, the court found the board had wrongfully considered only the interests of the preference shareholders to the exclusion of ordinary shareholders and failed to institute any procedural safeguards for common shareholders in approving the merger.[433] Even

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[427]Rosenbusch, N., Brinckmann, J. and Müller, V. (2013), 'Does acquiring venture capital pay off for the funded firms? A meta-analysis on the relationship between venture capital investment and funded firm financial performance', Journal of Business Venturing 28, No. 3, at pages 335-353.
[428]Cumming, D.J. and Knill, A. (2012), 'Disclosure, venture capital and entrepreneurial spawning', Journal of International Business Studies 43, No. 6, at pages 563-590.
[429]Cumming, D.J. and Knill, A. (2012), 'Disclosure, venture capital and entrepreneurial spawning', Journal of International Business Studies 43, No. 6, at pages 563-590.
[430]LeClair, G.D., Lay, D.M. and White, A.W. (2014), 'Advising Venture and Early Stage Clients Current Ear-to-the-Ground Assessment', Annual Tax Conference, Volume 60, at page clxvi. See also Bartlett, J.W. (1999), 'Fundamentals of Venture Capital Fundamentals of Venture Capital', Rowman & Littlefield Publishers, at pages 98-155. See also Brechbühl, B. and Wooder, R.J. (2004), 'Global Venture Capital Transactions: A Practical Approach', International Association of Young Lawyers Series, Kluwer Law International, at pages 16-18.
[431] *Trados Inc. Shareholder Litigation* 73 A.3d 17 (Del. Ch. 2013).
[432]Monterverde, J.E. (2014), 'A Review of Trados and Its Impact', American Bar Association, Securities Litigation Section, March 2014. Available at http://apps.americanbar.org/litigation/committees/securities/articles/winter2014-0314-recent-developments-in-entire-fairness-litigation.html, accessed in April 2015.
[433]Monterverde, J.E. (2014), 'A Review of Trados and Its Impact', American Bar Association, Securities Litigation Section, March 2014. Available at http://apps.americanbar.org/litigation/committees/securities/articles/winter2014-0314-recent-developments-in-entire-fairness-litigation.html, accessed in April 2015.

though the court found the board's process was procedurally unfair, it nevertheless found the transaction satisfied the entire fairness standard based on price alone.[434] The facts of the case were that Trados Inc. was founded in 1984 and began several rounds of venture capital financing through the issuance of preference shares in 2000.[435] The venture capitalists were issued convertible preference shares with features of the preference shares being: a liquidation preference payable upon any transaction that resulted in a change of control of the company; voting rights identical to ordinary shares; venture capital control rights, such as the veto right over change in control transactions; and the right to appoint directors to the Trados board.[436] As a result of these features, the venture capitalists collectively controlled a majority of the voting power and held the power to elect the majority of the board.[437]

In the years leading up to the merger, the company showed the ability to generate revenue but could not achieve meaningful profitability.[438] Consequently, the venture capitalist directors updated the partners at their respective venture capital firms throughout this period and advised them that although an exit was achievable, they were not likely to see significant returns on their investments. Against this background, in July 2004 the board hired a new chief executive officer (CEO).[439] The board also approved a management incentive plan that gave senior executives, including the newly appointed CEO, an incentive to pursue a sale of Trados by offering management an increasing percentage of the total sales proceeds as the sales price increased even if the ultimate sale paid nothing to ordinary shareholders.[440] Also in 2004, the board rejected an initial $40 million acquisition proposal from SDL plc, which it considered too low, because it was well below the venture capitalist liquidation preference at that time.[441] The new CEO advised the board that the company had two options, namely Trados and its venture capital investors could invest additional capital in the form of either debt or equity to reposition its core business for growth in the enterprise sector, or the company could focus on a potential sale or merger transaction as an exit strategy for the venture capitalist.[442] Although additional investment in Trados as a stand-alone enterprise may have permitted the

[434]Monterverde, J.E. (2014), 'A Review of Trados and Its Impact', American Bar Association, Securities Litigation Section, March 2014. Available at http://apps.americanbar.org/litigation/committees/securities/articles/winter2014-0314-recent-developments-in-entire-fairness-litigation.html, accessed in April 2015.
[435]Wimberly, J. (2014), 'Venture Capital and Private Equity and the 'Entire Fairness' Test: In re Trados', Review of Banking and Financial Law, Volume 331, at pages 418-429.
[436]Wimberly, J. (2014), 'Venture Capital and Private Equity and the 'Entire Fairness' Test: In re Trados', Review of Banking and Financial Law, Volume 331, at pages 418-429.
[437]Wimberly, J. (2014), 'Venture Capital and Private Equity and the 'Entire Fairness' Test: In re Trados', Review of Banking and Financial Law, Volume 331, at pages 418-429.
[438]Broughman, B. And Fried, J.M. (2013), 'Carrots and Sticks: How VCs Induce Entrepreneurial Teams to Sell Start-Ups', 98 Cornell Law Review 1319, 1346 No. 86.
[439]Gold, A.S and Miller, P.B (2014), 'Philosophical Foundations of Fiduciary Law', Oxford University Press at pages 41-47.
[440]Gold, A.S and Miller, P.B (2014), 'Philosophical Foundations of Fiduciary Law', Oxford University Press at pages 41-47.
[441]Bagley, C.E. (2015), 'Managers and the Legal Environment: Strategies for the 21st Century', 8th Edition, Cengage Learning, at pages 610-644.
[442]Bagley, C.E. (2015), 'Managers and the Legal Environment: Strategies for the 21st Century', 8th Edition, Cengage Learning, at pages 610-644.

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company to generate a modest return, it did not appear to offer a realistic opportunity for the type of success sought by the venture capitalist that would provide meaningful returns for both them and ordinary shareholders.[443] Thus, the board focused on an exit strategy for the venture capitalists. However, because venture capitalists in such sales often exit as preferred shareholders with liquidation preferences that must be paid in full before ordinary shareholders receive any pay-out, ordinary shareholders usually receive little (if any) pay-out.[444]

In June 2005, Trados agreed to be acquired by SDL for $60 million in cash. Owing to the terms of the management incentive plan, the first $7.8 million of proceeds went to the management directors and other employees. The remaining $52.2 million went to the venture capitalists to satisfy their total combined liquidation preference of the preference shares of $57.9 million.[445] Without the management incentive plan payments to management, the ordinary shareholders would have been entitled to $2.1 million in proceeds but instead received nothing.[446] The merger agreement was approved by the required percentages of the preference shareholders and the ordinary shareholders, with the venture capitalists owning enough of the preference shares to approve the merger on their own.[447] The plaintiff, an ordinary shareholder initially brought an action for appraisal of his shares but later brought a second action alleging a breach of the fiduciary duty of loyalty as a result of discovery during the appraisal action.[448] The plaintiff alleged that the board ignored the interests of the ordinary shareholders by focusing entirely on achieving an exit that would benefit the preference shareholders, despite the fact that the company could have continued to operate profitably as a stand-alone entity and thereby generate value for ordinary shareholders.[449]

The case *Trados Inc. Shareholder Litigation*[450] involved the typical situation of a venture capital or private equity firm investing in a company for preference shares and board control, thereafter the venture capital firm establishes that the company will not be able to produce the desired return, who in turn decides to exit and implement a sale of the business.[451] In the shareholder action for breach of fiduciary duty, the Delaware Court of Chancery in *Trados Inc. Shareholder Litigation*,[452] held that a majority of the directors were conflicted and that the venture capital fund's principal directors were inherently conflicted and that the transaction was thus subject to entire fairness review. However, under the particular facts of the case, entire fairness was satisfied despite lack of fair dealing,

[443] Bagley, C.E. (2015), 'Managers and the Legal Environment: Strategies for the 21st Century', 8th Edition, Cengage Learning, at pages 610-644.
[444] Broughman, B. And Fried, J.M. (2013), 'Carrots and Sticks: How VCs Induce Entrepreneurial Teams to Sell Start-Ups', 98 Cornell Law Review 1319, 1346 No. 86.
[445] Weakley, S.L. (2014), 'Sales and Mergers of California Businesses', CEB Publishers, at pages 2-41.
[446] Weakley, S.L. (2014), 'Sales and Mergers of California Businesses', CEB Publishers, at pages 2-41.
[447] Weakley, S.L. (2014), 'Sales and Mergers of California Businesses', CEB Publishers, at pages 2-41.
[448] Weakley, S.L. (2014), 'Sales and Mergers of California Businesses', CEB Publishers, at pages 2-41.
[449] Weakley, S.L. (2014), 'Sales and Mergers of California Businesses', CEB Publishers, at pages 2-41.
[450] *Trados Inc. Shareholder Litigation* 73 A.3d 17 (Del. Ch. 2013).
[451] Harner. M.N. (2013), 'A More Realistic Approach to Directors' Duties', Transactions 15, 17(8).
[452] *Trados Inc. Shareholder Litigation* 73 A.3d 17 (Del. Ch. 2013).

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because in receiving no consideration in the merger, the common stockholders received 'the substantial equivalent of what they had before' as the common stock had no value before the transaction. [453]

According to Wimberly, the court made clear that unfair process can 'infect the price' and lead to liability for directors.[454] Wimberly goes on to argue that:

> 'so preferred stockholding directors should be sure to thoroughly consider the interests of the common stockholders in structuring exits and implement procedural protections to the extent feasible. Additionally, in structuring the voting agreements for their portfolio companies, venture capital and private equity funds can largely insulate themselves from liability by negotiating for contractual provisions allowing them to dodge fiduciary duties.'[455]

The above mentioned case is important as it raises important issues for venture capital investing in that a typical venture capital start-up transaction similar to the hypothetical example discussed above, could subject venture capitalists to litigation and liability in terms of fiduciary law. South African case law on fiduciary duties is discussed in chapter three. Although venture capital has many advantages, it is also essential to consider the risks associated with venture capital investing.

In conclusion, one of the main advantages of venture capital financing is the ability for company expansion that would not be possible through a bank loan because most start-ups have a limited operating track record.[456] Furthermore, the repayment of the venture capitalist investment is often not an obligation like it would be for a bank loan because the venture capitalist carries the investment risk. In addition to financial capital, venture capitalists provide valuable expertise, advice and industry networks to the benefit of the company.[457] Venture capital is also associated with job creation as discussed in paragraph 1 of this chapter and has been used as a proxy measure of innovation within an economic sector or geography.[458]

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[453] *Trados Inc. Shareholder Litigation* 73 A.3d 17 (Del. Ch. 2013) at 76.
[454] Wimberly, J. (2014), 'Venture Capital and Private Equity and the 'Entire Fairness' Test: In re Trados', Review of Banking and Financial Law, Volume 331, at pages 428-429.
[455] Wimberly, J. (2014), 'Venture Capital and Private Equity and the 'Entire Fairness' Test: In re Trados', Review of Banking and Financial Law, Volume 331, at pages 428-429.
[456] Bengtsson, O. (2011), 'Covenants in venture capital contracts', Management Science 57, No. 11, at pages 1926-1943.
[457] Cumming, D.J. and Dai, N. (2011), 'Fund size, limited attention and valuation of venture capital backed firms', Journal of Empirical Finance 18(1), at pages 2-15. See Rosenbusch, N., Brinckmann, J. and Müller, V. (2013), 'Does acquiring venture capital pay off for the funded firms? A meta-analysis on the relationship between venture capital investment and funded firm financial performance', Journal of Business Venturing, 28(3), at pages 335-353. See Smolarski, J. and Kut, C. (2011), 'The impact of venture capital financing method on SME performance and internationalization', International Entrepreneurship and Management Journal 7(1), at pages 39-55.
[458] Cumming, D.J. and Dai, N. (2011), 'Fund size, limited attention and valuation of venture capital backed firms', Journal of Empirical Finance 18(1), at pages 2-15.

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Venture capital investing has also been shown to have disadvantages. For example, securing a venture capital investment for a company can be a difficult process for an entrepreneur due to the accounting and legal costs the company and/or the entrepreneur could incur.[459] The start-up company must also give up ownership to the venture capitalist and the extent of such ownership interest will vary from transaction to transaction. This results in a partial loss of control for the entrepreneur and it usually occurs that the venture capitalists become involved in most decision-making processes of the company.[460] In addition, venture capital transactions are subject to onerous stipulations and restrictions, such as the composition of the start-up's management team, employee salaries, decision making and such.

3.4 Growth Equity

Growth equity refers to a type of private equity investment, most often a minority investment, in relatively mature companies that are looking for capital to expand or restructure operations, enter new markets or finance a significant acquisition without a change of control of the business.[461] It is also referred to as expansion capital. Companies that seek growth equity will often do so in order to finance a transformational event in their lifecycle.[462] These companies are likely to be more mature than venture capital-funded companies, able to generate revenue and operating profits but unable to generate sufficient cash to fund major expansions, acquisitions or other investments.[463] Growth equity can also be used as part of a restructuring of a company's balance sheet, particularly to reduce the amount of debt the company has on its balance sheet. Growth equity is often structured as either ordinary shares or preference shares, although certain investors will use various hybrid securities

[459]Cumming, D.J. and Dai, N. (2011), 'Fund size, limited attention and valuation of venture capital backed firms', Journal of Empirical Finance 18(1), at pages 2-15. See Rosenbusch, N., Brinckmann, J. and Müller, V. (2013), 'Does acquiring venture capital pay off for the funded firms? A meta-analysis on the relationship between venture capital investment and funded firm financial performance', Journal of Business Venturing 28(3), at pages 335-353. See Smolarski, J. and Kut, C. (2011), 'The impact of venture capital financing method on SME performance and internationalization', International Entrepreneurship and Management Journal 7(1), at pages 39-55.

[460]Cumming, D.J. and Dai, N. (2011), 'Fund size, limited attention and valuation of venture capital backed firms', Journal of Empirical Finance 18(1), at pages 2-15. See Rosenbusch, N., Brinckmann, J. and Müller, V. (2013), 'Does acquiring venture capital pay off for the funded firms? A meta-analysis on the relationship between venture capital investment and funded firm financial performance', Journal of Business Venturing 28(3), at pages 335-353. See Smolarski, J. and Kut, C. (2011), 'The impact of venture capital financing method on SME performance and internationalization', International Entrepreneurship and Management Journal 7(1), at pages 39-55.

[461]Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', 5th edition, Wiley and Sons, ISBN 0470650915.

[462]Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', 5th Edition, Wiley and Sons.

[463]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', 2nd Edition, Elsevier Inc., at pages 39-43.

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that include a contractual return, for example an interest payment, in addition to an ownership interest in the company.[464]

A growth equity transaction can occur when for example, a company requires capital for expansion; or to develop a new product; or build a new plant; or to acquire a company for strategic purposes; or combinations hereof.[465] The company's capital requirements may exceed the amount it is able to raise from traditional funding sources such as a secured loan from a bank. In this instance the company may approach a private equity firm(s) to raise the capital needed or raise sufficient capital to serve as a foundation for borrowing the remainder of its capital needs from traditional lenders.[466] Such a private equity investment in an existing company is commonly referred to as a growth equity investment.[467] A company seeking a growth equity investment is usually more established than a start-up company therefore a growth equity investment is also often referred to as a later stage investment.[468] However, a growth equity investment has the characteristics of both a venture capital transaction and a leveraged buyout transaction. According to Stewart:

> 'Growth equity (or growth capital) resides on the continuum of private equity investing at the intersection of venture capital and control buyouts. Growth capital is designed to facilitate the target company's accelerated growth through expanding operations, entering new markets, or consummating strategic acquisitions.'[469]

The terms and conditions of a growth equity transaction vary from deal to deal. On the one hand a growth equity investment may be documented very similarly to a traditional later-stage venture capital financing transaction discussed in paragraph 3.3 of this chapter, and may vary depending on the operating history of the company, the financial performance, the capitalisation of the company and so forth. On the other hand a growth equity transaction may be documented very similarly to a traditional leveraged buyout as discussed in paragraphs 3.1 and 3.2 this chapter. For example, some growth equity investments involve acquisitions of majority stakes.[470] These transactions usually

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[464]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', 2nd Edition, Elsevier Inc., at pages 39-43.
[465]See Bertoni, F., Ferrer, M. A. and Martí, J. (2013), 'The different roles played by venture capital and private equity investors on the investment activity of their portfolio firms', Small Business Economics, 40(3), at pages 607-633.
[466]Raising capital to serve as a foundation for borrowing the remainder of its capital needs from traditional lenders would be the same as a leveraged buyout discussed in paragraph 3.1 of this chapter.
[467]See Klein, P. G., Siegel, D. S., Wilson, N. and Wright, M. (2014), 'The Effects of Alternative Investments on Entrepreneurship, Innovation, and Growth', Managerial and Decision Economics, 35(2), at pages 67-72.
[468]As compared to a seed money or early-stage investment in a start-up as discussed in paragraph 3.3 of this chapter.
[469]Stewart, M. (2012), 'Growth Equity: The Intersection of Venture Capital and Control Buyouts', Fenwick and West LLP, 9th November 2012. Available at https://www.pehub.com/2012/11/growth-equity-the-intersection-venture-capital-control-buyouts/, accessed in April 2015.
[470]Stewart, M. (2012), 'Growth Equity: The Intersection of Venture Capital and Control Buyouts', Fenwick and West LLP, 9th November 2012. Available at https://www.pehub.com/2012/11/growth-equity-the-intersection-venture-capital-control-buyouts/, accessed in April 2015.

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involve companies with a base of existing investors, such as founders, employees and venture capital and other private equity investor(s) who sell a stake to a larger investor who they believe can lead the next phase of the company's growth.[471] In situations where the company is owned by founders, a family for example, the growth equity investment may be the first institutional capital in the company.[472] In these so-called growth buyout transactions, the sellers typically retain active involvement in the business at the management level, while the institutional investors are represented at the board level.[473] LeClaire *et al* argue that it is difficult, if not impossible to define growth equity.[474]

According to LeClaire *et al*:

> 'the concept of 'growth equity' can be defined so broadly as to be meaningless. After all, every private equity and/or venture capital deal involves equity and the expectation that the enterprise in which the investment is made will grow. So defined, every private equity and venture capital investor is a growth equity investor.'[475]

Bertoni *et al* argue that growth equity investing is more complex than venture capital investing.[476] However, there are certain characteristics that differentiate growth equity from venture capital investments.[477] For instance, most growth equity investments involve acquisitions of minority interests in profitable, growing and usually substantial companies, while venture capitalist investments are in early stage operating companies with unproven business models.[478] Stewart argues that growth equity investments are in companies that are regarded as the market leader

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[471]Bruining, H., Verwaal, E. and Wright, M. (2013), 'Private equity and entrepreneurial management in management buy-outs', Small Business Economics, 40(3), at pages 591-605.
[472]Bruining, H., Verwaal, E. and Wright, M. (2013), 'Private equity and entrepreneurial management in management buy-outs', Small Business Economics, 40(3), at pages 591-605.
[473]Bruining, H., Verwaal, E. and Wright, M. (2013), 'Private equity and entrepreneurial management in management buy-outs', Small Business Economics, 40(3), at pages 591-605. Available at http://www.goodwinprocter.com/Publications/Newsletters/Private-Equity-Update/2013/Growth-Equity-The-Crossroads-Sector-Comes-to-the-Fore.aspx?article=1, accessed in April 2015.
[474]LeClaire, J.R., McCusker, A.J. and Kendall, M.J. (2013), 'Growth Equity - The Crossroads Sector Comes to the Fore', Private Equity Update, 31st July 2013. Available at http://www.goodwinprocter.com/Publications/Newsletters/Private-Equity-Update/2013/Growth-Equity-The-Crossroads-Sector-Comes-to-the-Fore.aspx?article=1, accessed in April 2015.
[475]LeClaire, J.R., McCusker, A.J. and Kendall, M.J. (2013), 'Growth Equity - The Crossroads Sector Comes to the Fore', Private Equity Update, 31st July 2013. Available at http://www.goodwinprocter.com/Publications/Newsletters/Private-Equity-Update/2013/Growth-Equity-The-Crossroads-Sector-Comes-to-the-Fore.aspx?article=1, accessed in April 2015.
[476]Bertoni, F., Ferrer, M. A. and Martí, J. (2013), 'The different roles played by venture capital and private equity investors on the investment activity of their portfolio firms', Small Business Economics, 40(3), at pages 607-633.
[477]Bertoni, F., Ferrer, M. A. and Martí, J. (2013), 'The different roles played by venture capital and private equity investors on the investment activity of their portfolio firms', Small Business Economics, 40(3), at pages 607-633.
[478]Bertoni, F., Ferrer, M. A. and Martí, J. (2013), 'The different roles played by venture capital and private equity investors on the investment activity of their portfolio firms', Small Business Economics, 40(3), at pages 607-633.

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within the industry and/or sector, while venture capital investments are in multiple early stage companies within an industry and/or sector.[479] A further differentiating characteristic is that a growth equity investment requires the company to have a defined plan to achieve its profitability potential, while a venture capital investment is based on substantial revenue growth projections.[480] In addition, venture capital investments are in companies with undefined future capital requirements, while growth equity investments are characterised by limited or no future capital requirements to achieve profitability potential after the growth equity investment has been completed.[481]

There are also certain characteristics that differentiate growth equity investments from buyout investments. For example, growth equity investments are in operating companies with limited or no free cash flow, while buyouts investments are in highly profitable operating companies with consistent free cash flow.[482] Furthermore, growth equity investments are in operating companies with minimal or no funded debt, while buyout investments apply debt financing to leverage the investment.[483] Growth equity investments occur at a point in the company's development where the investment will initiate substantial revenue and profitability growth, while buyouts invest at a point where revenue and profitability are in any event projected to grow steadily.[484] In addition, buyouts invest in a controlling equity interest, while growth equity investments invest in a minority equity interest.[485]

It must be noted before this discussion continues that this paragraph 3.4 will not analyse the tax implications of growth equity investments because it is beyond the scope of this thesis and because each growth equity transaction varies. In addition, most growth equity investments have similar characteristics to venture capital investments and buyouts and some of the principal tax

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[479]Stewart, M. (2012), 'Growth Equity: The Intersection of Venture Capital and Control Buyouts', Fenwick and West LLP, 9th November 2012. Available at https://www.pehub.com/2012/11/growth-equity-the-intersection-venture-capital-control-buyouts/ accessed in April 2015. Bertoni, F., Ferrer, M. A. and Martí, J. (2013), 'The different roles played by venture capital and private equity investors on the investment activity of their portfolio firms', Small Business Economics, 40(3), at pages 607-633.
[480]Stewart, M. (2012), 'Growth Equity: The Intersection of Venture Capital and Control Buyouts', Fenwick and West LLP, 9th November 2012. Available at https://www.pehub.com/2012/11/growth-equity-the-intersection-venture-capital-control-buyouts/ accessed in April 2015. Bertoni, F., Ferrer, M. A. and Martí, J. (2013), 'The different roles played by venture capital and private equity investors on the investment activity of their portfolio firms', Small Business Economics, 40(3), at pages 607-633.
[481]Stewart, M. (2012), 'Growth Equity: The Intersection of Venture Capital and Control Buyouts', Fenwick and West LLP, 9th November 2012. Available at https://www.pehub.com/2012/11/growth-equity-the-intersection-venture-capital-control-buyouts/ accessed in April 2015.
[482]Demaria, C. (2013), 'Introduction to Private Equity: Venture, Growth, LBO and Turn-Around Capital', John Wiley and Sons, at chapter 4, at paragraph 4.2.
[483] Demaria, C. (2013), 'Introduction to Private Equity: Venture, Growth, LBO and Turn-Around Capital', John Wley and Sons, at chapter 4, at paragraph 4.2.
[484]Stewart, M. (20120, 'Growth Equity: The Intersection of Venture Capital and Control Buyouts', Fenwick and West LLP, 9th November 2012. Available at https://www.pehub.com/2012/11/growth-equity-the-intersection-venture-capital-control-buyouts/ accessed in April 2015.
[485]Stewart, M. (20120, 'Growth Equity: The Intersection of Venture Capital and Control Buyouts', Fenwick and West LLP, 9th November 2012. Available at https://www.pehub.com/2012/11/growth-equity-the-intersection-venture-capital-control-buyouts/ accessed in April 2015.

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considerations have been discussed in paragraph 3.1 of this chapter. A hypothetical example of a growth equity investment would be if an existing company ('Growco') requires additional capital to expand its business and Growco is unable to secure such capital requirements from traditional sources, such as a secured bank loan.[486] Growco decides to approach a private equity firm(s) to make a growth equity investment in Growco in order to supply sufficient equity capital or equity capital plus subordinated debt to improve Growco's existing borrowing base so that Growco can secure the balance of its needed cash from traditional lenders such as a bank(s).[487] The private equity firm is of the opinion that Growco's value will increase once Growco has the required capital for expansion and Growco's share ownership is re-arranged to incentivize the incumbent management.[488]

In this hypothetical example, Growco is seeking R50 million of capital to acquire an existing company engaged in the same industry; expand Growco's business nationally; develop a new product; and build a new plant. Important features of Growco's business worth noting are that it has sales of R200 million; net income of R20 million; 100 ordinary shares; ten shareholders which consist of five active management shareholders owning 10 percent of the 100 ordinary shares and five passive shareholders owning 90 percent of the 100 ordinary shares. The private equity firm is considering an investment in Growco of R20 million to support a R30 million bank loan. In preparation for this growth equity investment, the private equity firm conducts an extensive due diligence.[489] The private equity firm believes that Growco has a fair value before the growth equity investment of R200 million. If the private equity firm were to make a R20 million ordinary share investment into Growco, the ordinary shares would be worth R220 million.[490] Therefore, the private equity firm's R20 million investment would be only 9,1 percent of Growco's ordinary shares,[491] so that the private equity firm would only own 10 ordinary shares out of 110 ordinary shares. However, the private equity firm seeks a larger share of Growco's ordinary shares[492] and also wants some Growco fixed securities[493] in exchange for a portion of its R20 million investment. In addition, the private equity firm wants Growco's active management shareholders to own a larger percentage of Growco's ordinary shares instead of the 10 percent they currently own or the 9,1 percent they would own if the private equity

[486]Other traditional sources could be for example an insurance company private debt placement, a private offering of debt or equity securities to Growco's shareholders, their friends and family, or a public offering of debt or equity securities.
[487]Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', Aspen Publishers, 2003 edition, at pages 4-3 to 4-4; from which this hypothetical growth equity investment have been modelled.
[488]The incentivisation of management may include new managers appointed by the private equity firm.
[489]Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', Aspen Publishers, 2003 edition, at pages 4-3 and 4-4.
[490]Namely R200 million fair value before investment plus R20 million new ordinary share investment.
[491]Namely R20 million investment divided by R220 million ordinary share fair value after the private equity firm's investment equals 9,1 percent.
[492]Namely a larger share of Growco's future appreciation.
[493]Namely subordinated debentures and/or preference shares.

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firm simply made a R20 million ordinary share investment, so that the active management shareholders will have a greater incentive to perform.

In order to achieve these objectives, the private equity firm would like Growco to engage in a front-end re-arrangement of the shareholding so that the passive non-management shareholders own a smaller share of Growco's ordinary shares;[494] and the active management shareholders own a larger share of Growco's ordinary shares. The private equity firm wants the active management shareholders to own 50 percent of Growco's ordinary shares which would give them a greater incentive to stay with Growco and perform. In addition, the private equity firm would like Growco to engage in a front-end re-arrangement of the shareholding so that the private equity firm is able to acquire for its R20 million of new money a larger share of Growco's ordinary shares, namely 25 percent in this instance plus some subordinated debentures and/or preference shares.[495] There are several methods of achieving this front-end re-arrangement of Growco's equity. Levin lists a few.[496] One such method could be an ordinary share redemption from the passive shareholders for subordinated debentures. Another method could be a preference share recapitalisation with the passive shareholders which basically involves an exchange of new preference shares for existing ordinary shares. A further method could be by way of a pro rata dividend of preference shares to all of Growco's shareholders combined with the formation of a new holding company ('Holdco') to hold all of Growco's ordinary shares. In the instance of the above mentioned hypothetical example, Holdco's ordinary shares would be owned in the desired 25-50-25 ownership ratio.[497] Any of the three above mentioned methods can also be combined with an issuance to active management of additional ordinary shares or options to acquire new ordinary shares.[498] As mentioned in paragraph 3.1.1 of this chapter, private equity firms usually incentivise management, for example by way of share options in the underlying portfolio investee companies. This is an important part of private equity investing.[499]

(a) Re-Arranging Equity Through Redemption

[494]Plus some preference shares or subordinated debentures.
[495]See Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', (Aspen Publishers), 2003 edition, at pages 4-5 and 4-6.
[496]See Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', (Aspen Publishers), 2003 edition, chapter 4, at pages 4-5 to 4-75.
[497]See Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', (Aspen Publishers), 2003 edition, chapter 4, at pages 4-5 to 4-75.
[498]For example, with each Rand of share purchase price, or option exercise price, purchasing a far higher percentage of post-transaction ordinary share interest than it would have purchased pre-transaction because each of the above three techniques have transformed much of Growco's ordinary equity value into preference shares or subordinated debentures.
[499]Discussed in greater detail in paragraph 2.2 of chapter 4, namely the taxation of share options in investee companies.

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In terms of this redemption approach, Growco's passive shareholders swap some or all of their ordinary shares for new subordinated debentures in order to increase the percentage of Growco's ordinary shares held by active management and the private equity firm. Before the redemption, Growco's fair value is R200 million, the five passive shareholders own 90 percent of Growco's ordinary shares (fair value R180 million), and the five active management shareholders own 10 percent (fair value R20 million). In the redemption, the five passive shareholders swap R170 million of their R180 million of Growco ordinary shares for new straight subordinated debentures with a R170 million face value at a fixed interest rate equal to the prevailing prime lending rate plus two percent and ten year maturity period. This leaves the passive shareholders with only R10 million of ordinary shares. Before the redemption, the passive shareholders own 90 percent of Growco's 100 common shares. In the redemption, they swap 85 of their 90 ordinary shares for the new subordinated debentures leaving them with 5 ordinary shares out of 15 ordinary shares outstanding or 33 percent of Growco's ordinary shares (plus R170 million of Growco subordinated debentures). Before the redemption, the five active management shareholders own 10 percent shares out of 100 ordinary shares. After the redemption (and before the new private equity firm's investment), they own 10 ordinary shares out of 15 ordinary shares or 67 percent of Growco's ordinary shares. Hence after the redemption and before the new private equity investment, Growco still has an enterprise value of R200 million, of which R170 million is now represented by the new subordinated debentures (held by the passive shareholders) and R30 million is now represented by 15 ordinary shares which is held 33 percent or R10 million fair value by the passive shareholders and 67 percent or R20 million by the active shareholders. The private equity firm then purchases 5 new shares of Growco's ordinary shares, which will then constitute 25 percent of Growco's ordinary shares, for R10 million; and R10 million of subordinated debentures. This transaction can be summarised as follows:[500]

Passive Shareholders	**Fair Value**
Ordinary Fair Value Before Redemption	R180 million
Surrender Ordinary for Subordinated Debentures	(R170 million)
Ordinary Fair Value after Redemption	R10 million

Private Equity Firm Purchases	**Fair Value**
Ordinary Shares	R10 million
Subordinated Debentures	R10 million
Total	R20 million

Summary of Ownership after Redemption and Private Equity Firm Investment

	Ordinary Shares	Subordinated Debentures Fair Value

[500]See Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', (Aspen Publishers), 2003 edition, at page 4-11; from which this hypothetical growth equity investment have been modelled.

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	No. of Shares	Fair Value	Percent	
Passive Shareholders	5	R10 million	25	R170 million
Active Mgmt Shareholders	10	R20 million	50	---------
Private Equity Firm	5	R10 million	25	R10 million
Total	20	R40 million	100	R180 million

(b) Preference Share Recapitalisation

In terms of the preference share recapitalisation approach, Growco's passive shareholders swap some or all their ordinary shares for new preference shares in order to increase the percentage of Growco's ordinary shares held by active management and the private equity firm.[501] The transaction summary in terms of this approach will be the same as the re-arranging of Growco's equity through redemption as discussed in (a) above, except that the passive shareholders swap ordinary shares for new preference shares instead of swapping ordinary shares for new subordinated debentures.[502]

(c) Re-Arranging Equity Through Preference Share Dividend

In terms of this approach, Growco first issues new preference shares pro rata to all of Growco's ordinary shareholders in order to make Growco's existing ordinary shares less valuable. Thereafter, newly formed Holdco organized by the private equity firm and to be owned by the private equity firm, active management and the passive shareholders in the desired ratio 25-50-25 respectively, acquires all of Growco's ordinary and the portion of Growco's preference shares held by the active management in exchange for Holdco ordinary shares.[503] Before the equity arrangement, Growco's fair value is R200 million, the five passive shareholders own 90 percent of Growco's ordinary shares and five active management shareholders own 10 percent as described above. Growco pays a pro rata dividend consisting of the R188,888,889, being the redemption amount of new preference shares, to all of its old ordinary shareholders; R170 million (90%) to the passive shareholders; and R18,888,889 (10%) to the active management shareholders thereby reducing the fair value of Growco's aggregate ordinary shares to R11,111,111.[504] At this point Growco's passive shareholders own 90 percent ordinary shares worth R10 million and Growco's active management 10 ordinary shares worth R1,111,111. In addition, the passive shareholders own R170 million of Growco's preference shares[505] and the active management shareholders own R18,888,889 of Growco

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[501] See Bratton, W. W. and Wachter, M. L. (2013), 'A Theory of Preferred Stock', University of Pennsylvania Law Review, Volume 161, at pages 1825-1831.
[502] See Bratton, W. W. and Wachter, M. L. (2013), 'A Theory of Preferred Stock', University of Pennsylvania Law Review, Volume 161, at pages 1825-1831.
[503] See Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', (Aspen Publishers), 2003 edition, at page 4-21 to 4-22.
[504] R200 million fair value before the private equity firm's investment less R188,888,889 of newly issued preference shares.
[505] 90 percent of R188,888,889.

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preference shares.[506] The private equity firm invests R1 million cash in Holdco and receives in exchange 100 Holdco shares. At the same time Growco's passive shareholders transfer all their Growco ordinary shares (fair value R10million) to Holdco in exchange for 100 Holdco ordinary shares with Growco's passive shareholders retaining their R170 million of Growco preference shares. Thereafter Growco's active management shareholders transfer all of their Growco ordinary shares (fair value R1,111,111) plus all of their Growco preference shares (fair value R18,888,889) to Holdco in exchange for 200 Holdco ordinary shares. Finally, the private equity firm purchases from Growco for R10 million cash Growco preference shares having a total face value of R10 million. The transaction is summarised:[507]

	Fair Value of Growco Ordinary Shares before Preferred Dividends	**Redemption Amount of Growco Preferred Distributed**	**Fair Value of Growco Ordinary Shares after Preferred Dividends**
Passive Shareholders	R180 million	R170 million	R10 million
Active Management Shareholders	R20 million	R18,888,889	R1, 111,111
Total	R200 million	R188,888,889	R11,111,111

Summary of Ownership After Equity Re-Arrangement and Private Equity Firm Investment

	Holdco Ordinary Shares			Growco Preference Shares Fair Value
	No. of Shares	Fair Value	Percent	
Passive Shareholders	100	R10 million	25	R170 million
Active Mgmt Shareholders	200	R20 million	50	---------
Private Equity Firm	100	R10 million	25	R10 million
Total	400	R40 million	100	R180 million

There are benefits for passive shareholders willing to exchange part of their ordinary shares for preference shares and/or subordinated debentures as discussed above, for example they will receive a higher yield on the new preference shares and/or subordinated debentures.[508] Also it could be argued that it is better to have a smaller shareholding percentage in a company that has a highly incentivized management team and capital, than having a larger shareholding in a company that has a dissatisfied management team and that lacks adequate capital. A further benefit put forth by Levin is that there is less downside risk on the preference shares than with the ordinary shares.[509] In contrast, Bratton and Wachter state that this is always not the case and argue that although directors

[506] 10 percent of R188,888,889.

[507] See Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', (Aspen Publishers), 2003 edition, chapter 4, paragraph 404.2 at pages 4-23 to 4-24.

[508] See Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', (Aspen Publishers), 2003 edition, chapter 4, paragraph 405, at page 4-28.

[509] See Levin, J.S. (2003), 'Structuring Venture Capital, Private Equity and Entrepreneurial Transactions', (Aspen Publishers), 2003 edition, chapter 4, paragraph 405, at page 4-28.

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do owe fiduciary duties to preference shareholders, preference shareholder rights are largely contractual in nature and are governed by the specific rights and preferences.[510]

In the case *LC Capital Master Fund, Ltd v James*[511] the Delaware Court of Chancery addressed the duties that directors owe to preference shareholders when allocating private equity investment consideration between ordinary and preference shareholders. The plaintiff, LC Capital Master Fund, Ltd ('LC Capital') was a preference shareholder of QuadraMed Corporation ('QuadraMed'). Pursuant to the certificate of designation establishing the rights and powers of preference shares (the 'Certificate'), preference shareholders had the right to convert their preference shares into ordinary shares at a specified ratio. The Certificate also established other rights and preferences, such as dividend rights and liquidation preferences.[512] The QuadraMed board formed a special committee of independent directors (the 'Special Committee') to evaluate the private equity investment bids. The Committee recommended the acquisition of QuadraMed by Francisco Partners II, L.P. ('Francisco Partners') via a merger.[513] In the merger, the holders of QuadraMed preference shares were cashed out at the price the preference shareholders would have received for their ordinary shares had they exercised their conversion rights before the merger.[514] LC Capital sought to stop the merger, alleging that the QuadraMed directors breached their fiduciary duties of care and loyalty to the holders of preference shares. LC Capital argued that the directors unfairly allocated the merger consideration between the ordinary and the preference shareholders by allocating based solely on the conversion rights of the preference shares and not according value to other contractual rights of the preference shares, such as the dividend rights and liquidation preferences.[515]

The Delaware Court of Chancery explained that, although directors do owe fiduciary duties to preference shareholders, preference shareholders' rights are largely contractual in nature and are governed by the specific rights and preferences set forth in the certificate of incorporation (including the certificate of designation).[516] Once directors honour the contractual rights of the preference shareholders, they are entitled to favour the interests of the ordinary shareholders. The Court explained that a board of directors must honour the contractual rights of preference shareholders, but it need not go further and grant unspecified benefits to the preference shareholders at the expense of the ordinary shareholders.[517] The Court held that LC Capital had failed to show a reasonable probability of success on the merits of its breach of fiduciary duty claims. In declining to

[510] Bratton, W. W. and Wachter, M. L. (2013), 'A Theory of Preferred Stock', University of Pennsylvania Law Review, Volume 161, at pages 1825-1831.
[511] *See LC Capital Master Fund, Ltd v James* C.A. No. 5214-VCS (Del. Ch. Mar. 8, 2010). Available at http://caselaw.findlaw.com/de-court-of-chancery/1594543.html, accessed in April 2015.
[512] *See LC Capital Master Fund, Ltd v James* C.A. No. 5214-VCS (Del. Ch. Mar. 8, 2010).
[513] *See LC Capital Master Fund, Ltd v James* C.A. No. 5214-VCS (Del. Ch. Mar. 8, 2010).
[514] *See LC Capital Master Fund, Ltd v James* C.A. No. 5214-VCS (Del. Ch. Mar. 8, 2010).
[515] *See LC Capital Master Fund, Ltd v James* C.A. No. 5214-VCS (Del. Ch. Mar. 8, 2010).
[516] *See LC Capital Master Fund, Ltd v James* C.A. No. 5214-VCS (Del. Ch. Mar. 8, 2010).
[517] *See LC Capital Master Fund, Ltd v James* C.A. No. 5214-VCS (Del. Ch. Mar. 8, 2010).

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stop the merger, the Court also considered the balance of the equities, noting that it would be reluctant to grant injunctive relief harmful to the ordinary shareholders where a preference shareholder could pursue appraisal rights and an equitable damages case.[518]

In the US this case is seen as a follow-on to the important case of *Trados Inc. Shareholder Litigation*[519] (discussed in paragraph 3.3 of this chapter) in which preference shareholders received gains on their investments, but the ordinary shareholders received nothing.[520] It is clear from that the judgments in both cases by the Delaware Chancery Court that in a conflict situation, a board of directors' duty is to the ordinary shareholders.[521] Secondly, the preference shares are limited to their express contract rights. This implies that preference share investors should take care to ensure that their underlying documents are properly drafted, as the preference shares are entitled to nothing more than what is in the governing documents.[522]

It is hereby submitted that a private equity backed growth equity investment is generally more complex than the venture capital investment discussed in paragraph 3.3 of this chapter where the venture capitalist had only the entrepreneur with whom to negotiate. In a growth equity investment transaction, the private equity firm is investing in an existing company which typically has several shareholders with different interest and goals. In addition, Growco in this hypothetical example has more assets, contingent liabilities and operating history than did Venco (in paragraph 3.3 of this chapter), therefore it is more important that the private equity firm undertake a substantial business, legal and accounting due diligence to uncover any possible weaknesses and risks. In this regard the private equity firm should draft a more extensive agreement allocating the risks of unknown liabilities and any other contingencies between the private equity firm and Growco's current shareholders. Growth equity investments are deal specific, however many growth equity investments share some of the same characteristics of venture capital investments and buyout investments as discussed in paragraphs 3.1 to 3.3 of this chapter. According to Demaria, growth equity investments have the characteristics of both buyout investments and venture capital investments and are to some extent a combination of both.[523] While there are a number of dedicated growth capital firms, growth capital

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[518] *See LC Capital Master Fund, Ltd v James* C.A. No. 5214-VCS (Del. Ch. Mar. 8, 2010).
[519] *Trados Inc. Shareholder Litigation* 73 A.3d 17 (Del. Ch. 2013).
[520] *Trados Inc. Shareholder Litigation* 73 A.3d 17 (Del. Ch. 2013), the Delaware Chancery Court refused to dismiss a breach of fiduciary duty action against directors brought by ordinary shareholders for a merger in which the preference shares was to receive less than its full liquidation preference and the ordinary shares was being wiped out. While this does not mandate a payment to the ordinary shareholders, that can be seen as the practical effect of the decision.
[521] 'It will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of the ordinary shares . . . to the interests of the preferred stock'. *LC Capital Master Fund, Ltd v James* C.A. No. 5214-VCS (Del. Ch. Mar. 8, 2010), citing *Trados Inc. Shareholder Litigation* 73 A.3d 17 (Del. Ch. 2013).
[522] Wimberly, J. (2014), 'Venture Capital and Private Equity and the 'Entire Fairness' Test: In re Trados', Review of Banking and Financial Law, Volume 331, at pages 418-429.
[523] Demaria, C. (2013), 'Introduction to Private Equity: Venture, Growth, LBO and Turn-Around Capital', John Wiley and Sons, at chapter 4 paragraph 4.2.

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investments are also made by late-stage venture capital investors as well as more traditional buyout equity firms.[524]

3.5 Conclusion

It is apparent from this discussion of the types of private equity,[525] that private equity firms play a central role in private equity transactions. Simplistically put: The private equity firm manages funds contributed by the private equity investors (such as pension funds) to acquire underlying portfolio investee companies, most often using additional debt capital borrowed from banks or debt markets.[526] To this end, the private equity firm, the investors, underlying portfolio investee companies, banks, and other debt providers are the main players in private equity transactions.[527] However, among the above mentioned key participants, the private equity firm plays the most important role because it obtains investor funds, identify the target company and initiate relationships with banks and other debt providers to finance private equity transactions.[528] This leads to the next part of this chapter, which will discuss the salient features of the private equity business model.

4. Characteristics of the Private Equity Investment Model

Private equity firms are central to the private equity investment model.[529] The private equity firms have four primary roles. Their first role is to raise funds from investors, which are used to make investments, mainly in private companies. The funds raised by the private equity firms are from investors such as pension funds, banks, insurance companies and high net worth individuals.[530] According to the South African Venture Capital and Private Equity Association (SAVCA), the largest investors in private equity, both locally and abroad, are pension funds and insurance funds.[531] These investors will generally invest via a private equity fund which in South Africa is legally structured as either a *bewind* trust or *en commandite* partnership.[532]

[524] Demaria, C. (2013), 'Introduction to Private Equity: Venture, Growth, LBO and Turn-Around Capital', John Wiley and Sons, at chapter 4 paragraph 4.2.
[525] Paragraphs 3.1 to 3.4 of this chapter.
[526] Hoskisson, R.E., Shi, W., Yi, X. and Jin, J. (2013), 'The Evolution and Strategic Positioning of Private Equity Firms', Academy of Management Perspectives, Volume 27, No. 1, at page 22.
[527] Hoskisson, R.E., Shi, W., Yi, X. and Jin, J. (2013), 'The Evolution and Strategic Positioning of Private Equity Firms', Academy of Management Perspectives, Volume 27, No. 1, at page 22.
[528] Hoskisson, R.E., Shi, W., Yi, X. and Jin, J. (2013), 'The Evolution and Strategic Positioning of Private Equity Firms', Academy of Management Perspectives, Volume 27, No. 1, at page 22.
[529] As stated above in paragraph 3 of this chapter.
[530] Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at page 4.
[531] KPMG and South African Venture Capital and Private Equity Association (2014), 'Private Equity and Venture Capital Industry Performance Survey of South Africa covering the 2013 calendar year', Survey 2014.
[532] Chapter two will show that the predominant legal forms used by private equity firms in South Africa are the *bewind* trust and the *en commandite* partnership. In addition, chapter two will argue that there are several drivers for the appropriate legal structure for a private equity fund; and that one of the main objectives in structuring a private equity fund is to ensure that the liability for taxes is not on the fund vehicle itself but on

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The second role of private equity firms is to source investment opportunities and make investments. A private equity fund must source and execute successful transactions to make a profit and support the raising of further funds.[533] It is evident from the discussion in paragraph 3 of this chapter that a significant amount of effort and resources is required on the part of private equity firms in sourcing, executing and managing private equity investments in underlying portfolio companies, including relationship management with individuals who may give access to such transactions.[534]

The third role of private equity firms is to manage the investments in underlying portfolio companies. The private equity business model is characterised by the active involvement by the private equity firm in the underlying portfolio companies.[535] Gilligan and Wright state that:

> 'While they do not exercise day-to-day control, they are actively involved in setting and monitoring the implementation of strategy. This is the basis of the argument that private equity has become an alternative model of corporate governance.'[536]

The fourth role of private equity firms is to exit underlying portfolio companies and make a profit for the private equity fund it manages, for example by selling the funds' interest in such underlying portfolio companies.[537] This is achieved by exiting the underlying portfolio investee companies and this process is an integral part of the private equity business model.[538] In addition, the ultimate success of a private equity firm is reflected by the number of successful exits it has achieved, which in turn has a direct impact on the ability of such a private equity firm to attract investors and raise more funds.[539] Therefore, the various potential exit routes in a private equity market also directly impacts on an investor(s) decision as to whether or not it will commit to invest in a particular private equity fund.[540] Chapter four will also highlight that although fund raising and investment activity in

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the investors in the fund. Therefore one of the main reasons why these legal vehicles are used to structure private equity funds is that they are 'tax transparent'.

[533]Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at page 4.

[534]These would include investment bankers, accountants, advisers and so forth.

[535]Kumpf, S. (2013), 'Listed Private Equity: Investment Strategies and Returns', Volume 6 of Alternative Investments, Diplomica Verlag Publishers, at pages 17-20.

[536]Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at page 5.

[537]In paragraph three of chapter four, it will be argued that the objective of a private equity fund is to realise the return on its investment in each underlying portfolio investee company after a period of time once the initial transaction was concluded.

[538]Cumming, D.J. (2010), 'Venture Capital: Investment Strategies, Structures, and Policies', Kolb Series in Finance, Essential Perspectives, 2010.

[539]Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', 5th edition, Wiley and Sons, ISBN 0470650915.

[540]Cumming, D.J., and Johan, S.A. (2007), 'Regulatory Harmonization and the Development of Private Equity Markets', Journal of Banking and Finance, Volume 31, pages 3218-3250.

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South Africa seems reasonably consistent, exiting alternatives remain a challenge for the local industry.[541]

It is submitted that the inherent strength of the private equity investment model described above is that it is based on a clear alignment of interests between the private equity firms, the investors and the underlying portfolio investee companies they support.[542] As discussed above, the success of a private equity investment is determined by the sale of all or a large part of the portfolio companies equity (exit) via a stock market listing or private sale. Therefore, it is a basic principle of private equity investing that the returns are achieved through the realized gains made once an investment is sold.[543] The common model is for the private equity firm employees to keep 20 percent of the difference between the amount initially invested and the amount realized in the fund at the end of the ten year lifetime of the fund and distributed to investors.[544] These arrangements help to align the interests of the investors and those of the private equity firm, specifically because rewards accrue based on success in delivering the returns.[545]

Nevertheless, like any other industry, the private equity industry has its critics.[546] The private equity industry has been criticised both in terms of how private equity firms finance and manage the underlying portfolio investee companies; as well as for the way that private equity firms operate its own business.[547] In addition, chapter three will consider corporate governance in relation to the private equity business model and will seek to explain the link between the private equity business model and corporate governance that is based on the assertion that there are two levels of corporate governance involved in private equity investing. In continuation of the discussion at hand, the next section discusses several features that underpin the private equity investment model.

4.1 Remuneration of the Private Equity Firm and Investors

As mentioned earlier, the most commonly used investment vehicle to invest in private equity in South Africa, is the fixed-life fund which is structured either as a *bewind* trust or an *en commandite* partnership, managed by a private equity firm. In the case of an *en commandite* partnership, the

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[541]KPMG and SAVCA (South African Venture Capital Association), (2013), ‘Private Equity and Venture Capital Industry Performance Survey of South Africa covering the 2012 calendar year’, Survey, 2013.
[542]Kumpf, S. (2013), ‘Listed Private Equity: Investment Strategies and Returns’, Volume 6 of Alternative Investments, Diplomica Verlag Publishers, at pages 17-20.
[543]Kumpf, S. (2013), ‘Listed Private Equity: Investment Strategies and Returns’, Volume 6 of Alternative Investments, Diplomica Verlag Publishers, at pages 17-20.
[544]The 20 percent is referred to carried interest and is discussed in greater detail below.
[545]Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), ‘Private Equity: History, Governance, and Operations’, John Wiley and Sons, 2nd edition.
[546]Gilligan, J. and Wright, M. (2010), ‘Private Equity Demystified: An Explanatory Guide’, ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at pages 1-2.
[547]Gilligan, J. and Wright, M. (2010), ‘Private Equity Demystified: An Explanatory Guide’, ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at pages 1-2. See also paragraph 1 of this chapter where several of the disadvantages of the private equity investing are highlighted.

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investors constitute the limited partners and the private equity firm act as general partners.[548] In the case of a *bewind* trust, the investors constitute the trust beneficiaries and the private equity firm acts as the fund manager of the *bewind* trust (private equity fund).[549] Since the private equity firm raises new funds every three to five years, a private equity firm usually manages several private equity funds, which are each set up between several investors and the private equity firm.[550] As mentioned above, a private equity fund usually has a fixed ten-year life during which the private equity firm selects investments, structures transactions, monitors investments and designs the appropriate exit strategies on behalf of the private equity fund. In exchange, the private equity firm is remunerated via two primary sources: a management fee plus a share of the capital gains of the private equity fund.[551] The private equity firm's sharing of the profits of the private equity fund is typically referred to as the carried interest or the 'carry'.[552] The payment of the private equity firm's management fee and the sharing of the profits of a particular private equity fund is typically governed by contractual arrangements, the terms and conditions of which are usually contained in the trust deed[553] or the partnership agreement.[554] The management fees received by the private equity firm are expressed as a percentage of the funds the private equity firm has managed to raise from investors.[555] According to Gilligan and Wright, the larger the private equity fund, the greater the management fee income, although the percentage typically declines from approximately 3 percent in smaller funds to 1 percent in larger private equity funds.[556] Lerner defines a management fee as the percentage of committed capital or net asset value ('NAV') that is paid by the private equity fund to the private equity firm to cover salaries and expenses.[557] Therefore, the management fees pay for the operating costs of the private equity firm and any excess belongs to the private equity firm. Gilligan and Wright argue that there is an incentive for a private equity firm to maximise the fund size in order to increase the management fee income. Gilligan and Wright state:[558]

> '… as fund size has grown, the funds' costs have grown less rapidly and therefore the profit from fee income has become material. It is argued that this income, which is effectively guaranteed, has created a misalignment between the partners in private equity funds and their investors. In

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[548]See chapter two.
[549]See chapter two.
[550]Adveq (2012), 'Benefits of Private Equity for the European Economy: Insights from the Macro, Company and Investor Perspective', Adveq Management AG, Winter 2012/2013.
[551]Adveq (2012), 'Benefits of Private Equity for the European Economy: Insights from the Macro, Company and Investor Perspective', Adveq Management AG, Winter 2012/2013.
[552]Gompers, P.A and Lerner, J. (1995), 'An Analysis of Compensation in the U.S. Venture Capital Partnership', Working Paper, Harvard University, at pages 3-44.
[553]If a trust is used.
[554]If a limited liability partnership is used.
[555]Adveq (2012), 'Benefits of Private Equity for the European Economy: Insights from the Macro, Company and Investor Perspective', Adveq Management AG, Winter 2012/2013.
[556]Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at page 5.
[557]Lerner, J. (1999), 'Venture Capital and Private Equity: A Casebook', John Wiley and Sons, at pages 11-144.
[558]Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at page 5.

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essence a new principal-agent problem is said to have been created by the high levels of guaranteed income from fees.[559]

For instance, an annuity stream of excessive management fees can represent a misalignment of interests by reducing the financial incentive of the private equity firm to achieve high returns. Therefore it can be argued that economic supply and demand factors ultimately dictate what the management fee will be. When the resultant demand for a private equity firm is high, then the management fee charged by such a manager will be at the higher end of the range. Additionally, strong private equity firms with proven track records tend to be able to command premium fees. In paragraph 2(b) of chapter three, it is argued that an area of potential conflict of interest between the private equity firm and investors relates to the final size of the private equity fund. It is submitted in chapter three that there remains a potential conflict of interest between the private equity firm's ambitions to raise increasingly larger sized private equity funds, whereas the potential investors' goal is to ensure that whatever capital is raised can be effectively deployed towards suitably attractive investment opportunities within the fund's proposed investment period.[560] Therefore, the larger the size of the private equity fund, the more fees the private equity firm would earn. This serves the interests of the private equity firm without any real increased investment benefit to the prospective investors.[561]

Chapter three will *inter alia* highlight some of the methods used by investors and private equity firms to show an alignment of interest. For example the private equity fund that is to be raised, would be subject to the condition that the private equity firm will commit to co-invest a set percentage of their own capital on a co-investment basis alongside the private equity fund.[562] The set percentage would be determined in relation to the total amount of investor committed capital. Another example of risk mitigation against the misalignment of interest is by adopting a budget-based approach to management fees, commonly referred to as 'budgeted fees'.[563] Budgeted fees are management fees determined by the budgeted annual operating expenses of the private equity fund.[564] In essence the annual budget is presented to the advisory board of the private equity fund or investors of the fund

[559]See also Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies 26, No. 2, at pages 368-402.
[560]Barret, R., Butler, M., and Bartlett, J.W., (2011), 'Advanced Private Equity Term Sheets and Series A Document: Business Structure and Operations', Release 19, Law Journal Press, New York, 2011, ISBN No. 978-1-58852-120-0.
[561]Barret, R., Butler, M., and Bartlett, J.W., (2011), 'Advanced Private Equity Term Sheets and Series A Document: Business Structure and Operations', Release 19, Law Journal Press, New York, 2011, ISBN No. 978-1-58852-120-0. See also Bartlett, J.W. (1995), 'Organising the Pooled Investment Vehicle (PIC), Equity Finance: Venture Capital, Buy-outs, Restructuring and Reorganisations', 2nd edition, Vol. 3. Aspen.
[562]Frase, D., Helm, R., and Day, M. (2012), 'Practitioner's Guide to Conflicts of Interest in the Financial Services Industry', Sweet and Maxwell Publishers, 1st edition, at pages 138-170.
[563]William Mecer Inc. (1996), 'Key Terms and Conditions for Private Equity Investing', William Mecer Inc., at pages 24-34.
[564]Schell, J.M. (1999), 'Private equity Funds: Business, Structure and Operations', Law Journal Press, revised edition.

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for approval.[565] This fee structure aims at creating accountability and implies a better alignment of interests. The budgeted fee approach is an application of the cost analysis private equity firms make when evaluating potential transactions.[566] In order to reduce the potential difficulties that may arise, the process by which budgeted fees are negotiated each year and resolution of any disputes should be formally defined in the fund agreements.[567] What is important is that this type of fee structure methodology creates a check and balance system each year that subjects the private equity firm to greater accountability, planning and cost control.[568] In essence it is no different from the disciplines applied by the private equity firm when monitoring and controlling expenses in the investments made by the private equity fund.[569]

Another example of risk mitigation against the misalignment of interest is by adopting a scaled fee approach.[570] This management fee structure can also be useful for reflecting the higher level of effort by the private equity firm during the earlier years of the private equity fund, where the deal-making and due diligence efforts are more intense.[571] A sliding fee scale is a management fee that varies over the life of the private equity fund.[572] Typically these are negotiated fees that attempt to recognise the higher level of due diligence and analysis required during the earlier years as the fund makes investments. These fees are higher during the earlier years of the private equity fund and decline over time.[573] Such a management fee structure, which first slides up during the earlier years of the fund, levels off, and then slides down in the later years, can also create an appropriate alignment of interests.[574] An example would be 1.5 percent in the first year, 2 percent during the second year, 2.5 percent in the years three through five, then scaling downward to 1.5 percent in years six and seven, and to 1 percent in years eight to ten. It is submitted in chapter three that a private equity firm is strongly motivated to protect its reputation and to maintain a healthy relationship with its investors

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[565]Schell, J.M. (1999), 'Private equity Funds: Business, Structure and Operations', Law Journal Press, revised edition.
[566]Schell, J.M. (1999), 'Private equity Funds: Business, Structure and Operations', Law Journal Press, revised edition.
[567]Lemke, T.P., Lins, G.T., Hoenig, K.L. and Rube, P.S. (2014), 'Hedge Funds and Other Private Funds: Regulation and Compliance', 2014 Edition, Securities Law Handbook Series, Thomson West Publishers, at 13:20.
[568]Lemke, T.P., Lins, G.T., Hoenig, K.L. and Rube, P.S. (2014), 'Hedge Funds and Other Private Funds: Regulation and Compliance', 2014 Edition, Securities Law Handbook Series, Thomson West Publishers, at 13:20.
[569]William Mecer Inc. (1996), 'Key Terms and Conditions for Private Equity Investing', William Mecer Inc., at pages 24-34.
[570]Goldman, Sachs and Co. and Frank Russell Capital Inc. (1996), 'Survey of Alternative Investments by Pension Funds, Endowments and Foundations', New York: Goldman, Sachs and Co. and Frank Russell Capital Inc.
[571]Goldman, Sachs and Co. and Frank Russell Capital Inc. (1996), 'Survey of Alternative Investments by Pension Funds, Endowments and Foundations', New York: Goldman, Sachs and Co. and Frank Russell Capital Inc.
[572]Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies 26, No. 2, at pages 368-402.
[573]Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies 26, No. 2, at pages 368-402.
[574]Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies 26, No. 2, at pages 368-402.

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because of future fund raising.[575] It is also submitted in chapter three that the main mitigating factor against the potential conflicts of interests is that the fund-raising process is subject to contractually binding negotiations between the private equity firm and the investors, where investors are able to negotiate definitive terms and conditions relating to the management fees and performance based fees to be earned by the private equity firm.[576]

4.1.1 Carried Interest

In addition to the management fee received by the private equity firm, the private equity firm also receives a share of the profits generated by the private equity fund. This is generally known as 'carried interest' as mentioned earlier.[577] According to Kocis *et al* the origin of carried interest can be traced back to the 16th century, when European ships were crossing to Asia and the Americas. The captain of the ship would take a 20 percent share of the profit from the carried goods, to pay for the transport and the risk of sailing over oceans.[578] According to Lemke *et al*, carried interest is:

> '… a form of performance fee that rewards the manager for enhancing performance.'[579]

The Private Equity Group Capital Council ('PEGCC') defines carried interest as:

> 'the share of profits that a general partner of an investment fund receives from his or her ownership interest in the fund's assets.'[580]

According to the PEGCC, carried interest plays a crucial role in private equity growth capital investing and is provided to the private equity firm in recognition of the substantial and material work required to restructure and direct the underlying portfolio investments of the private equity fund.[581] In addition, it also serves to align the interest of the private equity firm with those of the investors.[582] Carried interest is based on the principle that if the private equity fund does well, the private equity firm

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[575]Frase, D., Helm, R., and Day, M. (2012), 'Practitioner's Guide to Conflicts of Interest in the Financial Services Industry', Sweet and Maxwell Publishers, 1st edition, at pages 138-170.
[576]Frase, D., Helm, R., and Day, M. (2012), 'Practitioner's Guide to Conflicts of Interest in the Financial Services Industry', Sweet and Maxwell Publishers, 1st edition, at pages 138-170.
[577]Kumpf, S. (2013), 'Listed Private Equity: Investment Strategies and Returns', Volume 6 of Alternative Investments, Diplomica Verlag Publishers, at pages 17-20.
[578]Kocis, J.M., Bachman, J.C., Long, A.M. and Nichols, C.J. (2009), 'Inside Private Equity', John Wiley Publishers, 1st Edition, at page 22.
[579]Lemke, T.P., Lins, G.T., Hoenig, K.L. & Rube, P.S. (2014), 'Hedge Funds and Other Private Funds: Regulation and Compliance', 2014 Edition, Securities Law Handbook Series, Thomson West Publishers, at 13:20.
[580]Available at www.pegcc.org/about/the-pegcc-and-public-policy/carried-interest/, accessed in April 2015.
[581]Available at www.pegcc.org/about/the-pegcc-and-public-policy/carried-interest/, accessed in April 2015.
[582]Available at www.pegcc.org/about/the-pegcc-and-public-policy/carried-interest/, accessed in April 2015.

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shares in the gains; however if the private equity fund does not do well, the private equity firm receives nothing.[583] Investopedia defines carried interest as:

> 'A share of any profits that the general partners … receive as compensation, despite not contributing any initial funds. This method of compensation seeks to motivate the general partner (fund manager) to work toward improving the fund's performance … While all funds tend to have a small management fee, the management fee is meant to only cover the costs of managing the fund, with the exception of compensating the fund manager. Carried interest is meant to serve as the primary source of income for the general partner. However, the general partner must ensure that all the initial capital that the limited partners contribute is returned along with some previously agreed upon rate of return.'[584]

In order to receive carried interest, the private equity firm must first return all capital contributed by the investors, plus the pre-agreed rate of return referred to as the 'hurdle rate' to investors. The hurdle rate is calculated on the amounts actually invested.[585] According to Gilligan and Wright, the customary hurdle rate in the US is seven to eight percent per annum[586] and in South Africa it is eight to 10 percent per annum.[587] Therefore a hurdle rate of 10 percent means that the private equity fund needs to achieve a return of at least 10 percent before the profits are shared according to the carried interest arrangement.[588] Once this is achieved, then only will the private equity firm share in the excess, usually to the extent of 20 percent of any excess.[589] Typically in practice, the private equity firm will only receive its carried interest after the successful exiting of an underlying portfolio investment, which may take several years taking into account the long term nature of private equity investing. This sharing of the profits of the private equity fund is also referred to as the 80/20 rule because the profits are shared on an 80/20 basis with 80 percent going to the investors and 20 percent to the private equity firm.[590]

[583]Available at www.pegcc.org/about/the-pegcc-and-public-policy/carried-interest/, accessed in April 2015.
[584]Available at www.investopedia.com/terms/c/carriedinterest.asp#ixzz3a08qjHLY, accessed in April 2015.
[585]Fang, L., Ivashina, V. and Lerner, J. (2014), 'The disintermediation of financial markets: Direct investing in private equity', Journal of Financial Economics, August 2013, at pages 1-31.
[586]Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at page 5.
[587]Sourced and available at www.ethos.co.za/communications/archived-news/private-equitys-retail-tilt/, accessed in April 2015.
[588]Fang, L., Ivashina, V. and Lerner, J. (2014), 'The disintermediation of financial markets: Direct investing in private equity', Journal of Financial Economics, August 2013, at pages 1-31.
[589]Kumpf, S. (2013), 'Listed Private Equity: Investment Strategies and Returns', Volume 6 of Alternative Investments, Diplomica Verlag Publishers, at pages 17-20.
[590]Lerner, J. (1999), 'Venture Capital and Private Equity: A Casebook', John Wiley and Sons, at pages 11-144. It must be noted at this point, that it is not the intention of this discussion to discuss the various accounting methodologies and investment formulas used in calculating carried interest as it is beyond the scope of this discussion.

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The most vociferous criticisms of the remuneration of private equity firms relate to the taxation of carried interest.[591] Carried interest is typically taxed as a capital gain and the management fee income is usually taxed as income.[592] The reason why carried interest is taxed as capital gains is that a private equity firm hold its investments for several years and as such, the capital gains from private equity funds typically qualify as long term capital gains, which receive favourable tax treatment. The taxation of carried interest has been subject to much criticism since the mid-2000s.[593] Chapter four will examine these criticisms as part of the discussion of the taxation of carried interest in the US, Canada, Australia, UK and South Africa. For example, in paragraph 2.3 of chapter four it will be noted that there is a continuous debate in the US over the taxation of carried interest. This debate pertains to the treatment of carried interest as capital gain for the managers of private equity funds. Under current US tax law,[594] income resulting from carried interests is often taxed at capital gains rates. However, in terms of legislative proposals in the US carried interest income would be taxed at the higher ordinary income tax rates.[595] Nevertheless, in concluding this paragraph, it is submitted that carried interest serves as the primary source of income for the private equity firm for (a) successfully raising a private equity fund; (b) sourcing investment opportunities and structuring investment transactions on behalf of the private equity fund; (c) managing the underlying portfolio investments on behalf of the private equity fund; and (d) exiting the underlying portfolio investments on behalf of the private equity fund at a profit. In addition thereto, the private equity firm receives an annual management fee which is determined as a percentage of the capital it has raised from investors. This management fee is meant primarily to cover the operating costs of the private equity firm rather than for meaningful wealth creation for the private equity firm.

Despite the criticism of the remuneration model of private equity firms, it is also evident (particularly when considering the discussion in paragraph 3 of this chapter) that a significant amount of effort and resources are required on the part of private equity firms in sourcing, executing and managing private equity investments in underlying portfolio companies, including relationship management with individuals who may give access to such transactions.

4.1.2 Distribution Policy Provisions

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[591]Discussed in paragraph 4.1.1 of chapter one and paragraph 2.3 of chapter four.
[592]Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at page 6.
[593]Available at http://www.pegcc.org/issues/comment-letters/pegcc-comment-letter-on-flow-through-pass-through-taxation/#sthash.BQQlUci1.dpuf, accessed in April 2015.
[594]Section 702 of the Internal Revenue Code of 1986, as amended.
[595]Field, H.M. (2012), 'The Return-Reducing Ripple Effects of the Carried Interest Tax Proposals', Florida Tax Review, 13, 2012):1-503. Paragraph 4 of chapter three will discuss contractual techniques intended to create an alignment between the interests of the private equity firm and the outside investors, in relation to the remuneration arrangements between the private equity firm and investors.

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The distribution policy provisions are one of the most important provisions incorporated in private equity fund agreements. According to Schell, the distribution policy refers to the transfer of cash from the private equity fund to each investor and the private equity firm.[596] The distribution policy regulates and determines how both the private equity firm and the investors will receive the capital gains realized when the underlying portfolio investments are exited from the private equity fund.[597] The distribution policy is typically structured to ensure that the private equity firm will only receive its carried interest after the underlying portfolio investments have been exited and an amount equal to the committed capital plus the pre-agreed hurdle rate has been returned to each investor.[598] Typically all the expenses and fees (including the management fees paid to the private equity firm) incurred by the private equity fund are offset from the realized capital gains when calculating the hurdle rate because the realized gains referred to above must be net of all fees and expenses before the private equity firm can receive its carried interest.[599] Exceptions to this general principle do occur. A distribution policy may be drafted on the basis that the private equity firm will begin receiving the capital gains realized when the underlying portfolio investments are exited and the fund's committed capital is recovered, without regard to the recovery of management fees.[600] Investopedia defines the distribution policy as:

> 'the method by which capital is distributed to a fund's investors as underlying investments are sold. It specifies, for example, that an investor will receive his or her initial investment plus a preferred return before the general partners can participate in the profits.'[601]

Therefore, the crucial questions that need to be considered when drafting the private equity fund agreements are when and how the distribution policy is to be implemented. The distribution policy can be implemented in various ways, but the escrow[602] account mechanism is the most common

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[596]Schell, J.M. (1999), 'Private equity Funds: Business, Structure and Operations', Law Journal Press, revised edition, at pages 9-26 to 9-28.

[597]Private equity exits are more fully discussed in paragraph three of chapter four.

[598]Robinson, D.T. and Sensoy, B.A. (2013), 'Do private equity fund managers earn their fees? Compensation, ownership, and cash flow performance', Review of Financial Studies, 26(11), at pages 2760-2797.

[599]Robinson, D.T. and Sensoy, B.A. (2013), 'Do private equity fund managers earn their fees? Compensation, ownership, and cash flow performance', Review of Financial Studies, 26(11), at pages 2760-2797.

[600]Robinson, D.T. and Sensoy, B.A. (2013), 'Do private equity fund managers earn their fees? Compensation, ownership, and cash flow performance', Review of Financial Studies, 26(11), at pages 2760-2797. See also Bartlett, J.W. (1995), 'Organising the Pooled Investment Vehicle (PIC), Equity Finance: Venture Capital, Buy-outs, Restructuring and Reorganisations', 2nd edition, Vol. 3. Aspen.

[601]Available at http://www.investopedia.com/terms/d/distribution-waterfall.asp#ixzz3a7JaDjsD, accessed in May 2015.

[602]The term 'escrow' refers to a legal concept in which a financial instrument or an asset is held by a third party on behalf of two other parties that are in the process of completing a transaction. The funds or assets are held by the escrow agent until it receives the appropriate instructions or until predetermined contractual obligations have been fulfilled. Money, securities, funds, and other assets can be held in escrow. Available at www.investopedia.com/terms/e/escrow.asp, accessed in June 2017.

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method used.[603] In terms of the escrow account agreement, the private equity firm's share of the capital gains realized when the underlying portfolio investments are sold are held in escrow until certain agreed conditions are met.[604] For example, the private equity firm may only receive its share of the profits once all the underlying portfolio investments are sold and the entire private equity fund is liquidated.[605] Other variations are when the private equity firm and the investors receive profits simultaneously; and when the investors share profits on a predetermined date.[606]

In drafting the provisions regulating an escrow account, there are several basic features that should be considered. Firstly, effectively worded and drafted escrow agreements will reduce potential misunderstandings and conflict as to when and how the distribution policy is to be implemented.[607] Secondly, the provision should be drafted based on the underlying proposition that the investors should recover an amount equal to their capital commitment and their share of management fees paid to the private equity firm before the private equity firm receive the capital gains realized when the underlying portfolio investments are exited from the private equity fund.[608] Thirdly, the distribution should be made as profits become available, even though this may be inconvenient for the private equity firm which may prefer to make distributions on a predetermined date.[609] By making distributions on a predetermined date, the private equity firm can smooth its own income and establish greater certainty as to when it will receive distributions.[610] Fourthly, the profits can be distributed to the investors and the private equity firm both in the form of cash or shares in the underlying portfolio investment(s) (also referred to as in-kind distributions) or as a combination of both.[611] In addition, the actual distribution structure and escrow account format should be concisely defined in the fund's agreements, aimed at eliminating time-consuming interpretation and negotiation as to who can make distributions, when the distributions should be made, under what conditions the distributions should be made, and the types of distributions.[612]

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[603]Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', John Wiley and Sons, 2nd edition. See also Levin, J.S., Rocap, D.E. and Welke, W.R. (2010), 'Carried Interest Legislative Proposals and Enterprise Value Tax', Tax Notes, 1st November 2010.

[604]Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', John Wiley and Sons, 2nd edition. See also Levin, J.S., Rocap, D.E. and Welke, W.R. (2010), 'Carried Interest Legislative Proposals and Enterprise Value Tax', Tax Notes, 1st November 2010.

[605]See Burke, K.C. (2010), 'Sound and Fury of Carried Interest Reform', Columbia Journal of Tax Law, 1, 2010:1.

[606]See Burke, K.C. (2010), 'Sound and Fury of Carried Interest Reform', Columbia Journal of Tax Law, 1, 2010:1.

[607]Rosenzweig, A.H. (2009), 'Not All Carried Interests Are Created Equal', Northwestern Journal of International Law and Business, 29(3), at 713.

[608]Rosenzweig, A.H. (2009), 'Not All Carried Interests Are Created Equal', Northwestern Journal of International Law and Business, 29(3), at 713.

[609]Rosenzweig, A.H. (2009), 'Not All Carried Interests Are Created Equal', Northwestern Journal of International Law and Business, 29(3), at 713.

[610]Rosenzweig, A.H. (2009), 'Not All Carried Interests Are Created Equal', Northwestern Journal of International Law and Business, 29(3), at 713.

[611]Rosenzweig, A.H. (2009), 'Not All Carried Interests Are Created Equal', Northwestern Journal of International Law and Business, 29(3), at 713.

[612]Kogelman, S (1996), 'Survey: Alternative Investments by Pension Funds, Endowments & Foundations' at 1-12.

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These are just some of considerations to be taken into account, but ultimately distributions should at all times be made in accordance with the relevant provisions in the private equity fund's constitutional documents. Clarity over what is distributed and how it is accounted for in the calculation of carried interest are all important issues. Addressing these when drafting the private equity fund's constitutional documents will ensure that disputes do not arise as to the apportionment of profits and losses of the private equity fund, and mitigate against any misalignment of interest between the private equity firm and the fund's investors.

4.2 Allocation of Fees and Expenses

The management fee discussed above in paragraph 4.1 of this chapter, typically covers only salaries of the full-time professionals and administrative personnel and the ordinary and necessary expenses involved in the private equity fund's routine operations. Legal and accounting fees, and all other costs, are charged to the private equity fund as a current or capital expense.[613] Consulting fees for example can be a major burden because many private equity firms routinely contract the the services of professional consultants to act as advisors during the the feasibility process, when considering making an underlying investment.[614] On the one hand, consulting fees are typically charged to the private equity fund because the private equity firm usually cannot afford to pay them.[615] On the other hand, when and if the private equity firm's appointee serves on the boards of the underlying portfolio companies and are paid directors' fees, the usual rule is that these fees are either remitted to the private equity fund or credited against the management fee to avoid double counting.[616]

Quite often in the management of third party private equity funds, the private equity firm is also engaged in corporate finance activities that may yield fees or revenues earned from investment banking activities.[617] This could include fee income received by the private equity firm from the work involved in taking a company to market via a stock market listing, mergers and acquisitions and corporate finance services offered to the underlying portfolio investee companies.[618] Historically, the practice was that the private equity firm would receive all such transaction fee income in addition to the annual management fees for managing the private equity fund. The common practice now is for

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[613]Robinson, D.T. and Sensoy, B.A. (2013), 'Do private equity fund managers earn their fees? Compensation, ownership, and cash flow performance', Review of Financial Studies, 26(11), at pages 2760-2797.
[614]Robinson, D.T. and Sensoy, B.A. (2013), 'Do private equity fund managers earn their fees? Compensation, ownership, and cash flow performance', Review of Financial Studies, 26(11), at pages 2760-2797.
[615]Venture Economics Report (1999), '1998 Investment Benchmark Report: Buy-outs and Other Private Equity', Newark, NJ: Venture Economics Information Services.
[616]Venture Economics Report (1999), '1998 Investment Benchmark Report: Buy-outs and Other Private Equity', Newark, NJ: Venture Economics Information Services.
[617]Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies 26, No. 2, at pages 368-402.
[618]Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies 26, No. 2, at pages 368-402.

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private equity firms to share the transaction fee income with the fund's investors.[619] In the US, the general industry principle is that all such transaction fee income accrues to investors, as investors are already paying the manager a fee for managing a fund.[620] Transaction fees can be applied as a reduction of management fees by crediting them against future management fees or refunding earlier fees to the extent of the sharing arrangement.[621] This will resolve any potential timing differences between management fees paid and transaction fees received.

The allocation of fees and expenses between the private equity firm and the private equity fund should be fair and reasonable. For example, the non-disclosure and excessive allocation of fees and expenses to the private equity fund can represent a misalignment of interests between the private equity firm and the private equity fund. As mentioned in paragraph 4.1 of this chapter, chapter three will outline possible mitigating measures alongside this misalignment of interest with regard to the allocation of fees and expenses to the private equity fund. According to Hussein, both the US Securities and Exchange Commission ('SEC') Office of Compliance Inspections and Examinations ('OCIE') and the Asset Management Unit of the SEC's Division of Enforcement (the 'AMU') have increasingly focused their attention on conflicts of interest with respect to private equity firms.[622] Hussein argues that in the US, the SEC has made it clear that it views conflicts as material and that private equity firms, as fiduciaries to their clients, must disclose them.[623] In particular, the SEC beginning 2014 commenced the review of how private equity firms disclose the allocation of fees and expenses to their investors.[624]

According to Rendón *et al*, the SEC reported widespread violations of law or material weaknesses in controls related to the allocation of fees and expenses among the newly registered private equity firms it examined.[625] Rendón *et al,* referred to the remarks of Bowden[626] who stated that the OCIE

[619]Robinson, D.T. and Sensoy, B.A. (2013), 'Do private equity fund managers earn their fees? Compensation, ownership, and cash flow performance', Review of Financial Studies, 26(11), at pages 2760-2797.
[620]Robinson, D.T. and Sensoy, B.A. (2013), 'Do private equity fund managers earn their fees? Compensation, ownership, and cash flow performance', Review of Financial Studies, 26(11), at pages 2760-2797.
[621]Robinson, D.T. and Sensoy, B.A. (2013), 'Do private equity fund managers earn their fees? Compensation, ownership, and cash flow performance', Review of Financial Studies, 26(11), at pages 2760-2797.
[622]Hussein, A. (2015), 'Conflicts, Conflicts Everywhere: When 'No Harm, No Foul' is Not a Defense', 30th April 2015, for the Private Equity Growth Capital Council (PEGCC). Available at http://www.pegcc.org/newsroom/in-the-news/conflicts-conflicts-everywhere-when-no-harm-no-foul-is-not-a-defense/#_ftn3, accessed in May 2015.
[623]Hussein, A. (2015), 'Conflicts, Conflicts Everywhere: When 'No Harm, No Foul' is Not a Defense', 30th April 2015, for the Private Equity Growth Capital Council (PEGCC). Available at http://www.pegcc.org/newsroom/in-the-news/conflicts-conflicts-everywhere-when-no-harm-no-foul-is-not-a-defense/#_ftn3, accessed in May 2015.
[624]Rendón, V.E., Fleishhacker, E.K., Lavin, K.J., Esser, M.B. and Kurzman, J.S. (2014), 'Private Equity Management of Fees and Expenses: A Cautionary Tale', Arnold and Porter LLP, May 2014, at page 1.
[625]Rendón, V.E., Fleishhacker, E.K., Holton, R.E. and Sylvester, M.E. (2014), 'New Developments in the SEC Focus on Private Funds', Arnold and Porter LLP, December 2014, at page 1.
[626]Bowden, A.J. (2014), 'Spreading Sunshine in Private Equity', remarks of Bowden, A.J., Director, Office of Compliance, Inspections and Examinations, Private Equity International (PEI), Private Fund Compliance Forum, NY 6th May 2014. Available at http://www.sec.gov/News/Speech/Detail / Speech/1370541735361#, accessed in May 2015.

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found extensive evidence of insufficiently disclosed fees in the private equity industry, particularly payments to consultants;[627] expenses shifted from a private equity firm to the private equity fund sometime after the private equity fund's inception;[628] the characterisation of expenses (traditionally regarded as being part of the management fee) as fund expenses;[629] and a variety of hidden fees.[630] Therefore, despite the extensive negotiation of the terms and conditions of the fund agreements between the private equity firm and its investors, such agreements often still lack sufficient detail regarding the disclosure and allocation of fees and expenses.[631] Rendón *et al* state that:

> 'Undisclosed fees and expenses may run afoul of the securities laws, creating the risk of both regulatory actions and investor lawsuits based on claims of purported fraud, misrepresentation, breach of fiduciary duty and breach of limited partnership agreements. Although the typical rule is that a fact is material and must be disclosed if there is a substantial likelihood that the disclosure of this omitted fact would be viewed by a reasonable investor as important to its investment, there is the prospect that the SEC or investors may claim that any undisclosed allocation of fees and expenses is material.'[632]

Riewe goes on to state that in the context of conflicts of interest, that there is:

[627]Consultants, also known as 'operating partners', are individuals whom the private equity firm engages to provide assistance to underlying portfolio investee companies. Operating partners often appear to investors to be employees of the private equity firm. However, unlike actual employees of the private equity firm (the expense of which is generally borne by the private equity firm), they are either paid directly by the portfolio companies they advise or their compensation is expensed to the private equity fund, and such payments do not reduce the management fee paid by the private equity fund to the private equity firm. According to the SEC, this arrangement is often not sufficiently disclosed to investors. See Rendón, V.E., Fleishhacker, E.K., Lavin, K.J., Esser, M.B. and Kurzman, J.S. (2014), 'Private Equity Management of Fees and Expenses: A Cautionary Tale', Arnold and Porter LLP, May 2014, at page 2.

[628]For example, the private equity firm shifts expenses from the private equity firm to the private equity fund in the middle of the fund's life, without disclosure to the investors. In certain cases, a private equity firm will hire an individual as its employee during the fundraising phase, only later to terminate and rehire the individual as a consultant' or an 'operating partner', whose fees are paid by the private equity fund or by the underlying portfolio investee company rather than the private equity firm. See Rendón, V.E., Fleishhacker, E.K., Lavin, K.J., Esser, M.B. and Kurzman, J.S. (2014), 'Private Equity Management of Fees and Expenses: A Cautionary Tale', Arnold and Porter LLP, May 2014, at page 2.

[629]For example, a private equity firm bills the private equity fund for various functions that the private equity firm should perform in exchange for the management fee, such as certain regulatory compliance, accounting and investor reporting functions. However, private equity firms sometime change the characterization of such expenses from private equity firm expenses to private equity fund expenses without proper disclosure to investors. See Rendón, V.E., Fleishhacker, E.K., Lavin, K.J., Esser, M.B. and Kurzman, J.S. (2014), 'Private Equity Management of Fees and Expenses: A Cautionary Tale', Arnold and Porter, May 2014, at page 2.

[630]For example, certain fees are not disclosed to the private equity fund investors, such as transaction fees not contemplated by the private equity fund agreements that regulate the relationship between the private equity firm and investors. See Rendón, V.E., Fleishhacker, E.K., Lavin, K.J., Esser, M.B. & Kurzman, J.S. (2014), 'Private Equity Management of Fees and Expenses: A Cautionary Tale', Arnold and Porter LLP, May 2014, at page 2.

[631]See Berman, K., Larkin, G., Giglio, P.V., Berthou, E., Harrell, M P., Murray, J.C. and Kittredge, G. (2015), 'Expense allocation: the SEC brings down the hammer', Journal of Investment Compliance, 16(1).

[632]Rendón, V.E., Fleishhacker, E.K., Lavin, K.J., Esser, M.B. and Kurzman, J.S. (2014), 'Private Equity Management of Fees and Expenses: A Cautionary Tale', Arnold and Porter LLP, May 2014, at pages 1-2.

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> 'no exception to disclosure: no 'well-meaning or good-faith adviser' exception for an investment adviser that legitimately believes it is putting its clients' interests first notwithstanding any conflicts; no 'mitigation' exception for an investment adviser that believes it has taken adequate internal measures to account for potentially incompatible interests; and no 'potential conflict' exception for an investment adviser that did not act upon the conflict to enrich itself at the expense of its clients.'[633]

Hussien, referring to the remarks of Riewe quoted above, state:

> 'Differently said, 'no harm, no foul' is not a defense; a manager ought to be identifying, disclosing and mitigating all conflicts of interest.'[634]

Two important enforcement action cases in this regard was brought by the SEC in 2014, namely *Securities Exchange Commission (SEC) (US) v Clean Energy Capital, LLC and Scott A. Brittenham;*[635] ('Clean Energy') and *Securities Exchange Commission (SEC) (US) v Lincolnshire Management, Inc.*[636] ('Lincolnshire'). In the Clean Energy case,[637] the SEC brought charges against Clean Energy Capital, LLC ('CEC') and its main portfolio manager, Scott Brittenham.[638] The SEC alleged that CEC and Brittenham improperly allocated more than $3 million of CEC's expenses to certain private equity funds that CEC managed. The SEC alleged that such allocations were made without adequate disclosure to investors, and therefore constituted a misappropriation of assets from the CEC funds.[639] Such alleged improper expenses included the salaries of the majority of CEC employees, executive bonuses, health benefits, retirement benefits and rent.[640] These kinds of expenses are typically paid by the private equity firm out of the management fees that it receives from the private equity fund, rather than charged to the private equity fund. The SEC also alleged that CEC and Mr. Brittenham secretly caused the private equity funds to borrow money to pay the

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[633]Riewe, J. (2014), 'Conflicts, Conflicts Everywhere', remarks to IA Watch 17th Annual IA Compliance Conference: The Full 360 View, Julie M. Riewe is Co-Chief, Asset Management Unit, Division of Enforcement of the SEC, Washington, DC, 26th February 2015. Available at www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html, accessed in May 2015.
[634]Hussein, A. (2015), 'Conflicts, Conflicts Everywhere: When 'No Harm, No Foul' is Not a Defense', 30th April 2015, for the Private Equity Growth Capital Council (PEGCC). Available at http://www.pegcc.org/newsroom/in-the-news/conflicts-conflicts-everywhere-when-no-harm-no-foul-is-not-a-defense/#_ftn3, accessed in May 2015.
[635]*Securities Exchange Commission (SEC) (US) v Clean Energy Capital, LLC and Scott A. Brittenham*, (Respondents), Investment Advisers Act of 1940, SEC Release No. 9551, 2014 WL 709469, February 2014.
[636]*Securities Exchange Commission (SEC) (US) v Lincolnshire Management, Inc.*, (Respondents), Investment Advisers Act of 1940, SEC Release No. 3927, September 22, 2014.
[637]*Securities Exchange Commission (SEC) (US) v Clean Energy Capital, LLC and Scott A. Brittenham*, (Respondents), Investment Advisers Act of 1940, SEC Release No. 9551, 2014 WL 709469, February 2014.
[638]On 25th February 25, 2014 the SEC instituted proceedings pursuant to Section 8A of Securities Act of 1933, Sections 15(b) and 21C of Securities Exchange Act of 1934, Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of Investment Company Act of 1940 against Clean Energy Capital, LLC and Scott A. Brittenham.
[639]Available at www.sec.gov/litigation/admin/2014/33-9667.pdf, accessed in May 2015.
[640]Available at www.sec.gov/litigation/admin/2014/33-9667.pdf, accessed in May 2015.

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expenses from CEC at unfavorable rates, pledging the funds' own assets as collateral.[641] Initially, CEC refuted the SEC's charges and may have prevailed in the action, however on 17th October 2014 CEC and Brittenham agreed to pay $2.2 million to settle the action.[642] CEC and Brittenham neither admitted nor denied the final charges, which were listed in the settlement as fraud caused by negligence, a shift from the SEC's initial charges of intentional fraud.[643] According to Rendón *et al*, despite the allegations in the CEC case being extreme:

> 'any undisclosed fees or expense allocations may be deemed to run afoul of the securities laws, particularly in the context of an SEC regime that is strongly enforcement-oriented. Undisclosed fees and expense allocations put private equity fund managers at risk of both regulatory action and investor lawsuits based on claims of purported fraud, misrepresentation, breach of fiduciary duty and breach of limited partnership agreements.'[644]

In the Lincolnshire case,[645] the SEC entered a cease and desist order against Lincolnshire Management Inc. finding among other things, that it violated Section 206(2) of the Investment Advisers Act of 1940 by breaching its fiduciary duty owed to its funds.[646] The SEC charged Lincolnshire Management Inc. with failing to allocate expenses properly after Lincolnshire Management Inc. integrated portfolio companies of two affiliated private equity funds, which did have common ownership, and managed the two portfolio companies together, with the two companies sharing certain annual expenses based on each company's contributions to their combined revenue.[647] The SEC charged that this expense allocation policy was not properly followed. The SEC's argument was that the co-mingling of assets across different private equity funds must be done in a manner that satisfies the private equity firm's fiduciary duties to each fund and that prevents one private equity fund from benefiting to the detriment of the other. Although Lincolnshire Management Inc. never admitted to the charges, which included a failure to adopt and implement written policies and procedures reasonably designed to prevent the violation of section 206(4) and Rule 206(4)-7 of the Investment Advisers Act of 1940, Advisers Act violations, Lincolnshire

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[641] Available at www.sec.gov/litigation/admin/2014/33-9667.pdf, accessed in May 2015.
[642] Rendón, V.E., Fleishhacker, E.K., Holton, R.E. and Sylvester, M.E. (2014), 'New Developments in the SEC Focus on Private Funds', Arnold and Porter LLP, December 2014, at page 2.
[643] Rendón, V.E., Fleishhacker, E.K., Holton, R.E. and Sylvester, M.E. (2014), 'New Developments in the SEC Focus on Private Funds', Arnold and Porter LLP, December 2014, at page 2.
[644] Rendón, V.E., Fleishhacker, E.K., Lavin, K.J., Esser, M.B. and Kurzman, J.S. (2014), 'Private Equity Management of Fees and Expenses: A Cautionary Tale', Arnold and Porter LLP, May 2014, at page 2.
[645] *Securities Exchange Commission (SEC) (US) v Lincolnshire Management, Inc.*, (Respondents), Investment Advisers Act of 1940, SEC Release No. 3927, September 22, 2014. On 22nd September 2014, the SEC deemed it appropriate that cease-and-desist proceedings be instituted pursuant to Section 203(k) of the Investment Advisers Act of 1940 against Lincolnshire Management Inc., being the Respondent.
[646] The SEC also contended that Lincolnshire Management Inc. violated Section 206(4) and Rule 206(4)-7 of the Investment Advisers Act of 1940 separately by failing to adopt and implement written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940 arising from integrating two portfolio companies owned by separately advised Lincolnshire Management Inc. private equity funds.
[647] Available at http://www.sec.gov/litigation/admin/2014/ia-3927.pdf, accessed in May 2015.

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Management Inc. was ordered to cease and desist from such violations, and agreed to pay the SEC $2.3 million to settle the charges.[648] The allegations in both the above mentioned cases are extreme in nature. The cases were settled before going to trial and it would have been interesting to see the US courts response thereto. What is clear though is that the SEC in the US is taking the allocation of fees and expenses seriously and is prepared to take appropriate action where necessary. According to Rendón *et al*, the golden rule of disclosure in the private equity business model is that:

> 'if there is a substantial likelihood that the disclosure of an omitted fact would be viewed by a reasonable investor as important to its investment decision, then the fact is material and disclosure is required. Depending on the circumstances … any allocation of fees and expenses to the fund or its portfolio companies that is not fully disclosed is material.'[649]

Therefore it is important for private equity firms to adopt expense allocation policies and to take steps to ensure that expenses are allocated in accordance with those policies. In addition, private equity firms should ensure that they and the underlying portfolio companies also have written policies in place designed to allocate all expenses.[650] It will also be interesting to see whether or not South African policy makers, the local private equity industry body and/or the local Regulator will respond to the US example in reviewing how private equity firms disclose the allocation of fees and expenses to their investors. If they do, the next question would be how they intend implementing such a review.

4.3 Active Ownership

It is evident from the contents of the earlier discussions[651] that a key element of the private equity investment model is value creation through active ownership. For example, earlier it was stated that:

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[648]Rendón, V.E., Fleishhacker, E.K., Holton, R.E. and Sylvester, M.E. (2014), 'New Developments in the SEC Focus on Private Funds', Arnold and Porter LLP, December 2014, at pages 2-3.

[649]Rendón, V.E., Fleishhacker, E.K., Lavin, K.J., Esser, M.B. and Kurzman, J.S. (2014), 'Private Equity Management of Fees and Expenses: A Cautionary Tale', Arnold and Porter LLP, May 2014, at page 3.

[650]Robinson, D.T. and Sensoy, B.A. (2013), 'Do private equity fund managers earn their fees? Compensation, ownership, and cash flow performance', Review of Financial Studies, 26(11), at pages 2760-2797.

[651]Paragraph 2 of this chapter defined private equity and in so doing active ownership was highlighted as a key element central to the definition of private equity. Secondly, paragraph 3 of chapter one discussed the various types of private equity transactions and it is evident that the private equity firm is the most important role player with regard to private equity investing because it plays an active role in raising money from investors; sourcing and executing private equity investments; and actively managing the private equity fund's interest in such investments; and finally exiting the private equity fund's interest from such investments. Thirdly, in paragraph 4.1 of this chapter it is also evident that the remuneration model of private equity firms have evolved based on the underlying principle of active ownership, particularly when it comes to justifying a private equity firm's primary source of remuneration, namely carried interest.

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> 'The key characteristics of private equity investing can be highlighted as being that it requires equity participation; there is value added through active and ongoing involvement with the companies in which they invest; and that the investment objectives are of a long-term nature.'[652]

It was also earlier argued (quoting Wright *et al*[653]) that the structuring of a management buyout should include the introduction of significant equity incentives for the incumbent management involved, together with substantial external funding and active monitoring by investors, such the private equity firm.[654] Earlier in paragraph 2 of this chapter, the common characteristic in all the various definitions of private equity was active ownership. For example, an extract of the Emerging Markets Private Equity Association (EMPEA) definition of private equity reads:

> 'Given the core facets of the PE model – active ownership, often of minority stakes, in private businesses seeking not only capital but also enhanced governance or more professionalized management, over a period of several years.'[655]

In addition, an extract of the Australian Private Equity and Venture Capital Association Limited (AVCAL) definition of private equity reads:

> 'Both involve active involvement by the investor in the governance and management of the investee business and both contemplate, at the time of investment, the subsequent sale of the investment rather than the indefinite retention of it.'[656]

Therefore, as mentioned earlier in paragraph 3 of this chapter, private equity firms select portfolio companies at various stages of development into which they invest money and thereby acquire shareholder rights.[657] The financing of the company is restructured to align better the incentives of management and investors and increase the potential for growth and value creation.[658] Representatives from the private equity firm, often highly experienced in the industry of the portfolio company, take a very active governance role in directing the company's strategy and supervising

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[652]At page 17 earlier, quoting Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', 2nd edition, Elsevier Inc.

[653]Wright, M.S., Robbie, K., Thompson, S. and Starkey, K. (1994), 'Longevity and the life cycle of MBOs', Strategic Management Journal 15, at pages 215-27.

[654]At paragraph 3.2 of this chapter.

[655]Emerging Markets Private Equity Association (EMPEA) definition of private equity, as stated at paragraph 2 earlier in this chapter 1. Available at http://empea.org/resources/facts-about-pe/, accessed in April 2015.

[656]Australian Private Equity and Venture Capital Association Limited (AVCAL), (2007), 'Private Equity in Australia', Submission to the Senate Standing Committee on Economics, May 2007, at page 8, paragraph 5.1. As stated at page 14 of paragraph 2 earlier in this chapter 1.

[657]Wright, M.S., Robbie, K., Thompson, S. and Starkey, K. (1994), 'Longevity and the life cycle of MBOs', Strategic Management Journal 15, at pages 215-27.

[658]Wright, M.S., Robbie, K., Thompson, S. and Starkey, K. (1994), 'Longevity and the life cycle of MBOs', Strategic Management Journal 15, at pages 215-27.

management, though leaving day-to-day operational control to managers.[659] When the value creation plans have been executed and the companies are ready to move into the next development stage, the private equity firm will evaluate the best point at which to realise the value built up in the underlying portfolio investee company, at which point the private equity firm will divest the private equity fund's interest in the investee company.[660]

Private equity firms conduct extensive due diligence on each prospective investment for the private equity fund and secure any other financing that might complement the equity investment. Thereafter they act as very engaged non-executive directors to the company, with strong participation in determining the composition of the board, deployment of management incentive systems, selection, support and revision of management teams, development of strategy, monitoring of performance and in the introduction of best management practices.[661] According to Bloom *et al*, the active ownership by private equity firms often lead to better management practices and higher productivity growth.[662] This published study of four thousand manufacturing firms in Europe, the US and Asia showed that private equity owned firms had better management practices than firms under any other type of ownership.[663] A second study of US manufacturing firms demonstrates that private equity owned firms increase productivity two percentage points above non-private equity owned firms within two years and more than seventy percent of this outperformance is the result of better management of existing facilities.[664] In addition, Lerner *et al* looked at the impact of ownership structures on research and development (R and D) investments.[665] Their research shows that private equity owned companies are more effective investors in research and development than listed companies. The study analysed four hundred and ninety five firms and found that companies that undergo a buyout, pursue more economically important innovations as measured by patent citations in the years after private equity investment.[666]

This active ownership principle has been subject to criticism, largely because of the general view that there is often a misalignment of interest between private equity firms and the investors whose money they manage; and there is also often a misalignment between the interests of the private

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[659]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', 2nd edition, Elsevier Inc.
[660]The 'exiting' of private equity investments are discussed in paragraph 3 of chapter four.
[661]Acharya, V., Hahn, M., and Kehoe, C., (2009), 'Corporate Governance and Value Creation: Evidence from Private Equity', Centre for Economic Policy Research (CEPR), January 2009.
[662]Bloom, N., Sadun, R., and Van Reenen, J., (2009), 'Do Private Equity Owned Firms Have Better Management Practices?', The Global Economic Impact of Private Equity Report 2009.
[663]Bloom, N., Sadun, R., and Van Reenen, J., (2009), 'Do Private Equity Owned Firms Have Better Management Practices?', The Global Economic Impact of Private Equity Report 2009.
[664]Gurung, A. and Lerner, J. (2009), 'Private Equity, Jobs & Productivity', Economic Impact of Private Equity Report 2009.
[665]Lerner, J., Sorensen, M. and Strömberg, P., (2008), 'Private Equity and Long-Run Investment: The Case of Innovation', The Global Economic Impact of Private Equity Report 2008.
[666]Lerner, J., Sorensen, M. and Strömberg, P., (2008), 'Private Equity and Long-Run Investment: The Case of Innovation', The Global Economic Impact of Private Equity Report 2008.

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equity firm and the interest of the underlying portfolio investee companies within which the private equity firm's invest.[667] For example with regard to the misalignment of interest between the private equity firm and the underlying portfolio company, the general view is that private equity firms often engage in asset stripping by selling off important parts of the portfolio companies, without having due regard for the longer term viability of the remaining entity.[668] However, a response to such a criticism could be that often a company needs to undertake necessary restructuring by, for example, closing unprofitable business and/or product lines to preserve cash and defend its market position in order to guarantee long-term survival.[669] Another response could be that a company that sells off a non-essential part of its operations at a fair price to a better owner is acting economically rationally and in almost all cases in the best interests of all parties.[670] According to Davis *et al*, private equity owned companies in the US do divest more relative to non-private equity owned firms, but on the other hand they acquire more than non-private equity owned firms.[671] Acharya *et al*, analysed sixty six of the three hundred and fifty UK transactions whose value exceeded €100 million for the period 1996 to 2004.[672] This study showed that while there were significant divestments in thirteen of the transactions, sixteen involved significant acquisitions by the portfolio company; the balance of the thirty seven transactions had neither significant acquisitions nor divestments.[673] So the evidence is that private equity both divests and acquires more as they restructure the companies they own with a view of enhancing their value.[674] Therefore it is submitted that private equity creates returns by developing more focused, better managed, operationally stronger companies with better prospects for long-term development and growth.[675]

As mentioned earlier in paragraph 4 of this chapter, the private equity investment model has been criticised at two levels. Firstly, at the underlying portfolio investee company level and secondly, at the level of the private equity fund. At both levels, a common criticism has been the lack of transparency and disclosure of information by private equity firms and their investors; and the conflict of interests of the private equity firm with those of the investors whose money the private equity firm

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[667]Cumming, D.J., and Johan, S.A. (2007), 'Regulatory Harmonization and the Development of Private Equity Markets', Journal of Banking and Finance, Volume 31, at pages 3218-3250.
[668]Cumming, D.J., and Johan, S.A. (2007), 'Regulatory Harmonization and the Development of Private Equity Markets', Journal of Banking and Finance, Volume 31, at pages 3218-3250.
[669]Gurung, A. and Lerner, J., (2009), 'Private Equity, Jobs & Productivity', Economic Impact of Private Equity Report 2009.
[670]Cumming, D.J., and Johan, S.A. (2007), 'Regulatory Harmonization and the Development of Private Equity Markets', Journal of Banking and Finance, Volume 31, at pages 3218-3250.
[671]Davis, S.J., Haltiwanger, J.C., Jarmin, R.S., Lerner, J. and Miranda, J. (2008), 'Private Equity and Employment', The Global Economic Impact of Private Equity Report 2008.
[672]Acharya, V., Hahn, M., and Kehoe, C., (2009), 'Corporate Governance and Value Creation: Evidence from Private Equity', Centre for Economic Policy Research (CEPR), January 2009.
[673]Acharya, V., Hahn, M., and Kehoe, C., (2009), 'Corporate Governance and Value Creation: Evidence from Private Equity', Centre for Economic Policy Research (CEPR), January 2009.
[674]Acharya, V., Hahn, M., and Kehoe, C., (2009), 'Corporate Governance and Value Creation: Evidence from Private Equity', Centre for Economic Policy Research (CEPR), January 2009.
[675]Gurung, A. and Lerner, J., (2009), 'Private Equity, Jobs & Productivity', Economic Impact of Private Equity Report 2009.

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manages.[676] Also in paragraph 4.2 of this chapter it is evident that there is a developing trend towards an increased focus on conflicts of interest with respect to private equity firms. For instance, Hussein argues that in the US, the SEC has made it clear that it views conflicts as material and that private equity firms, as fiduciaries to their clients, must disclose them.[677] This is evident from the case *Securities Exchange Commission (SEC) (US) v BlackRock Advisors, LLC and Bartholomew A. Battista,*[678] whereby the SEC charged BlackRock with breaching its fiduciary duty by failing to disclose a conflict of interest created by the outside business activity of one of its portfolio managers (Daniel Rice).[679] According to the SEC's order instituting a settled administrative proceeding, Daniel Rice was managing energy-focused funds and separately managed accounts at BlackRock when he founded Rice Energy, a family-owned and operated oil-and-natural gas company.[680] Daniel Rice was the fund manager of Rice Energy and personally invested approximately $50 million in the company. Daniel Rice's three sons were the CEO, CFO, and VP of Geology of Rice Energy. In February 2010, Rice Energy formed a joint venture with Alpha Natural Resources, Inc. ('ANR'), a publicly-traded coal company held in the BlackRock funds and accounts managed by Rice.[681] By 30th June 2011, ANR shares was the largest holding (9.4 percent) in the Rice-managed $1.7 billion BlackRock Energy and Resources Portfolio, primarily as a result of ANR acquiring two other public companies held in that portfolio. The SEC's order finds that BlackRock knew and approved of Daniel Rice's investment and involvement with Rice Energy as well as the joint venture, but failed to disclose this conflict of interest to either the boards of the BlackRock registered funds or its advisory clients. The SEC's contention was that BlackRock violated its fiduciary obligation to eliminate the conflict of interest created by Daniel Rice's outside business activity or otherwise disclose it to BlackRock's fund boards and advisory clients. The SEC's argument was that by failing to make such a disclosure, BlackRock deprived its clients of their right to exercise their independent judgment to determine whether the conflict might impact portfolio management decisions.[682]

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[676]Chapter three will more fully examine these criticisms as part of the discussion on the corporate governance considerations for private equity. However, the discussion in chapter three will be restricted to the risks inherent to the private equity fund investors from potential conflicts of interest which may exist within the private equity firm or within the private equity fund and will outline possible mitigating measures alongside the potential conflict of interest risks.

[677]Hussein, A. (2015), 'Conflicts, Conflicts Everywhere: When 'No Harm, No Foul' is Not a Defense', 30th April 2015, for the Private Equity Growth Capital Council (PEGCC). Available at http://www.pegcc.org/newsroom/in-the-news/conflicts-conflicts-everywhere-when-no-harm-no-foul-is-not-a-defense/#_ftn3, accessed in May 2015.

[678]*Securities Exchange Commission (SEC) (US) v BlackRock Advisors, LLC and Bartholomew A. Battista*, Investment Advisers Act of 1940, SEC Release No. 4065, Investment Company Act of 1940, SEC Release No. 31558, April 2015.

[679]The SEC instituted public administrative and cease-and-desist proceedings pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, and Sections 9(b) and 9(f) of the Investment Company Act of 1940 against BlackRock Advisors, LLC and pursuant to Section 203(k) of the Advisers Act and Section 9(f) of the Investment Company Act against Bartholomew A. Battista (together being the Respondents).

[680]Available at www.sec.gov/litigation/admin/2015/ia-4065.pdf, accessed in May 2015, at page 2.

[681]Available at www.sec.gov/litigation/admin/2015/ia-4065.pdf, accessed in May 2015, at page 2.

[682]Available at www.sec.gov/litigation/admin/2015/ia-4065.pdf, accessed in May 2015, at page 2.

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The SEC's order also found that BlackRock and its then-chief compliance officer Bartholomew Battista caused the funds' failure to report a 'material compliance matter', namely Rice's violations of BlackRock's private investment policy, to their boards of directors.[683] The SEC's contention was that BlackRock failed to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940 and the rules thereunder, as required by Section 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-7 thereunder, concerning the outside activities of its employees, including how they should be assessed and monitored for conflict purposes, and when an employee's outside activity should be disclosed to the BlackRock funds' board of directors or to BlackRock advisory clients.[684] BlackRock's chief compliance officer Bartholomew Battista was held to have caused BlackRock's this compliance-related violations.[685]

The SEC's order also found that BlackRock and Battista caused the registered funds' failure to have the funds' chief compliance officer report to the funds' boards of directors, which was in violation of Rule 38a-1(a)(4)(iii)(B) under the Investment Company Act of 1940, Daniel Rice's violations of BlackRock's private investment policy.[686] The SEC's view was that BlackRock and Battista knew about Rice's violations, and knew or should have known that they were not reported to the funds' boards.[687] *Securities Exchange Commission (SEC) (US) v BlackRock Advisors, LLC and Bartholomew A. Battista,*[688] is the first SEC case to charge violations of Rule 38a-1(a)(4)(iii)(B) of the Investment Company Act of 1940 in the US for failing to report a material compliance matter such as violations of the private equity firm's policies and procedures to a fund board.[689] The SEC's argument is that BlackRock and Battista caused the funds' failure to report Rice's violations of BlackRock's private investment policy and denied the funds' boards critical compliance information alerting them to Rice's outside business interests.[690]

Similarly to the two previous cases discussed earlier in paragraph 4.2 of this chapter,[691] BlackRock agreed to be censured and consented to the entry of the SEC's order finding that the firm willfully violated Sections 206(2) and 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-

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[683]Available at www.sec.gov/litigation/admin/2015/ia-4065.pdf, accessed in May 2015, at page 2.
[684]Available at www.sec.gov/litigation/admin/2015/ia-4065.pdf, accessed in May 2015, at page 2.
[685]Available at www.sec.gov/litigation/admin/2015/ia-4065.pdf, accessed in May 2015, at page 2.
[686]Available at www.sec.gov/litigation/admin/2015/ia-4065.pdf, accessed in May 2015, at page 2.
[687]Available at www.sec.gov/litigation/admin/2015/ia-4065.pdf, accessed in May 2015, at page 2.
[688]*Securities Exchange Commission (SEC) (US) v BlackRock Advisors, LLC and Bartholomew A. Battista*, Investment Advisers Act of 1940, SEC Release No. 4065, Investment Company Act of 1940, SEC Release No. 31558, April 2015.
[689]Available at www.sec.gov/news/pressrelease/2015-71.html, accessed in May 2015.
[690]Available at www.sec.gov/news/pressrelease/2015-71.html, accessed in May 2015.
[691]*Securities Exchange Commission (SEC) (US) v Lincolnshire Management, Inc.*, Investment Advisers Act of 1940, SEC Release No 3927, September 2014 and *Securities Exchange Commission (SEC) (US) v Clean Energy Capital, LLC and Scott A. Brittenham*, (Respondents), Investment Advisers Act of 1940, SEC Release No. 9551, 2014 WL 709469, February 2014.

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7.[692] The order finds that the firm caused violations of Rule 38a-1 of the Investment Company Act of 1940.[693] Battista also consented to the entry of the order finding that he caused violations of Section 206(4) of the Advisers Act, Rule 206(4)-7, and Rule 38a-1.[694] BlackRock and Battista were required to cease and desist from committing or causing any further violations, however BlackRock and Battista neither admitted nor denied the findings. In the end, BlackRock agreed to settle the charges and pay a $12 million penalty and Battista agreed to pay a $60,000 penalty to settle the charges against him. In addition, BlackRock agreed to engage an independent compliance consultant to conduct an internal review.[695]

As mentioned at the beginning of this paragraph, a key element of the private equity investment model is value creation through active ownership. This is largely due to the fact that representatives from the private equity firm, often highly experienced in the industry of the underlying portfolio investee company, take a very active role in the company, though leaving day-to-day operational control to the company's managers. In addition, various academic studies mentioned above indicate that private equity investing creates value in portfolio companies; and that private equity backed companies grow employment, sales and assets faster than comparable firms without private equity backing.[696] However, this active ownership principle has been subject to criticism as highlighted above, largely because of the general view that there is a misalignment of interest between private equity firms and the investors whose money they manage.

5. Conclusion

It is evident from the above discussion that private equity is multi-faceted and a complex business that requires a wide range of legal, financial and business skills. It is important for policymakers to understand the fundamentals of private equity as an asset class because it forms an important part of the financial markets and can significantly enhance capital market efficiency.[697] Private equity can

[692]Available at www.sec.gov/news/pressrelease/2015-71.html, accessed in May 2015.
[693]Available at www.sec.gov/news/pressrelease/2015-71.html, accessed in May 2015.
[694]Available at www.sec.gov/news/pressrelease/2015-71.html, accessed in May 2015.
[695]Available at www.sec.gov/news/pressrelease/2015-71.html, accessed in May 2015.
[696]Achleitner, A.K. and Klockner, O., (2005), 'Employment contribution of Private Equity and Venture Capital in Europe', European Venture Capital Association, November 2005. For example, private equity firms are able to support portfolio companies in their innovation led growth by bringing experience and expertise in supporting growing firms and commercialising new technologies and business models. See also Acharya, V., Hahn, M., and Kehoe, C., (2009), 'Corporate Governance and Value Creation: Evidence from Private Equity', Centre for Economic Policy Research (CEPR), January 2009. See also Gurung, A. and Lerner, J., (2009), 'Private Equity, Jobs and Productivity', The Global Economic Impact of Private Equity Report 2009. See also Davis, S.J., Haltiwanger, J.C., Jarmin, R.S., Lerner, J. and Miranda, J. (2008), 'Private Equity and Employment', The Global Economic Impact of Private Equity Report 2008. See also Lerner, J., Sorensen, M. and Strömberg, P., (2008), 'Private Equity and Long-Run Investment: The Case of Innovation', The Global Economic Impact of Private Equity Report 2008. See also Bloom, N., Sadun, R., and Van Reenen, J., (2009), 'Do Private Equity Owned Firms Have Better Management Practices?', The Global Economic Impact of Private Equity Report 2009.
[697]Lerner, J., Sorensen, M. and Strömberg, P. (2011), 'Private equity and long-run investment: The case of innovation', The Journal of Finance, 66(2), at pages 445-477.

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widen the availability of capital, increase the effectiveness of company valuations, identify companies with significant growth potential and facilitate their transformation.[698] South African policy makers should bear in mind the significant variation in the level and form of regulation of private equity in different jurisdictions around the globe and should be conscious of the need to ensure that its regime is effective. Over-regulation can be detrimental to capital market efficiency, but too little regulation can damage market confidence. South African policy makers as part of their ongoing regulatory approach should aim to maintain the competitive position of the South African capital markets, of which the private equity market has become an important part.

It would be fair to state that South Africa faces two crucial challenges. South Africa needs more new companies that (a) can compete internationally and facilitate economic growth in sub-Saharan Africa, and (b) address the major issue of unemployment. The above-mentioned is reaffirmed by the South African government's vision for its economy, captured in the Integrated Manufacturing Strategy ('IMS') of the Department of Trade and Industry.[699] The IMS states that South Africa needs an economy that can sustainably meet the needs of all its citizens. The policy document on South Africa's company law reform stated that a key role for government is to ensure that the regulatory framework within which enterprises operate promotes growth, employment, innovation, stability, good governance, confidence and international competitiveness.[700] Furthermore, the South African Government's National Development Plan ('NDP') states that the private sector employs about three-quarters of South Africa's workers and accounts for over two thirds of investment and research and development ('R and D') expenditure.[701] The NDP states that:

> 'South Africa needs a thriving private sector that is investing in productive capacity. While the profit motive drives business, companies cannot grow unless they operate in an environment where employment and income levels are rising. Legislation requires business to consider employment equity, black economic empowerment, the environment, skills development, local content, small-business development, community social responsibility and several location-specific imperatives, such as mining area development strategies. In this complex context, it is in the long-term interests of all businesses for the country to grow faster and for more people to be employed.'[702]

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[698] Lerner, J., Sorensen, M. and Strömberg, P. (2011), 'Private equity and long-run investment: The case of innovation', The Journal of Finance, 66(2), at pages 445-477.
[699] Available at www.gov.za/sites/www.gov.za/files/ims_0.pdf, accessed at May 2015.
[700] Department of Trade and Industry (2004), 'South African Company Law for the 21st Century: Guidelines for Corporate Law Reform', Report presented by the Department of Trade and Industry, Pretoria, South Africa.
[701] South African Government, National Planning Commission (2013), 'National Development Plan 2030: Executive Summary', The Department of the Presidency of the South African Government, at pages 47-48. Available at http://www.gov.za/sites/www.gov.za/files/Executive%20Summary-NDP%202030%20-%20Our%20future%20-%20make%20it%20work.pdf, accessed in May 2015.
[702] South African Government, National Planning Commission (2013), 'National Development Plan 2030: Executive Summary', The Department of the Presidency of the South African Government, at pages 47-48.

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Private equity can to a large extent afford considerable economic and employment benefits that address these challenges. Policymakers around the world have tried to duplicate the success of the US private equity market because they believe that private equity spurred innovation, led to the formation of new companies and employment growth in the US, and can do so elsewhere. This is an important premise of this thesis, particularly in light of the prevailing socio-economic and political debate in South Africa. As discussed earlier,[703] the claim that private equity spurs economic growth via innovation and employment growth is supported by the results of two leading studies by Kortum and Lerner[704] and Belke *et al*[705]. Kortum and Lerner[706] set out to evaluate the common premise that private equity has a profound impact on innovation. Before Kortum and Lerner's article, the purported relationship between private equity and innovation, however, had not been systematically scrutinized. These authors addressed this omission by exploring the experience of twenty industries covering the US manufacturing sector over the three-decade period. They first examined, in reduced-form regressions, whether, controlling for R and D spending, the amount of private equity funding has an impact on the number of patented innovations. They found that private equity disbursements are associated with a significant increase in patenting.[707]

Whereas Kortum and Lerner attempted to answer the question of whether private equity fosters innovation; Belke *et al* go one step further in examining the premise that private equity is crucial for financing structural change, new firms and innovations and therefore possibly also for employment growth.[708] The authors argue that the ability of a country to encourage and sustain innovation by firms is one of the main sources of economic and employment growth. In addition, logic suggests that private equity firms have a key role to play in this respect because they have often been able to provide promising companies with adequate risk financing.[709] The authors highlight that economists in the past have not paid attention to the possibility of a virtuous circle between entrepreneurial dynamism, innovative start-ups, and a dynamic private equity industry and job creation.[710]

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[703]Department of Trade and Industry (2004), 'South African Company Law for the 21st Century: Guidelines for Corporate Law Reform', Report presented by the Department of Trade and Industry, Pretoria, South Africa, at pages 9-10.
[704]Kortum, S. and Lerner, J. (1998), 'Does Venture Capital Spur Innovation?', NBER Working Papers 6846, National Bureau of Economic Research, Inc.
[705]Belke, A., Fehn, R., and Foster, N., (2003), 'Does Venture Capital Investment Spur Employment Growth?', CESifo Working Paper Series No. 930.
[706]Kortum, S. and Lerner, J. (1998), 'Does Venture Capital Spur Innovation?', NBER Working Papers 6846, National Bureau of Economic Research, Inc.
[707]Kortum, S. and Lerner, J. (1998), 'Does Venture Capital Spur Innovation?', NBER Working Papers 6846, National Bureau of Economic Research, Inc.
[708]Belke, A., Fehn, R., and Foster, N., (2003), 'Does Venture Capital Investment Spur Employment Growth?', CESifo Working Paper Series No. 930.
[709]Belke, A., Fehn, R., and Foster, N., (2003), 'Does Venture Capital Investment Spur Employment Growth?', CESifo Working Paper Series No. 930.
[710]Belke, A., Fehn, R., and Foster, N., (2003), 'Does Venture Capital Investment Spur Employment Growth?', CESifo Working Paper Series No. 930.

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Both the above-mentioned studies show that private equity investing is conducive to job creation in new and innovative firms and that it facilitates the process of structural change towards the economy. Belke *et al* are quick to point out that their results, however, should not be misinterpreted as a justification for government subsidies to the private equity industry or for government-run private equity activities. On the contrary, the government should provide an institutional framework which is favourable to the development of a flourishing private equity industry and entrepreneurial dynamism. There are a number of possible ways of achieving the latter.[711] For example, the pension fund system could be capitalized to a greater extent and pension funds could be allowed to invest part of their assets in private equity firms.[712] Based on the US example, this should further spur the development of the private equity market. Secondly, a well functioning market for stock market listings needs to be created as an exit route for private equity investments.[713] Thirdly, the education system, especially at the university level, along with an institutional framework for transforming innovative ideas into new business ventures would be the primary levers to address the scarcity of able human resources.[714] Lastly, the tax system should provide adequate incentives for entrepreneurs to take risks rather than having the government participate only via highly progressive taxes in the upside of ventures.[715]

It will also become apparent from the discussion in chapter four that much of the regulatory developments in the US, Canada, Australia and UK have been directed towards mitigating against the risks posed by private equity investing rather than aimed at the promotion of private equity investing.[716] For example as mentioned at the beginning of chapter one, in the UK, a House of Commons Treasury Report listed several disadvantages of private equity investing relative to company shares traded on a stock exchange (publically traded shares).[717]

While private equity has been found to contribute to increased economic growth, it has also been argued that the studies analysing the interrelationship between private equity and economic growth have not clearly highlighted the influence of regulation on the impact of private equity on economic growth.[718] As mentioned earlier in this chapter, Stromberg argues that the relationship between private equity and economic growth could be in the reverse, that is, economic growth contributes to

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[711]Bedu, N., and Montalban, M. (2014), 'Analysing the uneven development of private equity in Europe: legal origins and diversity of capitalism', Socio-Economic Review, 12(1), at pages 33-70.
[712]Bedu, N., and Montalban, M. (2014), 'Analysing the uneven development of private equity in Europe: legal origins and diversity of capitalism', Socio-Economic Review, 12(1), at pages 33-70.
[713]See paragraph 3 of chapter four.
[714]Bedu, N., and Montalban, M. (2014), 'Analysing the uneven development of private equity in Europe: legal origins and diversity of capitalism', Socio-Economic Review, 12(1), at pages 33-70.
[715]See paragraph 2 of chapter four.
[716]Discussed in detail in chapter four.
[717]House of Commons Treasury Committee, (2007), 'Private Equity', Tenth Report of Session 2006-07, Volume 1, Ordered by House of Commons, July 2007, at chapter 3, at pages 11-18.
[718]Gatauwa, J.M & Mwithiga, A.S (2014), 'Private Equity and Economic Growth: A Critical Review of the Literature', Published: European Centre for Research Training and Development, June 2014 2(3) at pages 1-10.

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private equity activity.[719] Nevertheless, the above mentioned countries have recognised the contribution of private equity to economic growth and business development, but they have also been cognisant of the risks. Some of the risks commonly associated with private equity investing mentioned in this chapter are conflicts of interest, lack of transparency and disclosure, high leverage and the allocation of fees and expenses by private equity firms. However, the growth of the South African private equity industry will depend on creating an environment in which investors and regulators alike clearly see the advantages and disadvantages of private equity. Private equity as an asset class has clear and demonstrable benefits for the South African economy, but also poses several dangers. Despite obvious weaknesses, private equity has become an attractive investment choice amongst investors and as a source of equity financing.

Regulatory policy in South Africa needs to recognise the unique South African context and promote transformation consistent with the prevailing socio-political and economic climate. In addition using of private equity methodology as a financial instrument can assist the South African economy to foster the attainment of these objectives. As mentioned earlier, good regulatory policy can create a protective and vibrant environment for economic activity but it cannot, by itself, create that activity. Investors and economic participants in creating such activity respond to a wide range of incentives and disincentives. It is evident from the above discussion that private equity has, will and must continue to play an important role in the South African economy.

Chapter two will provide an analysis of the key features of private equity fund formation. The discussion will include a discussion of the general private equity fund structure, the regulatory requirements of private equity firms, and certain regulatory considerations relevant in operating a private equity fund in South Africa. The discussion will focus on fund formation as it pertains to South Africa, however at certain instances reference will be made to private equity fund formation in foreign jurisdictions such the US, UK, Australia, and Canada.

[719]Strömberg, P. (2009), 'The Economic and Social Impact of Private Equity in Europe: Summary of Research Findings', Stockholm School of Economics, Institute for Financial Research, September 2009, at page 6.

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Chapter Two: Private Equity Fund Formation

1. Introduction

This chapter will provide an analysis of the key features of private equity fund formation. This will include an analysis of the general private equity fund structure, the regulatory requirements of private equity firms, and certain regulatory considerations relevant in operating a private equity fund in South Africa. The analysis will focus on fund formation as it pertains to South Africa, however at certain instances reference will be made to private equity fund formation in foreign jurisdictions such the US, UK, Australia, and Canada. While this chapter will provide a legal analysis of the law as it pertains to partnerships and trusts, it will also attempt to cover the key legal and regulatory requirements of fund formation, such as the licensing requirements that have to be complied with by a private equity firm before it can manage a private equity fund. Chapter two will argue that the two main legal vehicles suitable for a equity fund is the *bewind* trust and *en commandite* partnership.[720] The reasons for the use of these two legal structures, are that they both (a) allow the income and capital gains of the private equity fund to be taxed in the hands of investors according to the tax status of each investor; (b) allow for the appointment of a private equity firm, which will be responsible for the daily administration of the private equity fund. This 'outsourcing' of the daily administration and all operational matters allows the private equity firm a fair amount of autonomy in sourcing and executing private equity investments on behalf of the private equity fund; (c) provide investors in the private equity fund with limited liability. The investor's liability is restricted to the actual capital amount committed to the private equity fund; and (d) afford contractual flexibility in structuring and documenting the commercial arrangements between the investors and the private equity firm, which also means that the private equity fund can be established fairly quickly applying internationally acceptable contractual terms.

The legal structure of a private equity fund needs to take into account all the specificities of the private equity business model, therefore this chapter will critically analyse, *inter alia*, the legal nature; general taxation considerations; administration; termination; and parties to both the *en commandite* partnership and *bewind* trust. The first part of this chapter comprehensively deals with the pertinent legal characteristics of the *en commandite* partnership and *bewind* trust, and examines the rationale behind these two legal structures and their tax implications. The second part of this chapter addresses the regulatory and licensing considerations as it pertains to South Africa. Reference will

[720] Chapter four will discuss the Venture Capital Company ('VCC') initiative, which is the only South African specific tax incentive scheme encouraging investment in unlisted companies and is regulated by section 12J of the Income Tax Act 58 of 1962. However, it is seldom used to structure third party private equity funds in.

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be made to the commonly used private equity fund vehicles in foreign jurisdictions such as the US, UK, Australia, and Canada.[721]

Paragraph 4 of this chapter analyses the key regulatory and licensing requirements, but also the key trends and developments in the relevant areas, highlighting the most significant issues which are current and emerging, both in South Africa and the foreign jurisdictions mentioned above. Nevertheless, with this in mind, chapter two aims to:

- Critically analyse the strengths and weaknesses of private equity fund structures such as the *en commandite* partnership and *bewind* trust, and contribute to the policy considerations postulated in chapter five; and
- Provide a critical comparison of the private equity fund structures and pertinent regulatory developments in foreign jurisdictions such the US, UK, Australia, and Canada, which would encourage best practices and necessitate requirements for efficient fund structuring in South Africa.[722]

2. Private Equity Fund Defined

Private equity funds are investment vehicles formed by private equity firms looking to raise capital to make multiple investments in a specified industry sector or geographic region.[723] According to Naidech:

> 'Private funds are 'blind pools' under which passive investors make a commitment to invest a set amount of capital over time, entrusting the fund's sponsor to source, acquire, manage and divest the fund's investments.'[724]

According to Persuad and Atkinson,[725] the 'term private equity fund' is used to describe a broad range of actively managed pooled investment vehicles that invest in underlying companies and these

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[721]Chapter four is a comparative study of the extent to which the law impacts the private equity market. The applicable regulatory developments and legislation of the US, UK, Canada and Australia are analysed and compared to the South African position in order to determine whether the South African law can learn anything from these jurisdictions. Chapter four will consider and analyse two key impediments; namely tax legislation and exit alternatives; and show how legislation could effectively address the former and how the lack of exit routes is an impediment to the growth of the South African private equity industry.

[722]See paragraph 3.6 of this chapter hereinafter.

[723]Naidech, S.W. (2011), 'Private Equity Fund Formation', Practice Note: Chadbourne and Parke LLP, published by Practical Law Company, at pages 1-5. Available at www.chadbourne.com/files/publication/ 3d5a9a56-734c-4d30-a5e4- 0a8c593967ab/presentation/publicationattachment/12cdc9fc-964d-4b0e-a0d4-c48ce9dd7c2f/naidech_privateequityfundformation_nov11.pdf, accessed in May 2015.

[724]Naidech, S.W. (2011), 'Private Equity Fund Formation', Practice Note: Chadbourne and Parke LLP, published by Practical Law Company, at page 1.

[725]Persuad, A.N. and Atkinson, A. (2012), 'Private Equity Funds: Legal Analysis of Structural, ERISA, Securities and Other Regulatory Issues', chapter 47 in Investment Adviser Regulation, 3rd Edition, by Kirsch, C.E., at page 47-3.

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pooled investment vehicles have a finite duration.[726] In South Africa, these private equity funds are typically organized as *bewind* trusts or *en commandite* partnerships where sophisticated and institutional investors make a capital commitment to fund investments over the duration of the fund. Gilligan and Wright define a private equity fund as a:[727]

> 'form of 'investment club' in which the principal investors are institutional investors such as pension funds, investment funds, endowment funds, insurance companies, banks, family offices/high net worth individuals and funds of funds, as well as the private equity fund managers themselves.'[728]

These authors argue that the objective of a private equity fund is to invest equity or risk capital in a portfolio of private companies which are identified and researched by the private equity firm; and which are generally designed to generate capital profits from the sale of investments in the portfolio companies rather than income from dividends, fees and interest payments.[729] As discussed in chapter one,[730] the key economic incentives for the private equity firm are management fees and profit participation.[731] The key economic incentive for investors is the opportunity to earn a rate of return on their invested capital through access to a portfolio of investee companies sourced and managed by the private equity firm that has expertise in the target sectors or geographies of the fund.[732]

According to Gilligan and Wright, a private equity fund can be structured in several ways; however they are very similar to many other collective investment vehicles.[733] These authors state that the differences are largely due to regulatory and tax issues in the various jurisdictions that impact the operation of the private equity fund and its investors; and the fact that private equity funds usually have a ten-year limited life period.[734] Nevertheless, a private equity fund must be structured to achieve a balance between the maximum tax efficiency to the investors and private equity firm; to be able to manage the fund's and private equity firm's regulatory obligations; control and manage

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[726] Typically ten years with the ability to extend the term for two or three consecutive one-year periods.
[727] Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at page 29.
[728] Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at page 29.
[729] Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at page 29.
[730] Discussed in paragraph 4 of chapter one.
[731] Referred to as 'carried interest' and as discussed in paragraph 4 of chapter one.
[732] Naidech, S.W. (2011), 'Private Equity Fund Formation', Practice Note: Chadbourne and Parke LLP, published by Practical Law Company, at page 1.
[733] Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at page 29.
[734] The aim of the private equity fund model is to eliminate entity-level tax while protecting the investors in the fund from personal liability for the debts and obligations of the fund.

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potential liabilities to the investors and private equity firm; and maintain confidentiality regarding its investors.[735]

There are several common criticisms of the private equity fund structure. For instance, a typical private equity fund is an institution-only investment vehicle that is predominantly only available to institutions and other larger sophisticated investors.[736] For example, a private equity fund will require investors to commit large minimum capital amounts.[737] This feature invariably limits access to many 'smaller' and less sophisticated investors. A further common criticism is that private equity funds are illiquid by their very nature because private equity firms take a long term view when investing in underlying portfolio investee companies.[738] It is for this reason that private equity funds are typically structured as ten-year vehicles.[739] Despite the criticisms of the private equity fund model, the primary aim of the model is to eliminate entity-level tax while protecting the investors in the fund from personal liability for the debts and obligations of the fund.

It is submitted that a private equity fund is a collective vehicle that makes investments in a portfolio of underlying companies. Typically a private equity fund has a number of investors whose liability is limited to the amount of their investment in the fund; and which is managed by one private equity firm on behalf of all the investors.[740] A private equity fund may take minority or majority stakes in its investments in underlying portfolio investee companies, for example it will typically take a majority stake in the case of a buyout.[741] When a private equity fund makes an investment in an underlying portfolio company, there is usually bank debt or other debt capital raised to meet part of the capital required to fund the acquisition.[742] In this regard, there are a variety of private equity funds with different investment types and purposes. For example, buyout funds acquire controlling interests in companies, whereas venture capital funds invest in early and development stage companies. This chapter intends to provide an analysis of the key considerations involved in forming a private equity fund including:

- The legal forms of a private equity fund in South Africa;
- The legal forms of private equity funds in the US, UK, Canada and Australia;

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[735] Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at page 29.
[736] Persuad, A.N. and Atkinson, A. (2012), 'Private Equity Funds: Legal Analysis of Structural, ERISA, Securities and Other Regulatory Issues', chapter 47 in Investment Adviser Regulation, 3rd Edition, by Kirsch, C.E., at pages 47-1 to 47-66.
[737] In South Africa, this could be R50 million upwards.
[738] For example, a private equity firm will typically commit to each underlying investment for several years.
[739] Persuad, A.N. and Atkinson, A. (2012), 'Private Equity Funds: Legal Analysis of Structural, ERISA, Securities and Other Regulatory Issues', chapter 47 in Investment Adviser Regulation, 3rd Edition, by Kirsch, C.E., at pages 47-1 to 47-66.
[740] Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, 2nd Edition, March 2010, at pages 29-30.
[741] As discussed in paragraph 3 of chapter one.
[742] As discussed in paragraph 3 of chapter one.

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- The regulatory requirements of private equity firms in South Africa and abroad; and
- Highlight further regulatory considerations relevant in operating a private equity fund in South Africa.

This chapter will not discuss the taxation of private equity funds, other than to highlight general taxation considerations with regard to partnerships and trusts in paragraphs 3.1.1 and 3.1.2 respectively. A discussion on the taxation of private equity funds is beyond the scope of this analysis, however chapter four does examine the key impediments to the development of a private equity market and will argue that tax legislation is one such impediment. Chapter four will also discuss the applicable regulatory developments and legislation of the US, UK, Canada and Australia and compare it to the South African position in order to determine whether the South African law can learn anything from these jurisdictions.

3. Private Equity Fund: Legal Form

Private equity funds are structured as closed-end investment vehicles. It will be discussed later that in South Africa these closed-end private equity investment vehicles are structured as either *bewind* trusts or *en commandite* partnerships. In addition, it will be noted that a principal advantage of using either a *bewind* trust or an *en commandite* partnership as a fund vehicle is because both these vehicles are 'pass-through' entities for income tax purposes and, therefore, are not subject to corporate income tax in terms of the Income Tax Act 58 of 1962. Instead, the *bewind* trust or *en commandite* partnership's income, gains, losses and deductions are passed through to the investor's and taxed only once at the investor level.[743] A second advantage of using these two legal structures is that the investors in the fund, similar to the shareholders in a company, benefit from limited liability and are not personally liable for the liabilities of the *bewind* trust or *en commandite* partnership.[744] Therefore an investor's obligations and liabilities to contribute capital and/or make payments to the private equity fund are limited to its capital commitment and its share of the fund's assets, subject to the applicable laws. A third advantage of using these two legal structures is that they both allow for the appointment of a private equity firm. The private equity firm becomes responsible for all the daily operational and administrative duties of the private equity fund, including the sourcing and execution of private equity investments on behalf of the private equity fund. Finally, these features, together with the contractual nature of both legal forms, allow for private equity funds to be established with relative ease; which typically include internationally acceptable contractual terms and organisational practices.

[743]See discussion on tax considerations impacting private equity in chapter four.
[744]See generally Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', 2nd edition, Juta and Co, Cape Town.

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3.1 Legal Form in South Africa

The private equity industry in South Africa does not have a specifically designated regulator or its own industry-specific legislation. Apart from case law, private equity investment in South Africa is regulated by various enactments. Applicable legislation include *inter alia* the Companies Act,[745] the Collective Investment Schemes Act,[746] Trust Property Control Act,[747] Financial Advisory and Intermediary Services Act,[748] Pension Funds Act,[749] The Financial Markets Act[750] and the Income Tax Act.[751] The choice of the most appropriate legal structure of a private equity fund starts with the choice of the most effective and suitable legal vehicle. As repeatedly stated, the predominant legal forms used by private equity firms in South Africa are the *bewind* trust and the *en commandite* partnership. As mentioned earlier, the legal structure of a private equity fund needs to take into account all the specificities of the private equity business model. The paragraph will analyse, therefore, the pertinent legal characteristics of the *en commandite* partnership and *bewind* trust, and examines the rationale behind these two legal structures and their tax implications.

There are no major tax advantages or disadvantages of the *bewind* trust over the *en commandite* partnership structure and vice versa, particularly where all the investors in the fund and all the investments of the fund are domiciled in South Africa. Income, capital gains and any other proceeds from the portfolio companies ought to be subject to taxation at the investor level but not at the private equity fund level (to avoid double taxation). Private equity funds are structured depending on the individual circumstances of the investors the funds are designed to attract. Investors can generally be classified into three categories, namely (a) local investors that are taxable in South Africa; (b) local investors that are exempt from a South African tax perspective, for instance pension funds; and (c) non-residents that are generally not subject to tax in South Africa.

A second driver is limited liability. The private equity fund must provide for limited liability because investors will generally require it. Limited liability can be provided by means of a company in terms of Companies Act 71 of 2008. A private equity fund can also be structured as a company incorporated or registered under the Companies Act 71 of 2008. In terms of the company structure, the ownership rights of an investor are those of a shareholder.[752] However, the downside of using a

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[745]Companies Act 71 of 2008.
[746]Collective Investment Schemes Act 45 of 2002.
[747]Trust Property Control Act, 57 of 1988.
[748]Financial Advisory and Intermediary Services Act, 37 of 2002.
[749]Pension Funds Act, 24 of 1956.
[750]The Financial Markets Act 19 of 2012.
[751]Income Tax Act, 58 of 1962.
[752]Pretorius, J.T., Delport, P.A., Havenga, M. and Vermaas, M. (1999), 'Hahlo's South African Company Law Through the Cases: A Source Book : a Collection of Cases on Company Law, with Explanatory Notes and Comments', Juta and Company Ltd, 6th Edition, at pages 35-37.

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company is that it does not create any conduit with reference to the flow-through of income and losses which may arise from the activities of the fund from a tax perspective. For instance, if a company is used, then capital gains and any other proceeds from the underlying portfolio investee companies would be subject to taxation at the investor level and at the private equity fund level (double taxation). Both a *bewind* trust and *en commandite* partnership provides investors with limited liability and an investor will not have liability exceeding its contractual commitment to the private equity fund.[753] In the case of the *en commandite* partnership, the rights and duties of the partners amongst themselves are determined by the partnership agreement.[754] Since the partnership, unlike a company, is not a separate legal persona in its own right, these rights and duties do not exist *vis-à-vis* the partnership, but only *vis-à-vis* the co-partners in the partnership.[755] Every partner is entitled to share in the net profits of the partnership and is obliged to share in the net losses too. In the case of a *bewind* trust, the beneficiaries of the trust will enjoy limited liability for the debts of the trust, irrespective of whether the trust is an ordinary trust or a *bewind* trust.[756]

A third driver would be the issue of perpetual succession. The private equity fund must provide for perpetual succession, a legal term which describes the continuation of an entity's existence despite the death, bankruptcy, change in membership or exit from the business of any owner or member or any transfer of shares. A fourth consideration would be the regulatory environment in South Africa. There must not be any laws or regulations restricting or limiting the investment activities and marketing of private equity funds.

3.1.1 Use of a Partnership

According to Henning, partnership law is as old as commerce itself and its history as a profit-sharing 'device' can be traced from the ancient Near-Eastern civilizations to its present day position as one of the most important forms of business enterprise.[757] At the outset it must be noted that it is not the intention of this chapter to critically analyse all the salient aspects of partnership law, but rather to list the five essentials of a partnership to provide a context for the discussion on the distinguishing features of an *en commandite* partnership.

[753] Pretorius, J.T., Delport, P.A., Havenga, M. and Vermaas, M. (1999), 'Hahlo's South African Company Law Through the Cases: A Source Book : a Collection of Cases on Company Law, with Explanatory Notes and Comments', Juta and Company Ltd, 6th Edition, at pages 35-37.

[754] Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition, at pages 239-240.

[755] Henning, J.J. and Delport, H.J. (1997), 'Partnership' in *LAWSA* volume 19 (revised in 2006 by Henning, J.J, assisted by Snyman-van Deventer).

[756] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894. See Haupt, P. (2012), 'Notes on South African Income Tax', 31st edition.

[757] Henning, J.J. (2007), 'The Mediaeval Contractum Trinius and the Law of Partnership', Fundamina: A Journal of Legal History, 13(2), at page 34.

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Nevertheless, it must be noted that partnerships are not addressed by the Companies Act 71 of 2008 and are largely governed by common law. The Companies Act 61 of 1973, which preceded the Companies Act 71 of 2008, imposed a maximum limit of twenty partners. The current Companies Act 71 of 2008 no longer places any restriction on the number of partners or members of an association formed for carrying on business for the acquisition of gain, and a partnership may now have an unlimited number of partners.[758] Henning also states that the contribution of Roman law is evident both in so far as the basic concept of partnership as a consensual contract of the utmost good faith as well as the relationship constituted by it between the partners *inter se* are concerned.[759] He states the following:

> 'Developments advanced by the *lex mercatoria* include the doctrine of *mutua praepositio*, the liability *in solidum* of partners to third parties for partnership obligations and the entity theory of the legal nature of partnership. The *commenda* was an arrangement by which an investor (*commendator*) entrusted capital to a merchant (*commendatarius*) for employment in business on the understanding that the *commendator*, while not in name a party to the enterprise and though entitled to a share of the profits, would not be liable for losses beyond his capital. This concept served as the precursor of the present day Continental (and South African) partnership *en commandite* as well as the Anglo-American limited partnership.'[760]

As stated above, the relationship between partners must display *uberrimae fides*,[761] the utmost good faith or commonly referred to as the highest degree of good faith; and this requirement must at all times be considered when drafting the terms of a partnership agreement and/or any dealing in relation to such partnership.[762] For instance, a partner would be in breach of his duty of utmost good faith, if it is found that such partner made a secret profit, or competes in business with the partnership. Therefore, a partner must not put him/herself in a situation where his/her personal interests and the interests of the partnership conflict or may potentially be in conflict.[763] According to Henning, a partner is accountable to the partnership for any profits or benefits he/she accrues in the

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[758]See Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', 2nd edition, Juta and Co, Cape Town, at pages 68-69.
[759]Henning, J.J. (2007), 'The Mediaeval Contractum Trinius and the Law of Partnership', Fundamina: A Journal of Legal History, 13(2), at pages 33-34.
[760]Henning, J.J. (2007), 'The Mediaeval Contractum Trinius and the Law of Partnership', Fundamina: A Journal of Legal History, 13(2), at pages 33-34. This concept of limiting the liability of non-managing investors spread from Italy to French commercial law, becoming the *société en commandite*, the predecessor of the present limited or *en commandite* partnership. It was incorporated into Roman-Dutch law retaining its French name. See Van der Linden, J. (1806), 'Regtsgeleerd, Practicaal en Koopmans Handboek', Unkown Publisher, at 4.1.12.
[761]The Latin expression meaning utmost good faith.
[762]This theoretical framework of the law of partnerships discussed in paragraph 3 of this chapter 2 will be contextualised to its practical aspects with regard to the relationship between the private equity fund manager and the investors, as well as the private equity funds' assets/underlying portfolio investee company(ies) in paragraph 4 of chapter 3.
[763]*See Robinson v Randfontein Estates Gold Mining Co Ltd* (1921) AD 168.

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performance of his/her duties and cannot apportion for themselves profits, assets, opportunities and benefits which are those of the partnership.[764] In *Robinson v Randfontein Estates Gold Mining Co Ltd,*[765] Innes CJ stated that:

> 'where one man stands to another in a position of confidence, involving a duty to protect the interests of that other he is not allowed to make a secret profit at the other's expense or place himself in a position where his interests conflict with his duty.'[766]

Furthermore, Gibson *et al* define a partnership as a contract between persons, in which the persons concerned agree to contribute money, labour or skill to a common stock and to carry on business with the object of making a profit for their joint benefit.[767] Gibson *et al* states that the term partnership may either refer to the contract between the parties or to the relationship brought about by that contract.[768] Therefore, a partnership may be established through a legally binding agreement between the intending partners, commonly referred to as a contract.[769] In *Oblowitz v Oblowitz*,[770] it was held that it is essential that there should be a valid contract between the parties, otherwise no partnership can arise. All essentials of a contract must therefore be present, for example, the contract must not be illegal or contrary to public policy. However, the essential feature is the contract, for the rights and obligations of the partners flow from the terms, express or implied, of their agreement.[771] It was held in *Festus v Worcester Municipality*[772] that a contract of partnership need not necessarily be expressed, it could be tacit or implied from the facts; provided the parties admit of no other conclusion than that the parties intended to create a partnership. However, it would be better for the partnership agreement to be in writing. Therefore a partnership may be formed by the conduct of the parties.[773]

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[764]Henning, J.J. (2007), 'The Mediaeval Contractum Trinius and the Law of Partnership', Fundamina: A Journal of Legal History, 13(2) at page 33.
[765]*Robinson v Randfontein Estates Gold Mining Co Ltd* (1921) AD 168.
[766]*Robinson v Randfontein Estates Gold Mining Co Ltd* (1921) AD 168.
[767]Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition, at page 240. See also Henning, J.J. (2015), 'Perspectives on the Law of Partnership in South Africa', Juta and Company Limited, 1st Edition.
[768]Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition, at page 239. See also Henning, J.J. (2015), 'Perspectives on the Law of Partnership in South Africa', Juta and Company Limited, 1st Edition.
[769]*Ex parte Buttner Brothers* 1930 CPD 138 at paragraph 145.
[770]*Oblowitz v Oblowitz* 1953 (4) SA 426 (C) at 433.
[771]Henning, J.J. (2015), 'Perspectives on the Law of Partnership in South Africa', Juta and Company Limited, 1st Edition.
[772]*Festus v Worcester Municipality* 1945 CPD 186 (C).
[773]In the case *Fink v Fink and Another* 1945 WLD 226, the facts of the case was that a wife owned the farm and the husband managed it. The husband and wife were married out of community of property. They bought cows and the milk produced being in excess of what they needed for their own use, the surplus was sold. From that small beginning a very substantial milk-producing and distribution business was established. To that business, both had contributed money and labour. All profits made were pooled back into the business. The question before the court was whether this could be seen as a partnership. The court looked at the essentials of what makes up a partnership. The court held that both parties added to the business aim of the business which was to benefit the partnership. The object of the business was to make profit and court found that the

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Briefly turning to the legal nature of a partnership, Pretorius *et al* states that, unlike a company, a partnership is not a separate person in law, with rights and duties apart from its members.[774] A company acts through its directors, while a partnership acts through its partners with each partner being an agent of the partnership.[775] The assets and liabilities of a partnership are the assets and liabilities of its members.[776] This principle is defined as follows in Wille *et al:*

> 'Although the assets or property mentioned above are invariably referred to as 'partnership property', they do not actually belong to the firm, since the firm is not a persona and cannot therefore own property. The property is owned jointly by the partners in undivided shares, i.e. they are co-owners, in such proportions as have been stipulated.'[777]

Gibson *et al* states that a partnership is simply a group of people acting jointly; and that the relationship between a partnership and third parties is governed by the law of agency.[778] Therefore, partners are agents of each other.[779] The agency of a partner for his co-partners arises by implication of law as soon as the relationship of partnership is established. In *Potchefstroom Diaries and Industries Co Ltd v Standard Fresh Milk Supply,*[780] De Villiers JP held that a partner has not only the powers of an agent, but he is also a surety for his fellow partners for they are all liable jointly and severally. The learned Judge stated further that not only is a partner an agent, but he has the double character of agent and principal in one and the same transaction.[781] When a partner makes a contract with a third party, he acts as an agent for his other partners and as a principal for himself. He can bind the partnership if he acts in the name of the partnership and within the scope of the partnership business.[782] However, at common law a partnership is not a persona, but as stated in *Potchefstroom*

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wife's contribution went far beyond the duties of a wife in such a case. The court held a partnership existed between the spouses.

[774]Pretorius, J.T., Delport, P.A., Havenga, M. and Vermaas, M. (1999), 'Hahlo's South African Company Law Through the Cases: A Source Book : a Collection of Cases on Company Law, with Explanatory Notes and Comments', Juta and Company Ltd, 6th Edition, at page 35.

[775]Pretorius, J.T., Delport, P.A., Havenga, M. and Vermaas, M. (1999), 'Hahlo's South African Company Law Through the Cases: A Source Book : a Collection of Cases on Company Law, with Explanatory Notes and Comments', Juta and Company Ltd, 6th Edition, at page 35.

[776]Pretorius, J.T., Delport, P.A., Havenga, M. and Vermaas, M. (1999), 'Hahlo's South African Company Law Through the Cases: A Source Book : a Collection of Cases on Company Law, with Explanatory Notes and Comments', Juta and Company Ltd, 6th Edition, at page 35. Support for this contention is to be found in Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition, at pages 242-243.

[777]Wille, G., Du Bois, F. and Bradfield, G. (2007), 'Wille's Principles of South African Law', Juta and Company Ltd, Eighth Edition, at page 612. See also *Muller and Another v Pienaar* 1968 (3) SA (A) 195 at 202 F-H; and *Strydom v Protea Eiendomsagente* 1979 (2) SA 206 (T) at 209 C-D.

[778]Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition, at page 246. See also Henning, J.J. (2015), 'Perspectives on the Law of Partnership in South Africa', Juta and Company Limited, 1st Edition.

[779]*Munro v Ekerold* 1949 (1) SA 584 (SWA) at 589.

[780]*Potchefstroom Diaries and Industries Co Ltd v Standard Fresh Milk Supply* Co 1913 TPD at 506-513.

[781]*Potchefstroom Diaries and Industries Co Ltd v Standard Fresh Milk Supply* Co 1913 TPD at 506-513.

[782]*Potchefstroom Diaries and Industries Co Ltd v Standard Fresh Milk Supply* Co 1913 TPD at 506-513.

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Diaries and Industries Co Ltd v Standard Fresh Milk Supply, is 'a contractual compound of several personae'.[783]

Nevertheless, a partnership is a contract as mentioned above, therefore all the essentials of a contract must be present.[784] The essential features of a partnership were expressed in the following terms in the case *Joubert v Tarry and Co:*

> 'These essentials are fourfold. First, that each of the partners brings something into the partnership, or binds himself to bring something into it, whether it be money, or his labour or skill. The second essential is that the business should be carried on for the joint benefit of both parties. The third is, that the object should be to make profit. Finally, the contract between the parties should be a legitimate contract.'[785]

According to Gibson *et al,* if these four essentials are present then prima facie a partnership exists, however they are not in themselves a sufficient test because there may be other facts that show that actually no partnership was intended and that there was no partnership.[786] For example in *Pezzutto v Dreyer,*[787] the court held that each partner must contribute something appreciable, thus something of commercial value, although such contribution need not be capital. The contribution may be in the form of money, skill or labour. In *Pezzutto v Dreyer*[788] the partners had intended jointly to exploit a mine dump. Thus the contribution made by Pezzutto and De Polo was the right to exploit the mine dump. In *Pezzutto v Dreyer,*[789] Smalberger JA stated the following:

> 'For a partnership to come about there must be an agreement to that effect between the contracting parties. In determining whether or not an agreement creates a partnership a court will have regard, *inter alia*, to the substance of the agreement, the circumstances in which it was made and the subsequent conduct of the parties. The fact that parties regard themselves as partners, or referred to themselves as such, is an important, though not necessarily decisive, consideration. What is necessary to create a partnership agreement is that the *essentialia* of a partnership should be present … The three essentials are (1) that each of the partners bring something into the partnership, whether it be money, labour or skill; (2) that the business should be carried on for the joint benefit of the parties; and (3) that the object should be to make a profit

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[783] *Potchefstroom Diaries and Industries Co Ltd v Standard Fresh Milk Supply* Co 1913 TPD at 513. See also *Gcilitshana v General Accident Insurance Co SA Ltd*, 1985 (2) SA 367 at paragraph 371.
[784] Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition, at page 240.
[785] *Joubert v Tarry and Co* 1915 TPD 277 at 280-281.
[786] Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition, at page 240. See also Henning, J.J. (2015), 'Perspectives on the Law of Partnership in South Africa', Juta and Company Limited, 1st Edition.
[787] *Pezzutto v Dreyer* 1992 (3) SA 379 (A) at 390.
[788] *Pezzutto v Dreyer* 1992 (3) SA 379 (A) 390.
[789] *Pezzutto v Dreyer* 1992 (3) SA 379 (A) 390.

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> … A fourth requirement mentioned … is that the contract should be a legitimate one. However, as has been pointed out previously, this requirement is one common to all contracts and is therefore not a particular essential of a partnership … Where Pothier's four requirements are found to be present the court will find a partnership established unless such a conclusion is negatived by a contrary intention disclosed on a correct construction of the agreement between the parties ... In essence, therefore, a partnership is the carrying on of a business (to which each of the partners contributes) in common for the joint benefit of the parties with a view to making a profit. In this context a business is 'anything which occupies the timê and attention and labour of a man for the purpose of profit' (*Standard General Insurance Co v Hennop*[790]). The business need not be a continuous one; a joint venture in respect of a single undertaking can amount to a partnership provided the *essentialia* of a partnership are present … Finally, it should be noted that the contribution to be made by each partner need not be of the same character, quantity or value (Pothier: 1.3.9). However, each partner must contribute something 'appreciable', i.e something of commercial value, although such contribution need not be capable of exact pecuniary assessment as, for example, where a partner contributes his labour or skill (Pothier: 1.3.9 and 10; *B v The Commissioner of Taxes*[791]).'[792]

Nevertheless, the final essential element to be discussed is that the business must be carried on for the joint benefit of the parties. The aforesaid element is a defining element of a partnership.[793] The element of joint benefit includes several other related elements discussed above, namely that the business must be carried on; the parties to the contract must be co-owners of property rights of the partnership and co-holders of all other rights belonging to the partnership; the partnership must have a common stock; and the business must be carried on in common because where each party can act independently and in his own interest no partnership exists.[794] According to Gibson *et al*, it is an essential of a partnership that the profit made be for the joint benefit of the partners.[795] These authors state:

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[790] *Standard General Insurance Co v Hennop* 1954(4) SA 560 (A) at 565 A.
[791] *B v The Commissioner of Taxes* 1958(1) PH T4 (SR).
[792] *Pezzutto v Dreyer* 1992 (3) SA 379 (A) 390 at paragraphs 31-35.
[793] See Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition. See Also Clarkson, K., Miller, R. and Cross, F. (2010), 'Business Law: Text and Cases: Legal, Ethical, Global, and Corporate Environment', Cengage Learning. See also Henning, J.J. (2007), 'The Mediaeval Contractum Trinius and the Law of Partnership', Fundamina: A Journal of Legal History, 13(2). See also Henning, J.J. and Delport, H.J. (1997), 'Partnership' in *LAWSA* volume 19 (revised in 2006 by Henning, J.J, assisted by Snyman-van Deventer). See also Havenga, M.K. and Locke, N. (2010), 'Corporations and Partnerships in South Africa', Kluwer Law International, at pages 109-118.
[794] As discussed in paragraph 3.1.1 of this chapter above, co-owners are not necessarily partners. It must not only be agreed that a person will act on his own behalf but on behalf of all the parties to the contract. The partnership should not merely be carried on for the benefit of every partner but on his behalf.
[795] Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition, at page 242.

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> 'Put differently, they must share the profits between them. These profits are not gross profits – the losses must first be deducted. So it is essential that the partners share in profits and losses.'[796]

In *Blumberg and Sulski v Brown and Freitas*[797] the court held that if the partnership activities result in the making of a profit, this will be divided among the partners. Profit in this instance, was held by the court to be net profit after the deduction of all expenses so that an agreement whereby one person receives a proportion of the gross income of any undertaking, such as a commission on sales, is not an agreement of partnership.[798] In *Blumberg and Sulski v Brown and Freitas* it was stated as follows:

> 'The sharing of profits and losses therefore implies that a partner must at all events share in the losses 'so far, at least, as G they constitute a charge upon, and a diminution or deduction from the profit'.'[799]

In *Fink v Fink and Another*,[800] the court stated that the profits are shared by the partners in the proportions expressly agreed between them. However, in the absence of an agreement, the profits are shared in the same ratio as the value of their contributions to the common stock. Furthermore, if it is impossible to say that one partner has contributed more than another, the profits are shared equally.[801] This commonly occurs where one of the partners contributes money and the other skills or know-how necessary to the successful running of the undertaking.[802] A partnership agreement can specify any proportion for sharing of the profits and can even provide for such matters as the payment of a salary to a partner before the determination of distributable profit or payment of interest on the various capital accounts.[803] On the other hand, in *Enslin v Colonial Trust Corporation*[804] the court held that if a partner fails to share profits, such a partner may be compelled to do so by the *actio pro socio*. Losses are typically shared in the same proportion as profits; however variations can also be made when dealing with losses incurred by the partnership.[805] For instance, one partner may share only in profits but bear no share of any losses incurred. In *Dickenson and Brown v Fisher's Executors*[806] the court held this to mean net losses or profit over a period and not to mean that one person will share only in the results of profitable transactions and not in those of unprofitable

[796] Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition, at page 242.
[797] *Blumberg and Sulski v Brown and Freitas* 1922 TPD 130 at 138.
[798] *Blumberg and Sulski v Brown and Freitas* 1922 TPD 130 at 138.
[799] *Blumberg and Sulski v Brown and Freitas* 1922 TPD 130 at 138.
[800] *Fink v Fink and Another* 1945 WLD 226.
[801] *Fink v Fink and Another* 1945 WLD 226.
[802] Mcleary, F. (2000), 'Accounting and Its Business Environment', Juta and Company Ltd, at page 34.
[803] Mcleary, F. (2000), 'Accounting and Its Business Environment', Juta and Company Ltd, at page 34.
[804] *Enslin v Colonial Trust Corporation* 1923 CPD 358.
[805] Mcleary, F. (2000), 'Accounting and Its Business Environment', Juta and Company Ltd, at page 35.
[806] *Dickenson and Brown v Fisher's Executors* 1915 AD 166.

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ones. Furthermore, an agreement to exempt a partner from any losses is again only valid within the partnership, and creditors of the partnership can attach the assets of the protected partner.[807]

Therefore, in determining whether a particular contract gives rise to a partnership, regard must be had both to the essentials of the partnership as evidenced in the agreement and the intention of the parties. The fact that a contract does contain the essentials of a partnership does not necessarily mean that the legal relationship created by the contract is that of a partnership.[808] Henning and Delport state that upon a proper construction of the relationship, the true intention of the parties may well be that, notwithstanding the existence of the essentials of a partnership agreement, a contract other than a partnership has been created.[809] The then Appellate Division in the case *Bester v Van Niekerk*[810] accepted that the requirement that the contract be legitimate was strictly speaking not a particular essential of a partnership but a common requirement of all contracts.[811] The essentials of a special contract of partnership were confirmed in the case of *Pezzutto v Dreyer,*[812] where it was stated as follows:

> 'Our courts have accepted Pothier's formulation[813] of such essentials as a correct statement of the law … The three essentials are (1) that each of the partners bring something into the partnership, whether it be money, labour or skill; (2) that the business should be carried on for the joint benefit of the parties; and (3) that the object should be to make a profit ... A fourth requirement mentioned by Pothier is that the contract should be a legitimate one.'[814]

Therefore the essentials of a partnership can be categorised as follows: there must be (1) a contract (2) usually between two or more persons (3) to contribute to a common stock (4) in order to carry on business with the object of making a profit (5) for their joint benefit.[815]

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[807] Mcleary, F. (2000), 'Accounting and Its Business Environment', Juta and Company Ltd, at page 35.
[808] Henning, J.J. and Delport, H.J. (1997), 'Partnership' in *LAWSA* volume 19 (revised in 2006 by Henning, J.J, assisted by Snyman-van Deventer), at 274.
[809] Henning, J.J. and Delport, H.J. (1997), 'Partnership' in *LAWSA* volume 19 (revised in 2006 by Henning, J.J, assisted by Snyman-van Deventer), at 274.
[810] *Bester v Van Niekerk* 1960 (2) SA 779 (A) at 783H-784A. See *Butters v Mncora* 2012 (2) All SA 485 (SCA) at paragraph 11. See Pothier, R.J. (1854), 'A Treatise on the Contract of Partnership', Translated from the French, with Notes Referring to the Decisions of the English Courts, by Tudor, O.D., Butterworths.
[811] See also *Butters v Mncora* 2012 (2) All SA 485 (SCA) at paragraph 11. See also Pothier, R.J. (1854), 'A Treatise on the Contract of Partnership', Translated from the French, with Notes Referring to the Decisions of the English Courts, by Tudor, O.D., Butterworths Reprint Edition.
[812] *Pezzutto v Dreyer* 1992 (3) SA 379 (A).
[813] Pothier, R.J. (1854), 'A Treatise on the Contract of Partnership', Translated from the French, with Notes Referring to the Decisions of the English Courts, by Tudor, O.D., Butterworths Reprint Edition. The French jurist, Pothier was regarded as an authority of great importance in the Netherlands toward the eighteenth century. His treatise was translated to English and Dutch and regarded by the courts as an important authority on this branch of the law.
[814] *Pezzutto v Dreyer* 1992 (3) SA 379 (A) at 390.
[815] Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition, at page 240.

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It is evident from the analysis above that the most apparent weakness of the partnership lies in the fact that the liability of the partners for the debts of the partnership business in unlimited. It was stated above that the liability of the partners is joint and several, therefore any of the partners can be called upon to settle the total debts of the partnership once a partnership is insolvent.[816] The partner that had been called upon in such an instance can then proceed against his fellow partners for recovery of their *pro rata* part of the debt.[817] However, such proceedings can only be instituted against individual partners once the partnership has ceased to exist. Proceedings can only be instituted against the partnership as a whole while the partnership is still in existence, despite the fact that the partnership has no legal personality.[818] If a creditor obtains a judgment against the partnership and the assets of the partnership are insufficient to settle his claim he can proceed against the assets of the individual partners.[819] A complicating factor is the position of the partnership in cases where one of the partners has a judgment taken against him in his personal capacity.[820] If court judgment is obtained, the partner's creditors can attach his individual share in the partnership and sell this for the satisfaction of the judgment, which can have negative consequences for the partnership as a whole.[821] The position is even worse where one of the partners is declared bankrupt in his personal capacity. This insolvency immediately leads to the dissolution of the partnership and calls for the distribution of the assets among the partners so that the creditors of the insolvent partner may attach his share of the partnership assets.[822] To prevent this attachment, which may result in serious financial loss to the remaining partners, the other partners may undertake to settle the insolvent partner's share of the undertaking out of their personal estates.[823] Should the partnership be declared insolvent, the personal estates of each of the partners will also be sequestrated unless one (or more) of the partners undertakes to pay the debts of the partnership and provides satisfactory surety within a time stipulated by the court.[824]

However, there are certain types of partnership, referred to as extraordinary partnerships, in which some of the members of the partnership are protected in respect of partnership debts.[825] The distinction between these types of partnerships is not significant because both involve silent partners

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[816]Mcleary, F. (2000), 'Accounting and Its Business Environment', Juta and Company Ltd, at page 35.
[817]Havenga, M.K. and Locke, N. (2010), 'Corporations and Partnerships in South Africa', Kluwer Law International, at pages 115-123.
[818]Havenga, M.K. and Locke, N. (2010), 'Corporations and Partnerships in South Africa', Kluwer Law International, at pages 115-123.
[819]Havenga, M.K. and Locke, N. (2010), 'Corporations and Partnerships in South Africa', Kluwer Law International, at pages 115-123.
[820]Mcleary, F. (2000), 'Accounting and Its Business Environment', Juta and Company Ltd, at page 35.
[821]Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition, at pages 255-258.
[822]Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition, at pages 255-258.
[823]Mcleary, F. (2000), 'Accounting and Its Business Environment', Juta and Company Ltd, at page 35.
[824]Mcleary, F. (2000), 'Accounting and Its Business Environment', Juta and Company Ltd, at page 35.
[825]Sharrock, R. (2011), 'Business Transactions Law', Juta and Company Ltd, Eighth Edition, at pages 503-520.

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with limited liability for partnership debts in relation to outside creditors.[826] An extraordinary partnership requires a specific partnership agreement setting out the position of the various partners, or classes of partners in relation to each other.[827] This specific partnership agreement is not registered in any public registry. This leads to an important part of the analysis to follow, namely the distinguishing features of an *en commandite* partnership as an extraordinary partnership.

(a) The Distinguishing Features of an En Commandite Partnership

The biggest distinction between various types of partnerships for the current purpose is between ordinary and extraordinary partnerships. In the case of an ordinary partnership, the partners are jointly and severally liable for the debts of the partnership.[828] Three forms of extraordinary partnerships existed in South Africa. Two of the three forms of extraordinary partnerships, namely the *en commandite* and anonymous partnerships may still be formed, while the third form was created in terms of legislation in the old Cape Province and in Natal no longer exist.[829] It is distinct from an ordinary partnership in that the liability of certain partners to third parties is limited.[830] The two forms of extraordinary partnerships are very similar.[831] The only difference between the two is that in the case of an anonymous partnership, the anonymous partner is liable for his proportionate share of all partnership debts, whereas the *en commandite* partner is only liable insofar, and limited to, the amount of his or her agreed capital contribution.[832] In terms of a partnership *en commandite*, the partners agree that the undisclosed partner is to have a share of the profits, if any, and to take losses, if any, but in no circumstance is his liability to exceed his specific contribution.[833] Therefore an anonymous partner's liability is not limited to any sum unlike the *en commandite* partner. Gibson *et al* quotes Pothier[834] stating that the anonymous partner is liable only to his partner, but to the full extent of his share in the partnership's deficiency.[835] For a partnership to either be an *en commandite*

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[826] Sharrock, R. (2011), 'Business Transactions Law', Juta and Company Ltd, Eighth Edition, at pages 503-520.
[827] Sharrock, R. (2011), 'Business Transactions Law', Juta and Company Ltd, Eighth Edition, at pages 503-520.
[828] Sharrock, R. (2011), 'Business Transactions Law', Juta and Company Ltd, Eighth Edition, at pages 503-520.
[829] In the Cape it was created in terms of the Special Partnership's Liability Act 24 1861 as amended by the Special Partnership's Limited Liability Amendment Act 12 1906 (Cape). In Natal it was created in terms of the Special Partnerships Limited Liability Act 1 1865 (Natal). However, these Acts were both repealed by the Pre-Union Statute Law Revision Act 36 1976 (not with retroactive effect) as a result of the provisions rarely being used. Until 1958, only 70 limited partnerships had been registered in the Cape and 240 in Natal.
[830] Sharrock, R. (2011), 'Business Transactions Law', Juta and Company Ltd, Eighth Edition, at pages 503-520.
[831] *Butcher & Sons v Baranov Bros* 1905 (26) NLR 589.
[832] *Mmabatho Fruit Corporation (Pty) Ltd v Fourie en Andere* 1985 (1) SA 318 (T).
[833] See Pothier, R.J. (1854), 'A Treatise on the Contract of Partnership', Translated from the French, with Notes Referring to the Decisions of the English Courts, by Tudor, O.D., Butterworths reprint edition, at 2.60.
[834] Pothier, R.J. (1854), 'A Treatise on the Contract of Partnership', Translated from the French, with Notes Referring to the Decisions of the English Courts, by Tudor, O.D., Butterworths reprint edition, at 2.63.
[835] Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition, at page 252. See also Henning, J.J. (2015), 'Perspectives on the Law of Partnership in South Africa', Juta and Company Limited, 1st Edition.

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partnership or anonymous partnership, it must be expressly stated so by way of agreement between the partners, because case law indicates that the courts will lean to the view that an ordinary partnership was created instead of an extraordinary partnership when called upon to interpret a deed of partnership.[836]

The *en commandite* partner and anonymous partner are both undisclosed[837] and both are not liable for partnership debts to creditors of the partnership, but only to their partners in as much as they contributed to the partnership.[838] In *Eaton and Louw v Arcade Properties (Pty) Ltd*,[839] Munnik AJ stated the following:

> '… The anonymous (or sleeping) partnership is created where parties agree to share the profits of a business which is to be carried on by one or more of the partners in his or their name while the partners whose names are not disclosed remain anonymous partners … Although the anonymous partner may be described as a partner the essence of the arrangement is that this fact must be carefully concealed from the outside world.'[840]

The court in *Butcher and Sons v Baranov Brothers*[841] held that the fact that an undisclosed partner may become known to outsiders does not change the form of the partnership, but if such a partner was held out as having acted as an ordinary partner, he or she will lose such protection. According to Mcleary, the aim behind this protection is to protect the undisclosed partner from a person who has entered into a contract with a partnership with the view that in the case of default by the partnership, he can rely on the private estates of the individual partners and may rely on this to the extent he would not have entered into the contract with the partnership if he had not had this assurance of security.[842] Mcleary states as follows:

> 'If he enters into an agreement with a partnership and is not aware of the existence of silent partners, he is obviously not relying on the private estates of those partners at the time of entering into the agreement and can therefore not claim against those estates later on. It follows that the silent partner must take care not to allow himself to be seen as a partner by his actions or words; his name must not appear on any documents such as letterheads which are available for general perusal and he must not participate in the management of the business.'[843]

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[836] *Barker and Co v Blore* 1908 TS 1156 at 1160-1161.
[837] Which means they are not held out to the public as partners.
[838] Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition, at page 251.
[839] *Eaton and Louw v Arcade Properties (Pty) Ltd* 1961 4 SA 233 (T).
[840] *Eaton and Louw v Arcade Properties (Pty) Ltd* 1961 4 SA 233 (T), at 239.
[841] *Butcher and Sons v Baranov Brothers* 1905 (26) NLR 589.
[842] Mcleary, F. (2000), 'Accounting and Its Business Environment', Juta and Company Ltd, at page 36.
[843] Mcleary, F. (2000), 'Accounting and Its Business Environment', Juta and Company Ltd, at page 36.

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In addition, the logic behind keeping the names of such partners secret is to avoid persons dealing with the partnership to have the impression that they are entitled to rely on the credit of the *en commandite* or anonymous partner. In *Van Oudtshoorn v Investec Bank Ltd*,[844] Wallis JA stated the following:

> 'Whilst it is so that in general the foundation for a partnership *en commandite* is that the existence of the partnership and the identity of the partners, save the disclosed or managing partner, should not be disclosed, the mere fact of disclosure does not serve to render the partnership or the individual partners, as opposed to the disclosed or managing partner, liable on contracts concluded with that partner. Such disclosure may be forced upon the managing partner in the course of performing its functions. Thus a request for finance addressed to a financial institution is unlikely to be successful when made in the name of a shelf company, without disclosure of the financial worth and commitments of those standing behind it. That is what happened here. Such disclosure does not infringe upon the reason for anonymity, namely that third parties should not be induced to deal with the managing partner in reliance on the credit of the other members of the partnership as members of the partnership.[845] In the result the mere fact of disclosure does not serve to render either the partnership or the undisclosed partners liable on the contracts concluded by the managing or disclosed partner.'[846]

It was held in *Mmabatho Fruit Corporation (Pty) Ltd v Fourie en Andere*[847] that the very nature of the *en commandite* partner is that his name must be kept secret, so as to not create expectations with creditors which will not be realized. In *Lamb Brothers v Brenner and Co*,[848] the court held that the undisclosed partner whose credit has not been relied upon by third parties dealing with the partnership, has no general liability as an 'undisclosed principal' beyond that fixed by the limited agreement of the parties. However, the *en commandite* partner and anonymous partner both cannot claim repayment of their contributions or payment of their share of the partnership profits until the creditors of the partnership have been settled and while the partnership is still in existence.[849] In *Sabatelli v St. Andrew's Building Society and Ors*,[850] it was stated:

> 'as an anonymous partner … had no right to claim possession of assets while the partnership remained in existence.'[851]

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[844] *Van Oudtshoorn v Investec Bank Ltd* 2011 SA 205 SCA.
[845] Wallis JA referenced: *Mmabatho Food Corporation (Pty) Ltd v Fourie en 'n Andere* 1985 (1) SA 318 (T) at 322G-I. R v Siegel & Frenkel 1943 SR 13 at 15
[846] Wallis JA referenced: *R v Siegel and Frenkel* 1943 SR 13 at 15.
[847] *Mmabatho Fruit Corporation (Pty) Ltd v Fourie en Andere* 1985 (1) SA 318 (T).
[848] *Lamb Brothers v Brenner and Co* 1886 (5) EDC 152 at 165.
[849] *Sabatelli v St. Andrew's Building Society and Ors* 1933 WLD 55.
[850] *Sabatelli v St. Andrew's Building Society and Ors* 1933 WLD 55.
[851] *Sabatelli v St. Andrew's Building Society and Ors* 1933 WLD 55.

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The further similarity between an *en commandite* partner and anonymous partner is that both may not participate actively in the business of the partnership. Therefore, the immunity from liability of the *en commandite* partner and anonymous partner to creditors for partnership debts flows from the fact that the disclosed partner has neither actual nor apparent authority to bind the undisclosed partner. In *Eaton and Louw v Arcade Properties (Pty) Ltd*,[852] Munnik AJ stated the following:

> '…Furthermore, the anonymous partner may not participate actively in the business of the partnership … The partnership *en commandite* has the same features as the anonymous partnership save that the anonymous or undisclosed partner, while sharing in the profits, is not liable for the losses of the fixed sum contributed by him to the partnership as capital.'[853]

In both the *en commandite* partnership and anonymous partnership, the business of the partnership is carried out in the name of the disclosed partners. The rules by which a partnership in which the liability of certain partners (undisclosed partners) are expressly limited are set out in *Siegel and Frenkel v R*.[854] These rules are summarised as follows (i) the undisclosed partner must be carefully concealed from the world; (ii) the undisclosed partner has no right to interfere in the partnership business; and (iii) the undisclosed partner cannot claim his capital until creditors have been paid.[855] However creditors do not look to the undisclosed partner for their claims as he is unknown to them, therefore the undisclosed partner must not be held out as a partner. If there is a breach of anonymity he becomes an ordinary partner.[856]

The *en commandite* partnership is widely used to structure private equity funds in South Africa, as opposed to the anonymous partnership because the *en commandite* partner (for example an investor such as a pension fund) is only liable insofar, and limited to, the amount of its agreed capital contribution. In practice, the investor participants contribute capital to an *en commandite* partnership for a share in the profits or losses of the partnership.[857] The private equity firm or a related entity could be appointed as the general partner (the disclosed partner) for the *en commandite* partnership. In the case of *en commandite* partnership, only the general partner is known to the outside world and contracts with the outside world. The other partners, namely the *en commandite* partners are called limited partners or simply investors and do not participate in the active affairs of the partnership. They are only liable to the extent of their capital contributed and/or profits derived by

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[852] *Eaton and Louw v Arcade Properties (Pty) Ltd* 1961 4 SA 233 (T).
[853] *Eaton and Louw v Arcade Properties (Pty) Ltd* 1961 4 SA 233 (T), at 239-240. See also *Sabatelli v St Andrew's Building Society* 1933 WLD 55.
[854] *Siegel and Frenkel v R* 1943 SR.
[855] *Siegel and Frenkel v R* 1943 SR.
[856] Havenga, M.K. and Locke, N. (2010), 'Corporations and Partnerships in South Africa', Kluwer Law International, at pages 109-118.
[857] As discussed earlier in this paragraph, a partnership is not a legal person distinct from the persons comprising the partnership including for tax purposes, therefore a partnership must keep proper books and records and submit a copy of the partnership balance sheet and income statements in support of each individual partner's annual tax return.

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the partnership.[858] In the current context, the main risk for an investor is that it is held out to the world as an ordinary partner or acts as such. It is therefore important that they not advertise their involvement in a private equity fund (partnership), or seek to engage with third parties in respect of the partnership. Private equity funds commonly establish investment committees to which investors may nominate representatives (depending on the size of their investment). The investment committee will typically assess potential investments identified by the private equity firm. This would not of itself render the investors ordinary partners, provided the committee does not participate in the business or affairs of the partnership. For example by attending meetings or negotiations with potential portfolio companies, a third party could consider them to be ordinary partners.

(b) The General Taxation Provisions

As mentioned earlier, this chapter will not discuss the taxation of private equity funds.[859] Such a discussion is beyond the scope of this analysis; however the next paragraph will mention the key tax principles aimed at highlighting an important structural feature of an *en commandite* partnership. This being: to eliminate entity-level tax while protecting the investors in the fund from personal liability for the debts and obligations of the fund. An advantage of using an *en commandite* partnership, as previously stated, was that it serves as a 'pass-through' entity for income tax purposes and, therefore, is not subject to corporate income tax in terms of the Income Tax Act 58 of 1962. A partnership is not a 'person' as defined in the Income Tax Act 58 of 1962 and therefore is not regarded as a taxpaying entity.[860] A partnership is not subject to tax and the partners are taxable in their individual capacities.[861] As a partnership does not form a separate taxable entity for normal tax purposes, the partners are taxed on the profits accruing to them in terms of the partnership agreement in their personal capacities, whether or not there has been a distribution. In addition, they are able to claim deductions and allowances in their personal capacities.[862] Therefore, the *en commandite* partnership's income, gains, losses and deductions are passed through to the investors and taxed only once at the investor level.

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[858]As discussed earlier in this paragraph 3.1.1(a) of this chapter, these limited partners or investors may not participate in the management of the partnership or hold themselves out to the public as partners.

[859]Including the tax treatment of underlying portfolio interests. However, in the context of a private equity fund, brief reference is made in paragraph 3.1.3(e) of this chapter two to *African Life Investment Corporation (Pty) Ltd v SIR* (1969) 4 SA 259 (A), *CIR v Nussbaum* 1996 (4) SA 1156 (A), 58 SATC 283, 1996 Taxpayer 150, and *ITC 1412* (1983) 48 SATC 157. The brief discussion relates to the proceeds from the realisation of the shares in the investee company which can be said to be of a capital nature resulting in the return to the investors being liable to the lower capital gains tax.

[860]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragragraph 15, at page 475. There are certain sections in the Income Tax Act 58 of 1962 which deal with partnerships, such as section 66(15), which require that the partnership makes a joint return (the respective investors/partners collectively) and each partner is separately and individually liable for rendering such a return.

[861]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragragraph 15, at pages 475-488.

[862]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragragraph 15, at pages 475-488.

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The *en commandite* partnership involves an undisclosed partner who contributes a specified amount of capital and in return receives a percentage of the profits.[863] In practice the South African Revenue Service ('SARS') apportions the taxable income from the partnership amongst the partners in their profit-sharing ratio and each partner is taxed on his share of the profits.[864] Losses are restricted to the amount of capital contributed by the limited partner. Section 24H of the Income Tax Act 58 of 1962 regulates the tax treatment of *en commandite* partners and clarifies the question of accruals to individual partners in general. Section 24H(1) of the Income Tax Act 58 of 1962 defines the term 'limited partners'. It reads as follows:

> ' 'limited partner' means any member of a partnership *en commandite*, an anonymous partnership, any similar partnership or a foreign partnership, if such member's liability towards a creditor of the partnership is limited to the amount which the member has contributed or undertaken to contribute to the partnership or is in any other way limited.'

In terms of section 24H(2) of the Income Tax Act 58 of 1962, each partner is deemed to be carrying on the trade or business of the partnership whether or not it is *en commandite* partnership. Section 24H(2) of the Income Tax Act 58 of 1962, reads as follows:

> 'Where any trade or business is carried on in partnership, each member of such partnership shall, notwithstanding the fact that he may be a limited partner, be deemed for the purposes of this Act to be carrying on such trade or business.'

The impact of section 24H(2) of the Income Tax Act 58 of 1962 is that all partners, even *en commandite* partners, of a partnership that is carrying on a trade or business, are deemed to be carrying on that trade or business. Furthermore, the introduction of section 23H(3) of the Income Tax Act 58 of 1962 is aimed at discouraging the use of limited partnerships in tax-avoidance schemes, by limiting claimable deductions and allowances.[865] Section 24H(3)(a) and (b) of the Income Tax Act 58 of 1962 is the most important part of section 24H. It reads as follows:

> 'Notwithstanding anything to the contrary in this Act contained, the amount of any allowance or deduction which may be granted to any taxpayer under any provision of this Act in respect of or in connection with any trade or business carried on by him in a partnership in relation to which he is a limited partner shall not in the aggregate exceed the sum of —

[863] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 15, at page 485.
[864] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 15, at page 485.
[865] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 15, at page 486.

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(a) the amount, whether it consists of the taxpayer's contribution to the partnership or of any other amount, for which the taxpayer is or may be held liable to any creditor of the partnership; and

(b) any income received by or accrued to the taxpayer from such trade or business.'

Section 24H(3) of the Income Tax Act 58 of 1962 restricts any allowance or deduction which *en commandite* partners may claim. The total which may be deducted or subject to an allowance is; the amount for which the *en commandite* partner is or may be held liable to creditors,[866] plus any income received by or accrued to the *en commandite* partner from the partnership.[867]

As mentioned above, a partnership is not a taxable entity rather it is the individual partners who are liable for normal tax on their portion of the partner's profits.[868] Section 24H(5) of the Income Tax Act 58 of 1962 states that any income received by or accrued to the partners in common, namely to the partnership, is deemed to accrue to the partners in their profit-sharing ratios on the same date on which it is received by or accrues to the partnership. Expenses and allowances relating to such amounts are also deemed to be those of the individual partners in this ratio. Section 24H(5)(a) and (b) of the Income Tax Act 58 of 1962 reads:

'(a) Where any income has in common been received by or accrued to the members of any partnership or foreign partnership, a portion (determined in accordance with any agreement between such members as to the ratio in which the profits or losses of the partnership are to be shared) of such income shall, notwithstanding anything to the contrary contained in any law or the relevant agreement of partnership, be deemed to have been received by or to have accrued to each such member individually on the date upon which such income was received by or accrued to them in common.

(b) Where a portion of any income is under the provisions of paragraph (a) deemed to have been received by or to have accrued to a taxpayer, a portion (determined as aforesaid) of any deduction or allowance which may be granted under the provisions of this Act in the determination of the taxable income derived from such income shall be granted in the determination of the taxpayer's taxable income so derived.'

[866]Section 24H(3)(a) of the Income Tax Act 58 of 1962.
[867]Section 24H(3)(b) of the Income Tax Act 58 of 1962.
[868]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 15, at page 476.

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The purpose of Section 24H(5)(a) and (b) of the Income Tax Act 58 of 1962 is to override a legal principle which arose in the case *Sacks v CIR*[869] where it was held that the taxpayer's share of profits only accrued to him at the end of the partnership's financial year, when the profits were brought to account.[870] The facts of this case involved a change in the partnership agreement prior to dissolution, which provided for the payment of a lump sum to any outgoing partner in respect of his portion of the profits earned by the partnership during the period of assessment until the date of dissolution. The arrangement was made for administrative reasons, such as escaping the need to prepare a balance sheet and doing a stock-take.[871] Had the accounts been prepared as at the date of the partner's retirement, the outgoing partner's profit share would have been considerably larger than the amount of the lump sum he received. In *Sacks v CIR*, Watermeyer CJ held that that any amount that accrued to the partnership, namely the partners in common, only accrued to the individual partners in their profit-sharing ratio at the end of the period established in the partnership agreement, when account of the profits would be taken.[872] According to Meyerowitz, this view was in contrast to the Commissioner's contention that each partner became entitled to his share of any partnership accrual on the day that it accrued to the partnership.[873] In *ITC 75152*[874] the court did not refer to the judgment in *Sacks v CIR*[875] and the judgment was in favour of the Commissioner, while in *ITC 1042*[876] tax court decision court followed the precedent set in *Sacks v CIR*[877] and decided against the Commissioner.[878]

It was for this reason that section 24H(5) of the Income Tax Act 58 of 1962 was introduced to end the confusion noted above. According to Williams, the implementation of section 24H(5) of the Income Tax Act 58 of 1962 is also a preventative measure against partnerships being used as tax avoidance mechanisms.[879] Williams argues that in terms of judgment in *Sacks v CIR,*[880] partners had

[869] *Sacks v CIR* 1946 AD 31, 13 SATC 343.
[870] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragragraph 15, at page 476. See Haupt, P. (2015), 'Notes on South African Income Tax', 34th edition, at page 272.
[871] *Sacks v CIR* 1946 AD 31, 13 SATC 343.
[872] *Sacks v CIR* 1946 AD 31, 13 SATC 343, at 40-41.
[873] Meyerowitz, D. (2004), 'Meyerowitz on Income Tax [2003-2004]', Cape Town: The Taxpayer, at 16-27.
[874] *ITC 751* 1952 (18) SATC 416.
[875] *Sacks v CIR* 1946 AD 31, 13 SATC 343.
[876] *ITC 1042* 1964 (26) SATC 189.
[877] *Sacks v CIR* 1946 AD 31, 13 SATC 343.
[878] Meyerowitz, D. (2004), 'Meyerowitz on Income Tax [2003-2004]', Cape Town: The Taxpayer, at pages 16-27. See also Bamford, B.R. (1982), 'The Law of Partnerships and Voluntary Associations in South Africa', Juta and Company Ltd, Third Edition.
[879] Williams, R.C. (1996), 'Income tax in South Africa Law and Practice', Third Edition, Butterworths Publishers, at 389. See also Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 15, at pages 475-488.
[880] *Sacks v CIR* 1946 AD 31, 13 SATC 343.

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the possibility of postponing income from accruing to them; as well as the freedom to manipulate their profit-share percentages, provided all partners agree, before the end of the period of account.[881]

Insofar as a partnership conducts share trading,[882] the revenue resulting from the sale of shares will constitute 'income' for purposes of section 24H(5)(a) of the Income Tax Act 58 of 1962 in the hands of the partners; and the cost of purchasing shares,[883] will result in an allowable deduction for each of the partners. Dividends received on shares will be apportioned among the partners in accordance with the respective participation interests, and will not attract income tax.[884] Concomitantly, as mentioned above, there is a deeming provision in section 24H(5)(b) of the Income Tax Act 58 of 1962 that in each such instance of a deemed receipt by or accrual to each partner, each partner is entitled to claim as a deduction, a portion of the allowed deductions (and allowances) pertaining to the business that is carried on in partnership.[885]

Certain private equity funds, such as leveraged buyout funds discussed in paragrapgh 3.1 of chapter one, include gearing-up as a fundamental part of their strategy. However, as discussed in chapter one, such gearing is typically undertaken at the underlying portfolio/target company level and not at the private equity fund level. Therefore the liability for the interest bearing debt is generally restricted at the target company level and remains the responsibility of the underlying portfolio company. However, should a private equity fund incur interest bearing debt, each partner must deduct from its income, for each year of assessment in terms of section 24J(2) of the Income Tax Act 58 of 1962, its proportional share of the interest amount incurred.[886] However, in terms of section 24H(3) of the

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[881]Williams, R.C. (1996), 'Income tax in South Africa Law and Practice', 3rd Edition, Butterworths Publishers, at 389. See also Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragragraph 15, at pages 475-488.

[882]For example, a private equity fund structured as an *en commandite* partnership that acquires shares in underlying portfolio investee companies.

[883]The cost of purchasing the shares will be subject to the provisions in section 22 of the Income Tax Act 58 of 1962, which deals with trading stock adjustments. Section 22(1)(a) and (b) of the reads as follows: 'The amount which shall, in the determination of the taxable income derived by any person during any year of assessment from carrying on any trade (other than farming), be taken into account in respect of the value of any trading stock held and not disposed of by him at the end of such year of assessment, shall be (a) in the case of trading stock other than trading stock contemplated in paragraph (b), the cost price to such person of such trading stock, less such amount as the Commissioner may think just and reasonable as representing the amount by which the value of such trading stock, not being any financial instrument, have been diminished by reason of damage, deterioration, change of fashion, decrease in the market value or for any other reason satisfactory to the Commissioner; and (b) in the case of any trading stock which consists of any instrument, interest rate agreement or option contract in respect of which a company have made an election which have taken effect as contemplated in section 24J(9), the market value of such trading stock as contemplated in such section.'

[884]Each partner must include in his gross income for each year of assessment as required by section 24J(3), a proportional part of the interest amount accrued by the partnership at any stage during the year of assessment.

[885]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 15, at page 476.

[886]Section 24J(2)(a) and (b) of the Income Tax Act 58 of 1962 reads as follows: 'Where any person is the issuer in relation to an instrument during any year of assessment, such person shall for the purposes of this Act be deemed to have incurred an amount of interest during such year of assessment, which is equal to (a) the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within such

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Income Tax Act 58 of 1962 discussed above, the allowed deductions of an *en commandite* partner would be capped at the sum of (a) the amount for which such partner is or may be held liable to any creditor of the partnership; and (b) any income received by or accrued to such partner from the trade or business that is carried on in partnership.

(c) The Termination of a Partnership

As mentioned in chapter one, a critical characteristic of the private equity business model is the pre-determined, fixed life period of a private equity fund. Therefore, a private equity fund structured as an *en commandite* partnership will be terminated at some point. A partnership relationship may be terminated or dissolved in several ways, for instance by mutual agreement (express or implied) between partners; unilateral action of a partner; court order; insolvency of the partnership or partner; mental incapacity and death; and the happening of some other event or a supervening impossibility.[887] For the purpose of the current discussion, it is important to emphasize that a partnership has a contractual basis and therefore it is important for the partnership agreement itself to provide express terms as to when the partnership can be terminated. For instance, a private equity fund *en commandite* partnership agreement may contain early termination provisions that allow the investors to remove and replace the private equity firm or elect to liquidate the fund, for example, on the grounds of fraud, regulatory breaches and/or gross negligence committed on the part of the private equity firm. It makes perfect sense that while the law does not require a written partnership agreement; it is obviously advisable that the partnership agreement be in writing. According to Gibson *et al*, a partnership relationship may be terminated by agreement between the parties, whether express or implied in accordance with the ordinary rules of contract.[888]

In the case of a private equity fund, the *en commandite* partnership agreement is entered into for a fixed term and the dissolution of the partnership will come about by the expiration of that term. Typically in such partnership agreements, there will be many examples of express dissolution clauses which expand the available grounds for dissolution. However, in theory there seems to be a limitation in the transferability of investor’s interests in the private equity partnership structure despite the numerous dissolution clauses contained in such partnership agreements. For example, every instance a new partner joins or an existing partner leaves a partnership, a new partnership is formed.

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year of assessment in respect of such instrument or (b) an amount determined in accordance with an alternative method in relation to such year of assessment in respect of such instrument; which must be deducted from the income of that person derived from carrying on any trade, if that amount is incurred in the production of the income.’

[887] Havenga, M.K. and Locke, N. (2010), ‘Corporations and Partnerships in South Africa’, Kluwer Law International, at pages 119-123.

[888] Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), ‘South African Mercantile and Company Law’, Juta and Company Ltd, 8th Edition, at page 253. See also Henning, J.J. (2015), ‘Perspectives on the Law of Partnership in South Africa’, Juta and Company Limited, 1st Edition.

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In *Standard Bank v Wentzel and Lombard*[889] the court held that even if there is an agreement amongst the partners to change the membership of the partnership, the result will be that the original partnership has been terminated. Therefore if a new partner is introduced into a partnership, the old partnership is put to an end and new partnership is constituted.[890] Similarly, if the agreement between the partners at the time of entering into the agreement, states the period for which the partnership will last, the partnership will terminate at the end of that period.[891] In practice, the partnership agreement of a private equity fund will at the time of concluding the agreement between the *en commandite* (investors) and disclosed (private equity firm) partners, expressly provide for the period for which the partnership will last. As mentioned earlier in this chapter, these private equity funds are closed-end funds which have a specific term, typically ten years, and which may be extended by one to two year periods. However, these extension periods would require the consent of all the partners, namely the *en commandite* (investors) and disclosed (private equity firm) partners. A further theoretical limitation is that any partner can, generally speaking, freely terminate a partnership. A partner may terminate a partnership by his unilateral act in giving notice of renunciation, if a definite time for the partnership has not been fixed.[892] Despite private equity funds being structured with a definite time period, one partner[893] may still terminate the partnership by notice before the fixed term has expired. This was held to be case by the court in *Wiehahn and Others v Marias*. [894] However, the court in this case noted that if a partner unilaterally terminates the partnership before the expiry of the fixed term, he will be in breach of contract and will be liable for damages, but the partnership is still terminated.[895]

Nevertheless, after the termination of the partnership relationship, liquidation is necessary.[896] In *Bosman NO v The Registrar of Deeds and The Master*[897] it was held that liquidation of a partnership entails the payment of the debts of the partnership, the realisation of the assets, and a division of the surplus; and for this purpose the mutual mandate of the partners continues even after termination. In terms of a private equity fund structured as a partnership, the liquidation process would be expressly agreed at the time of the formation of the partnership. In practice, there are often unforeseen circumstances that may warrant a change in the manner of liquidation, in such circumstances the partners will usually agree amongst themselves, at least at the time of termination, to an appropriate alternative manner of liquidation. In *Meissner v Joubert*[898] the court held that once

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[889] *Standard Bank v Wentzel and Lombard* 1904 TS 828 at 385.
[890] *Standard Bank v Wentzel and Lombard* 1904 TS 828 at 385.
[891] Van der Linden, J. (1806), 'Regtsgeleerd, Practicaal en Koopmans Handboek', Unkown Publisher, at 4.1.14.
[892] Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition, at page 253.
[893] May be an *en commandite* (investor) or disclosed (private equity firm) partner.
[894] *Wiehahn and Others v Marias* 1965 (1) SA 398.
[895] *Wiehahn and Others v Marias* 1965 (1) SA 398.
[896] Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition, at page 256.
[897] *Bosman NO v The Registrar of deeds and The Master* 1942 CPD 303 at 307.
[898] *Meissner v Joubert* 1946 CPD 618.

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the partners have agreed to a process of termination albeit expressly in terms of the original partnership agreement or amongst the partners at the time of termination, if no express agreement was originally concluded or in terms of an agreed variation subsequent to the original agreement; then the liquidation simply takes place along the agreed lines. In Gibson *et al,* quoting the cases of *Ferreira v Fouche,*[899] *Vigne's Executor v MacKenzie*,[900] *Simon v Cramb*,[901] and *Commissioner for Inland Revenue v Estate Whiteway*[902] stated the following with regard to the liquidation of a partnership agreement:

> '… A liquidator is appointed by the partners…. Such liquidator then collects what is due to the partnership if anything, by each partner, pays the debts of the partnership, realizing certain of the assets, if necessary, for this purpose, and distributes the balance, with or without realisation; in the manner expressly agreed between the partners … If the partners cannot agree upon a liquidator the Court may be approached to appoint one, but only if good cause is shown…. Such good cause will be shown if the partners 'are at arm's length' … After satisfaction of the partnership debts, the assets are distributed between the partners, in the absence of agreement in the same proportions as the value of their contribution to the common stock ... But if one partner's contribution has no value placed upon it or no clearly ascertainable value (such as where the partner has contributed labour or skill), the same proportion as their share in the profits.'[903]

Termination can cause considerable disruption and problems, especially in the case of an ongoing business such as a private equity fund. In practise this rarely occurs, because investors in private equity funds are typically sophisticated investors that fully understand the risks and structural features of private equity funds such as it being ten year, fixed life, and illiquid investment vehicle. As mentioned above, while the law does not require a written partnership agreement; it is obviously advisable that the partnership agreement be in writing. In this regard, Mcleary aptly states that the partnership agreement:

> ' … should specify the method of division of profits and losses; provide for the carrying on of the business of the partnership in the case of the death of one of the partners; provide for the carrying of insurance policies on the lives of the partners to enable surviving partners to have the cash available to settle claims by the deceased estate; provide a mechanism for the easy dissolution of the partnership and distribution of the assets; and include any limitations on the powers to act

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[899] *Ferreira v Fouche* 1949 (1) SA 67 (T).
[900] *Vigne's Executor v MacKenzie* 1913 TPD 42.
[901] *Simon v Cramb* 1926 TPD 37.
[902] *Commissioner for Inland Revenue v Estate Whiteway* (1933) TPD 486, at 501.
[903] Gibson, J.T.R., Visser, C., Pretorius, J.T., Sharrock, R. and Van Jaarsveld, M. (2003), 'South African Mercantile and Company Law', Juta and Company Ltd, 8th Edition, at page 257.

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of any of the partners and any other matters which are relevant to the particular partnership concerned.'[904]

It is submitted in conclusion of this part of the discussion, that there are several reasons why *en commandite* partnership has become one of the dominant legal structures that are used in the private equity industry in South Africa. For instance, the popularity of such vehicles is due to its contractual nature which allows for the alignment of interest between the private equity firm and investors. The *en commandite* partnership structure permits the private equity firm to achieve extensive control over the operation of the private equity fund subject to the terms and conditions of the partnership agreements. In addition, this type of structure includes the tax benefits it affords, the flexibility surrounding its conditions and terms and its fixed life. The flexibility of the limited partnership allows the internal and external participants to enter into schemes and express contractual terms that align the incentives of the private equity firm with those of outside investors.

3.1.2 Use of a Trust

This paragraph will introduce a cursory discussion on the salient aspects of the law of trusts. The purpose is to provide a context for the critical analysis of the distinguishing features of a *bewind* trust as a vehicle used to structure private equity funds in South Africa. The trust concept was established in South Africa during the early 1800's as a result of court judgments and through legislation.[905] However, it must be noted that this paragraph will not discuss the historical development and treatise of the law of trusts in South Africa because the subject is extensive and is beyond the scope of this discussion.[906] However, the aim is to introduce the salient aspects of the law of trusts as part of the discussion of the appropriate legal vehicles used to structure private equity funds in South Africa. According to Geach and Yeats, the law of trusts in South Africa is not contained in a single statue.[907] According to Honiball and Olivier, the Trust Property Control Act 57 of 1988 regulates administrative aspects relating to trusts, but is not a codification of the law regulating trusts.[908] Therefore, the next paragraph on the definition of a trust will canvass the statutory and judicial definitions of trusts.

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[904]Mcleary, F. (2000), 'Accounting and Its Business Environment', Juta and Company Ltd, at page 37.
[905]Olivier, P.A., Strydom, S. and Van den Berg, G.P. (2009), 'Trusts Law and Practice Service Issue 2', LexisNexis: Durban.
[906]In this regard see *Braun v Blann and Botha NNO and Another* 1984 (2) SA 850 (A) at 858(H)-866 (D). See also De Bruin, J.H., Snyman, E. and Henning, J.J. (2003), 'Die Suid-Afrikaanse trustreg in historiese perspektief', Journal for Estate Planning Law, 1-25, at 5. See also Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at pages 1-30.
[907]Geach, W.D. and Yeats, J. (2007), 'Trusts: Law and Practice', Juta and Company Ltd, at page 4.
[908]Honiball, M. And Olivier, L. (2009), 'The Taxation of Trusts in South Africa', First Edition, Siber Ink, at 10.

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According to Van der Merwe and Rowland, the word 'trust' can be used in both a wide and narrow sense.[909] Olivier describes trust in the wide sense as a relationship of confidence or good faith with respect to property and beneficiaries.[910] The author states that such a relationship could, for instance arise in the case of an appointee who is the executor of a deceased estate, the curator of a mentally ill person or the trustee of an insolvent estate.[911] The important point to bear in mind is that these functionaries never become the owners of the property; instead they merely hold or administer the property for the benefit of a beneficiary or class of beneficiaries.[912] Similar to the relationship between partners having to display *uberrimae fides*,[913] this requirement must also be present in relation to trusts.[914] In *Doyle v Board of Executors*,[915] the court held that a trustee occupies a fiduciary office, which imposes upon such trustee the duty of utmost good faith all towards beneficiaries. Nevertheless, Du Toit argues that the duty of care is the most important aspect of the fiduciary nature of a trustee's office, and therefore must exercise his/her duties and powers in utmost good faith, which in essence implies compliance with the duty of care.[916]

Du Toit argues that in the narrow sense, 'trust' refers to the trust as a legal institution.[917] Cameron *et al*,[918] made reference to the case *Land and Agricultural Bank of South Africa v Parker and Others*,[919] where Cameron JA stated that this type of trust is a species of the trust in the wide sense; the core idea behind which is the separation of ownership and control from the enjoyment of the trust benefits so derived.[920] This type of trust is defined by Cameron *et al* as being:

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[909]Van Der Merwe, N.J. and Rowland, C.J. (1990), 'Die Suid-Afrikaanse Erfreg', 6th Edition, Van der Walt, Pretoria at 343. Van der Merwe and Rowland states that the word 'trust' must be used with caution 'omdat die woord soms in 'n wye sin gebruik kan word en ander kere weer in 'n enge of juridies-tegniese sin'. See *Zinn NO v Westminster Bank Ltd NO* 1936 AD 89, at 96-97 and *Conze v Masterbond Participation Trust Managers (Pty) Ltd and Others* 1996(3) SA 786(C) at 794(D)-(E).

[910]Olivier, P.A. (1990), 'Trust Law and Practice', First Edition, De Jager-Haum Publishers, at page 2.

[911]Olivier, P.A. (1990), 'Trust Law and Practice', 1st Edition, De Jager-Haum Publishers, at page 2. See also Du Toit, F. (2007), 'South African Trust Law: Principles and Practice', 2nd Edition, Butterworths, at page 2.

[912]Olivier, P.A. (1990), 'Trust Law and Practice', 1st Edition, De Jager-Haum Publishers, at page 2. See also Du Toit, F. (2007), 'South African Trust Law: Principles and Practice', 2nd Edition, Butterworths, at page 2.

[913]The Latin expression meaning utmost good faith. See paragraph 3.1.1(a)-(c) of this chapter.

[914]Du Toit, F. (2007), 'The Fiduciary Office of Trustee and the Protection of Contingent Trust Beneficiaries', Stellenbosch Law Review, 3, at pages 469-482. See also Du Toit, F., (2002), 'South African trust law and practice', Butterworths. See also paragraph 3.1.1(a)-(c) of this chapter.

[915]*Doyle v Board of Executors* 1999 (2) SA 805 (C).

[916]Du Toit, F. (2007), 'The Fiduciary Office of Trustee and the Protection of Contingent Trust Beneficiaries', Stellenbosch Law Review, 3, at pages 469-482. See also Du Toit, F., (2002), 'South African trust law and practice', Butterworths. This theoretical framework of the law of trusts will be contextualised to its practical aspects with regard to the relationship between the private equity fund manager and the investors, as well as the private equity funds' assets/underlying portfolio investee company(ies) in paragraph 4 of chapter 3.

[917]Du Toit, F. (2007), 'South African Trust Law: Principles and Practice', 2nd Edition, Butterworths, at page 2.

[918]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at pages 4-5.

[919]*Land and Agricultural Bank of South Africa v Parker and Others* 2005 (2) SA 77 (SCA).

[920]*Land and Agricultural Bank of South Africa v Parker and Others* 2005 (2) SA 77 (SCA) at para. 19 and 22.

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> 'a legal institution in which a person, the trustee, subject to public supervision, holds or administers property separately from his or her own, for the benefit of another person or persons or for the furtherance of a charitable or other purpose.'[921]

In this form, the founder of the trust transfers the ownership of certain assets to a trustee (or trustees) who are to administer those trust assets for the benefit of certain named beneficiaries, or for the achievement of some purpose.[922] Both the ownership and the control of the trust assets are vested in the trustee, not in his personal capacity but in his capacity as trustee.[923] The trust assets must be kept separate from the personal assets of the trustee, and thus form a separate 'trust estate', even though the trust is not regarded as a separate legal person in its own right.[924] The trustee enters into contracts in his capacity as trustee, and creditors of the trust look to the assets of the trust for satisfaction of their claims.[925] Should the trust go insolvent, the creditors cannot execute against the personal estates of either the trustee or the beneficiaries, who accordingly enjoy a form of limited liability.[926] Nevertheless, one of the main differences between 'trust' in the wide and the 'trust' in the narrow sense is the fact that in the narrow sense the person so entrusted (the trustee) generally becomes the owner, but not for his own personal benefit.[927] In the case *Conze v Masterbond Participation Trust Managers (Pty) Ltd and Others,*[928] the court held that this type of trust, namely one where the trustee becomes the owner of the trust property, can be termed an 'ownership' trust. In the narrow sense, all the benefits which accrue or arise as a consequence of this ownership are passed on to the trust beneficiaries.[929] Furthermore, in the case of the trust in the narrow sense, the trustee holds an office, while this is not necessarily the case with the trust in the wide sense.[930] In *Land and Agricultural Bank of South Africa v Parker and Others*,[931] Cameron JA stated:

> ' ... the trustee is appointed and accepts office to exercise fiduciary responsibility over property on behalf of and in the interests of another.'[932]

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[921]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' 5th Edition, Juta and Co. Ltd, at page 1.
[922]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at pages 1-30. See also Du Toit, F. (2007), 'South African Trust Law: Principles and Practice', Second Edition, LexisNexis, Butterworths.
[923]Cameron, E, De Waal, M., Wunsh, B, Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' 5th Edition, Juta & Co., at 1-30. See also Olivier, P.A. (1990), 'Trust Law and Practice', 1st Edition, De Jager-Haum Publishers.
[924]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' 5th Edition, Juta and Co. Ltd, at pages 1-30.
[925]Du Toit, F. (2007), 'South African Trust Law: Principles and Practice', 2nd Edition, Butterworths.
[926]Olivier, P.A. (1990), 'Trust Law and Practice', First Edition, De Jager-Haum Publishers.
[927]*Conze v Masterbond Participation Trust Managers (Pty) Ltd and Others* 1996 (3) SA 786(C) at 794D-E.
[928]*Conze v Masterbond Participation Trust Managers (Pty) Ltd and Others* 1996 (3) SA 786(C) at 794D-G.
[929]*Conze v Masterbond Participation Trust Managers (Pty) Ltd and Others* 1996 (3) SA 786(C) at 794D-E.
[930]*Land and Agricultural Bank of South Africa v Parker and Others* 2005 (2) SA 77 (SCA) at paragraph 20.
[931]*Land and Agricultural Bank of South Africa v Parker and Others* 2005 (2) SA 77 (SCA).
[932]*Land and Agricultural Bank of South Africa v Parker and Others* 2005 (2) SA 77 (SCA) at paragraph 20.

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Furthermore, in the exceptional case of the trustee of a trust in the wide sense actually holding an office, this office is subject to different legal rules.[933]

(a) The Definition of a Trust

The Trust Property Control Act 57 of 1988 introduced a statutory definition of trust into South African law.[934] It defines a trust as a contract whereby a donor, or settlor, transfers assets to a trustee or trustees. No trust can exist without the settlor handing over control of the trust property or having bound himself or herself to hand over control of the trust property.[935] Usually the handing over of control of the trust property means that ownership of the trust assets is transferred by the settlor to the trustee.[936] The settlor may be a co-trustee and therefore co-owner of the trust property.[937] Furthermore, there can be no objection to the settlor being the only trustee, provided he/she is not also the only beneficiary.[938] In South African law it is also possible for a settlor to transfer ownership of trust property directly to the beneficiary, in which case the trustee will then simply administer the property for the benefit of the beneficiary.[939] Therefore, the trustee controls the trust property on behalf of the beneficiary who is the owner.[940] This type of trust is known as a *'bewind'* trust, which will be discussed below.

As mentioned above, the administration of trusts is governed by the provisions of the Trust Property Control Act 57 of 1988. There are two types of trust, namely an *inter-vivos* trust and a testamentary trust: (a) an *inter-vivos* trust is created between living persons; and (b) a testamentary trust derives from a valid will of a deceased.[941] An important distinction must be drawn between these two concepts. Firstly, the testamentary trust or the trust *mortis causa,* is created by a will during the testator's lifetime, but it only becomes effective on his or her death.[942] On the other hand, the trust *inter vivos* is created between living persons in the form of a contract.[943] This trust is thus established

[933]Du Toit, F. (2007), 'South African Trust Law: Principles and Practice', 2nd Edition, Butterworths, at pages 2-3.
[934]Du Toit, F. (2007), 'South African Trust Law: Principles and Practice', 2nd Edition, Butterworths.
[935]Du Toit, F. (2007), 'South African Trust Law: Principles and Practice', 2nd Edition, Butterworths, at page 9.
[936]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at page 6.
[937]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at page 6. See also Du Toit, F. (2007), 'South African Trust Law: Principles and Practice', Second Edition, LexisNexis, Butterworths, at page 9.
[938]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at page 6.
[939]Section 1(b) of the Trust Property Control Act 57 of 1988.
[940]Du Toit, F. (2007), 'South African Trust Law: Principles and Practice', 2nd Edition, Butterworths, at page 4.
[941]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894. See Haupt, P. (2015), 'Notes on South African Income Tax', Thirty Fourth Edition, at page 920.
[942]Olivier, P.A. (1990), 'Trust Law and Practice', First Edition, De Jager-Haum Publishers, at pages 25-26.
[943]Du Toit, F. (2007), 'South African Trust Law: Principles and Practice', 2nd Edition, LexisNexis, Butterworths, at page 7. See also Olivier, P.A. (1990), 'Trust Law and Practice', 1st dition, De Jager-Haum Publishers, at page 26.

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during the founder's lifetime and exists from the moment of execution of the founding contract or agreement.[944] In terms of both of these trusts, there are two types of rights a beneficiary can have.[945] Firstly, either a vested right in terms of which either the income or the capital of the trust must be paid to the particular beneficiary; or secondly, a contingent right in terms of which no particular beneficiary is entitled to any income or capital unless the trustees decide to make a distribution to him/her.[946] If the beneficiary has a vested right, this means that the trustees are merely administering the capital or the income,[947] for that beneficiary only.[948] The author states that if the beneficiary has a contingent right, this means that the trust is a discretionary trust and there is a chance that the beneficiary will never receive any portion of the income or capital in the trust.[949] Kourie and Ryder defines a discretionary trust, as a trust where the ownership and control vest in the trustees in their representative capacity, however, the trust beneficiaries have no right to claim the trust benefits, except and until the trustees have exercised their discretion.[950]

There is a third type of trust, which was previously mentioned, known as the *bewind* trust.[951] The *bewind* trust is a legal construction which has its origins in Dutch Law.[952] In terms of a *bewind* trust, the trust does not own the assets, but it is the beneficiaries that have ownership of the asset(s)s.[953] The trust has the power to manage and control the asset(s) on behalf of the beneficiary who owns it. Therefore, the *bewind* trust occurs when ownership of the trust property is conferred on the trust beneficiary, while control over and administration of the same trust property is vested in the trustee(s) of the trust.[954] Since the beneficiary owns the asset, any income or capital gain arising on the use or

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[944]De Waal, M.J. (2000), 'The Core Elements of the Trust: Aspects of the English, Scottish and South African Trusts compared', The South African Law Journal, at page 548.

[945]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894. See Haupt, P. (2015), 'Notes on South African Income Tax', Thirty Fourth Edition, at page 920.

[946]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894. See Haupt, P. (2015), 'Notes on South African Income Tax', Thirty Fourth Edition, at page 920.

[947]Which have vested in the beneficiary.

[948]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894. See Haupt, P. (2015), 'Notes on South African Income Tax', Thirty Fourth Edition, at page 920.

[949]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894. See Haupt, P. (2015), 'Notes on South African Income Tax', Thirty Fourth Edition, at page 920. The trustees in this case are administering the capital and income for the beneficiaries as a group, with no certainty as to which beneficiaries will ultimately benefit from the funds in the trust, and to what extent.

[950]Kourie, M.A. and Ryder, K. (1997), 'Law and Estate Planning', Easiguide, Butterworths, at page 225.

[951]Section 1(b) of the Trust Property Control Act 57 of 1988 defines the *bewind* trust. See below.

[952]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894. See Haupt, P. (2015), 'Notes on South African Income Tax', Thirty Fourth Edition, at page 921. See also De Waal, M.J. and Schoeman-Malan, M.C. (2003), 'Introduction to the Law of Succession', Third Edition, Juta and Company Ltd, at page 159.

[953]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at pages 6-7. See also *Conze v Masterbond Participation Trust Managers (Pty) Ltd and Others* 1996 (3) SA 786 (C) at 794(D) -(E).

[954]Honoré, T and Cameron, E. (2002), 'Honoré's South African Law of Trusts,' 5th Edition, Juta and Co. Ltd, at pages 6-7.

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disposal of the asset vests in the beneficiary.[955] Du Plessis, quoting De Waal,[956] Koppenol-Laforce and Kottenhagen,[957] and Kortmann and Verhagen[958] states:

> 'The *bewind* is a form of fiduciary administration … The *bewindvoerder* manages the assets for the benefit of a beneficiary, but it is the beneficiary and not the *bewindvoerder* who is the owner of the assets. Thus the *bewind* differs from the trust in the sense that in a trust the trustee is the owner of the trust assets. In a *bewind* the beneficiary is protected in the case of the insolvency of the *bewindvoerder*, as the assets do not form part of the latter's estate.'[959]

In *Braun v Blann and Botha NNO and Another*,[960] Joubert JA described the '*bewindhebber/bewindvoerder* (administrator)' as follows:

> 'In Roman-Dutch law it is possible to couple a *fideicommissum* with *bewind (administratio)* by appointing a *bewindhebber/bewindvoerder* (administrator) to administer the *fideicommissary* property. The legal ownership of the latter, however, does not vest in the *bewindvoerder* who has mere control over *res aliena* for purposes of administration.'[961]

Kourie and Ryder defines a *bewind* trust, as a trust in which the real right of ownership of the trust assets vests in the trust beneficiaries but the management and control over these assets vest in the trustees, but because the trustees do not hold title to the benefits in their own names, their capacity is that of an agent in relation to the trust assets.[962] Section 1 of the Trust Property Control Act 57 of 1988, contains the definition of a trust and distinguishes between trusts where the trustee owns trust property (which includes discretionary and vested trusts) and *bewind* trusts. It reads as follows:

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[955] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894. See also Haupt, P. (2015), 'Notes on South African Income Tax', Thirty Fourth Edition, at page 921. See also Lupoi, M. (2000), 'Trusts: A Comparative Study', Cambridge University Press, at page 298.

[956] De Waal, M.J. (2006), 'Comparative Succession Law', in Reimann, M. and Zimmermann, R. (2006), 'The Oxford Handbook of Comparative Law', Oxford University Press, 1088, at page 1092.

[957] Koppenol-Laforce, M.E. and Kottenhagen, R.J.P. (1998), 'The Institution of the Trust and Dutch Law', in Hondius, E. (1998), 'Netherlands Reports to the Fifteenth International Congress of Comparative Law', Intersentia Rechtswetenschappen, 137, at page 143.

[958] Kortmann, S. and Verhagen, H. (1999), 'National Report for the Netherlands', in Hayton, D., Kortmann, S. and Verhagen, H. (1999), 'Principles of European Trust Law', Kluwer Law International, 195, at pages 199-200.

[959] Du Plessis, I. (2014), 'A South African Perspective On Some Critical Issues Regarding The OECD Model Tax Convention On Income And On Capital, With Special Emphasis On Its Application To Trusts', Dissertation presented for Doctor of Laws Degree: Faculty of Law at Stellenbosch University, December 2014, at page 53.

[960] *Braun v Blann and Botha NNO and Another* 1984 (2) SA 850 (A).

[961] *Braun v Blann and Botha NNO and Another* 1984 (2) SA 850 (A) at 864(G)-(H). See Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at pages 6-7. See Olivier, P.A. (1990), 'Trust Law and Practice', 1st Edition, De Jager-Haum Publishers, at page 107.

[962] Kourie, M.A. and Ryder, K. (1997), 'Law and Estate Planning', Easiguide, Butterworths, at page 224.

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'arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed:

(a) to another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument;

(b) or to the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument, but does not include the case where the property of another is to be administered by any person as executor, tutor or curator in terms of the provisions of the *Administration of Estates Act*, 1965 (Act 66 of 1965).'[963]

According to Cameron *et al*, even before the definition of 'trustee' was inserted into section 1 of the Trust Property Control Act 57 of 1988, the word 'trustee' was found by the Courts to be wide enough to include the trustee of a *bewind* trust.[964] These authors[965] referred to *Estate Kemp and Others v McDonald's Trustee*[966] where Innes CJ states:

> 'And the trustees' designation in its English meaning denotes persons entrusted (*as owners or otherwise*) with the control of property with which they are bound to deal for the benefit of others.'[967]

From the above definition, Section 1 of the Trust Property Control Act 57 of 1988 makes a clear distinction where ownership in property is made over to the trustee for the benefit of the beneficiaries and where the property is made over to the beneficiaries, but the control thereof to the trustees. It is apparent that the *bewind* trust falls within the latter part. Furthermore, Section 1 of the Trust Property Control Act 57 of 1988 defines 'trust property' or 'property' as follows:

> 'Trust property or property means movable or immovable property, and includes contingent interests in property which in accordance with the provisions of a trust instrument are to be administered or disposed of by a trustee.'

[963]Section 1 of the Trust Property Control Act 57 of 1988.
[964]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at pages 6-7.
[965]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at pages 6-7.
[966]*Estate Kemp and Others v McDonald's Trustee* 1915 AD 491.
[967]*Estate Kemp and Others v McDonald's Trustee* 1915 AD 491 at 499.

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This indicates that the *bewind* trust is properly covered by trust property, although neither the Deeds Registries Act 47 of 1937 nor the Trust Property Control Act 57 of 1988 makes specific reference to a *bewind* trust. However, in *CIR v Dyefin Textiles (Pty) Ltd*,[968] it was held that the trust in question was a:

> 'trust property so called, where the assets of the trust vested in the trustees, as opposed to a '*bewind* trust', where the founder made a gift or bequest directly to the beneficiary but vested the control of the assets in a trustee or administrator.'[969]

According to Van der Westhuizen, the trust defined in section 1(a) of the Trust Property Control Act 57 of 1988 is the trust in the narrow sense as discussed above.[970] The trust defined in section 1(b) of the Trust Property Control Act 57 of 1988 is the trust in the wide sense and would include a *bewind* trust discussed above.[971] Van der Westhuizen states that a trust will have the *bewind* structure when the beneficiaries provide the trust capital themselves or by guaranteeing the loans made against the security of their own property, in return for which they receive share certificates as proof of their *pro rata* interest in the venture, and as proof of their vested rights in the trust capital.[972] Once the capital has been repaid, they cease to be the beneficiaries.[973]

Section 1 of the Income Tax Act 58 of 1962 defines a trust as meaning:

> 'any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person'[974]

In *Land and Agricultural Bank of South Africa v Parker,*[975] Cameron JA described a trust as:

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[968] *CIR v Dyefin Textiles (Pty) Ltd* 2002(4) SA 606 (N).
[969] *CIR v Dyefin Textiles (Pty) Ltd* 2002(4) SA 606 (N) at 611.
[970] Van Der Westhuizen, W.M. (1997), 'Wills and Trusts', Service Issue Two, Butterworths, at 6. A trust will have a narrow sense when the beneficiaries do not have a vested right in the income and capital of the trust and the trustee have discretionary powers to deal in the income and capital of the trust in a manner he deems fit for the benefit of the beneficiaries.
[971] Van Der Westhuizen, W.M. (1997), 'Wills and Trusts', Service Issue Two, Butterworths, at 6.
[972] Van Der Westhuizen, W.M. (1997), 'Wills and Trusts', Service Issue Two, Butterworths, at page 6.
[973] Van Der Westhuizen, W.M. (1997), 'Wills and Trusts', Service Issue Two, Butterworths, at page 6.
[974] See Du Plessis, I. (2009), 'The residence of a trust for South African income tax purposes', South African Mercantile Law Journal, 21, at 322-343. According Du Plessis (at pages 322-324), the definition of 'trust' in terms of section 1 of the Income Tax Act 58 of 1962, is broader than the definitions offered, for instance, in terms of section 1 of the Trust Property Control Act 57 of 1988; by academics such as Kourie, M.A. and Ryder, K. (1997), 'Law and Estate Planning', Easiguide, Butterworths, at page 224; Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at pages 6-7; and in terms of case law such as *Estate Kemp and Others v McDonald's Trustee* 1915 AD 491 at 499; and *Land and Agricultural Bank of South Africa v Parker and Others* 2005 (2) SA 77 (SCA) at paragraph 10.
[975] *Land and Agricultural Bank of South Africa v Parker and Others* 2005 (2) SA 77 (SCA).

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> ' … an accumulation of assets and liabilities. These constitute the trust estate, which is a separate entity. But though separate, the accumulation of rights and obligations comprising the trust estate does not have legal personality. It vests in the trustees, and must be administered by them - and it is only through the trustees, specified as in the trust instrument, that the trust can act.'[976]

According to Olivier the trust in the narrow sense refers to the legal institution where an intermediate person, the trustee, holds property as owner thereof in accordance with the expressed wishes of another person, the settlor or founder, not for his personal benefit but for the benefit of named or ascertainable beneficiaries or for an impersonal object.[977] While Honoré and Cameron states as follows:

> 'In the narrow or strict sense a trust exists when the creator of the trust, hands over the control of an asset which, or the proceeds of which, is to be administered by another (the trustee or administrator) in his capacity as such for the benefit of some person (beneficiary) other than the trustee or for some impersonal object.'[978]

It is submitted that the discretionary trust is more commonly used for estate planning purposes and in particular in family trusts established for these purposes. The *bewind* trust is rarely used in South Africa other than for the structuring of investment funds, more specifically third party private equity funds. In addition, it is important to note that the discussions below in this chapter with regard to the legal nature (paragraph 3.1.2(b)) and essentials of the generic trust (paragraph 3.1.2(c)) are important, even though it has already been established that the *bewind* trust is predominantly used to structure third party private equity funds in South Africa; because it is aimed at providing greater context for the analysis in paragraph 3.1.2(d) (distinguishing features of a *bewind* trust). Similarly paragraph 3.1.2(f) (the termination, variation and revocation of a trust) has been included below.

(b) The Legal Nature of a Trust

The legal nature of the trust has been the subject of much legal debate in South Africa.[979] In *CIR v MacNeillie's Estate*[980] the court held that neither the *inter vivos* nor the testamentary trust possesses legal personality.[981] Cameron *et al* states that although the common law does not recognise the trust as a legal person, the trustee in his official capacity is regarded in civil procedure as a separate

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[976] *Land and Agricultural Bank of South Africa v Parker and Others* 2005 (2) SA 77 (SCA) at paragraph 10.
[977] Olivier, P.A. (1990), 'Trust Law and Practice', First Edition, De Jager-Haum Publishers, at 4 and 108.
[978] Honoré, T. and Cameron, E. (1992), 'Honoré's South African Law of Trusts,' 4th Edition, Juta and Company, at page 3.
[979] South African Law Commission ('SALC'), 'Report on the Review of the Law of Trusts', Project 9, June 1987.
[980] *CIR v MacNeillie's Estate* 1961 3 SA 833 (A) at 840.
[981] See also *Braun v Blann and Botha* 1984 2 SA 850 (A). See also *Kohlberg v Burnett* 1986 3 SA 12 (A) at 25C. See also *CIR v Friedman NNO* 1993 1 SA 353 (A) at 370. See also *Land and Agricultural Bank of South Africa v Parker* 2005 2 SA 77 (SCA) at 83(F)-(I).

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entity.[982] Therefore, the court in *Erlich v Rand Cold Storage and Supply*[983] held that the trustee *ex officio* is regarded in civil procedure as different from the trustee in his private capacity, and that trust creditors cannot take the trustee's private property in execution. Rather, the trust creditors must proceed against the trustee in his/her capacity as trustee.[984] On the other hand, a trustee, if the action relates to trust assets, must sue in an official, not private capacity.[985] In *Magnum Financial Holdings v Summerly NO,*[986] the trustees had the power to incur debts and the assets were shares and corporeal movables. In this case the court held that the trust estate is a 'debtor' but not a 'body corporate' for insolvency purposes.[987] This means that a trust is to be sequestrated and not liquidated.[988] In *Ex parte Milton NO,*[989] immovable property was registered in the name of the trustee for the time being of the Milton Children's Trust. The court in *Ex parte Milton NO*,[990] held that this trust estate might be sequestrated; and the decision as to whether or not the trust estate might be sequestered, does not depend on the fact that the trust was registered against the title deeds of the property. In *BOE Bank v Trustees, Knox Property Trust,*[991] the court rejected the proposition that a suretyship undertaken for the debts of a trust could not be valid since the trust was not a legal entity. Cameron *et al*[992] refers to the remarks of McCall J in *BOE Bank v Trustees, Knox Property Trust,*[993] where the learned Judge states:

> '… in the developing law of trusts in South Africa, it is recognised that a trust has a legal existence, whether it be called 'an entity', 'an institution' or 'an arrangement'.'[994]

Furthermore, Section 12 of the Trust Property Control Act 57 of 1988 stipulates that trust property does not form part of the personal estate of the trustee, except in so far as he is entitled to it as a trust beneficiary. Section 12 of the Trust Property Control Act 57 of 1988 reads as follows:

> 'Trust property shall not form part of the personal estate of the trustee except in so far as he as the trust beneficiary is entitled to the trust property.'

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982 Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at page 70. See also *Rosner v Lydia* Swanepoel Trust 1998 (2) SA 123 (W) at 127B-C.
983 *Erlich v Rand Cold Storage and Supply* 1911 TPD 170. See also *Zinn NO v Westminster Bank NO* 1936 AD 89, at 98.
984 *Erlich v Rand Cold Storage and Supply* 1911 TPD 170.
985 *Erlich v Rand Cold Storage and Supply* 1911 TPD 170.
986 *Magnum Financial Holdings v Summerly NO* 1984 1 SA 160 (W).
987 *Magnum Financial Holdings v Summerly NO* 1984 1 SA 160 (W) at 163.
988 *Magnum Financial Holdings v Summerly NO* 1984 1 SA 160 (W) at 163.
989 *Ex parte Milton NO* 1959 (3) SA 347 (SR).
990 *Ex parte Milton NO* 1959 (3) SA 347 (SR), at 350.
991 *BOE Bank v Trustees, Knox Property Trust* 1999 (1) All SA 425 (D) at 432-437.
992 Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at page 71.
993 *BOE Bank v Trustees, Knox Property Trust* 1999 (1) All SA 425 (D).
994 *BOE Bank v Trustees, Knox Property Trust* 1999 (1) All SA 425 (D) at 436.

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In addition, section 1 of the National Credit Act 34 of 2005 defines a 'juristic person' as follows:

> ' 'juristic person' includes a partnership, association or other body of persons, corporate or unincorporated, or a trust if –
> (a) there are three or more individual trustees; or
> (b) the trustee is itself a juristic person ...'

Section 1 of the Firearms Control Act 60 of 2000, defines a 'juristic person' to include a trust.[995] The court decisions in *Joubert v Van Rensburg*[996] and *Mkangeli v Joubert*,[997] led to the amendment of the Deeds Registries Act 47 of 1937, whereby section 102 of the Deeds Registries Act 47 of 1937 included a definition of 'person' to include a trust. Furthermore, section 1 of the Companies Act 71 of 2008 includes in its definition of a 'juristic person' a trust. It reads as follows:

> ' 'juristic person' includes –
> (a) a foreign company; and
> (b) a trust, irrespective of whether or not it was established within or outside the Republic.'

In addition, sections 2(1)(b) and 2(2)(c) of the Companies Act 71 of 2008 reads:

> '(1) For all purposes of this Act –
> (b) an individual is related to a juristic person if the individual directly or indirectly controls the juristic person, as determined in accordance with subsection (2) ...
> (2) For the purpose of subsection (1), a person controls a juristic person, or its business, if–
> (c) in the case of a juristic person that is a trust, that first person has the ability to control the majority of the votes of the trustees or to appoint the majority of the trustees, or to appoint or change the majority of the beneficiaries of the trust ...'

The significance of sections 1 and 2 of the Companies Act 71 of 2008 is that it does not impose upon the trust a general legal personality, particularly in terms of the provisions of the Companies Act 71 of 2008 where trusts and companies are involved and where they are 'related'. Section 1 of the Companies Act 71 of 2008, defines the term 'related' as follows:

> 'when used in respect of two persons, means persons who are connected to one another in any manner contemplated in section 2(1)(a) to (c).'

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[995] Firearms Control Act 60 of 2000 now also includes a 'trust'. Section 1 of the Firearms Control Amendment Act 28 of 2006 amends section 1 of the Firearms Control Act 60 of 2000. Definition substituted by section 1(h) of the Firearms Control Amendment Act 28 of 2006.
[996] *Joubert v Van Rensburg* 2001 1 SA 753 (W).
[997] *Mkangeli v Joubert* 2002 4 SA 36 (SCA).

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It is evident from the above discussion that the trust has acquired legal personality in terms of the Companies Act 71 of 2008. One of the implications of the trust being a juristic person in terms of the Companies Act 71 of 2008 could for instance be where a trust controls a company by holding its majority shareholding, to declare such trustees who are also directors of the related company to be delinquent or under probation in terms of the Companies Act 71 of 2008, and to regulate such delinquency in terms of section 162 of the Companies Act 71 of 2008.[998]

As mentioned above, section 12 of the Trust Property Control Act 57 of 1988 provides that trust property does not form part of the personal estate of the trustee, except in so far as he or she is entitled to it as a trust beneficiary.[999] In *Shahmahomed v Hendricks*[1000] the court held that a trustee may also in a private capacity make a gift to the trust, namely to himself/herself in an official capacity. Cameron *et al* takes the view that no unilateral segregation of assets is possible, and a landowner who wishes to transfer his or her land into a trust should do so by agreement with at least one fellow trustee.[1001] On the other hand, Olivier argues that it is actually the founder who acts unilaterally and that there is no consensus *ad idem* between the founder and trustee.[1002] The court held in *Vaal Reefs Exploration and Mining Co Ltd v Burger*[1003] that the proposition, that a contract whereby a person as a representative of another had concluded with himself was legally impermissible, was not a correct reflection of South African law.[1004]

The South African trust created by means of an agreement between the founder and the trustees, namely the *inter vivos* trust, has the structure of a contract for the benefit of a third party.[1005] This has been referred to by the majority of the court in *Crookes NO v Watson*[1006] as a trust that is created by means of a *stipulatio alteri*. According to Du Toit, a contract is entered into between the trust settler/*stipulans* and the trustee/*promittens* for the benefit of the trust beneficiary, being the third

[998]It is beyond the scope of this thesis to discuss the provisions of section 162 of the Companies Act 71 of 2008.
[999]See *Erlich v Rand Cold Storage and Supply* 1911 TPD 170, at 186-7, where Bristow J stated that creditors are obliged to sue the trustee in his/her capacity as trustee, and if they obtain judgment, they are confined to executing against the trust property. In this respect the trust estate alone is liable to the trust creditors and not the private estate of the trustee. However, if the trustee holds himself/herself out as undertaking personal responsibility for the dealings, he/she may be personally liable to trust creditors. In addition, De Villiers JP in *Erlich v Rand Cold Storage and Supply* 1911 TPD 170, at 186, stated that if the trustee is guilty of bad faith or negligence, then the beneficiaries may also sue the trustee personally.
[1000]*Shahmahomed v Hendricks* 1920 AD 151.
[1001]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at pages 6 and 146.
[1002]Olivier, P.A. (1990), 'Trust Law and Practice', First Edition, De Jager-Haum Publishers, at 19 and 29.
[1003]*Vaal Reefs Exploration and Mining Co Ltd v Burger* 1999 4 SA 1161 (SCA).
[1004]Also confirmed in *Van der Merwe v Nedcor Bank Bpk* 2003 1 SA 169 (SCA).
[1005]*Crookes NO v Watson* 1956 1 SA 277 (A).
[1006]*Crookes NO v Watson* 1956 1 SA 277 (A).

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party.[1007] The majority of the court in *Crookes NO v Watson*[1008] held that the acceptance by the trustees of the donation and the trust does not amount to an acceptance by them on behalf of the beneficiaries, rather their acceptance could simply be seen as an agreement to carry out the provisions of the trust deed. The court held that on execution of the agreement between the trust settlor and the trustee, the beneficiary obtains no right and that the agreement constitutes an offer of a donation by the settlor to the beneficiary, through the acceptance of which the beneficiary obtains a *jus perfectum* against the trustees.[1009] Du Plessis refers to the remarks of Steyn JA in *Crookes NO v Watson*,[1010] where he stated that a trust is brought into operation by the contract between the settlor and the trustees; and that up to the stage of acceptance by the beneficiary, there is no *vinculum juris* between the beneficiary and the settlor or trustees.

The authoritative decision in *Crookes NO v Watson,*[1011] which held that an *inter vivos* trust is simply a contract and the law applicable to *inter vivos* trusts is therefore the law relating to contracts, was reconfirmed in *Hofer v Kevitt NO*.[1012] In *Hofer v Kevitt NO*,[1013] the court held that unless the beneficiaries have accepted the benefit stipulated for them in terms of the provisions of the trust deed, a trust deed can be varied by agreement between the founder and the trustees because these two parties are the contracting parties that formed the trust. In *Hofer v Kevitt NO,*[1014] an *inter vivos* trust had been amended, the amendments having been initiated by the founder and consented to by the trustees, however these amendments had prejudiced the beneficiaries and their descendents. It is important to note that in this case the beneficiaries had not accepted any benefits under the trust and the beneficiaries argued that the rights of trustees to vary the deed were not unfettered and if the proposed variations were not in the interests of both the founder and the potential beneficiaries, then it was the duty of the trustees not to agree thereto.[1015] It was argued in this case that the trustees had not even considered the interest of the potential beneficiaries and had acted directly on the founder's request for the amendment.[1016] The decision of the court was based on the principle that an *inter vivos* trust is a contract and can therefore be amended by agreement between the parties to the contract, but if the beneficiaries accepted any benefits conferred on them in terms of the contract, then the beneficiaries would became party to that contract.[1017] Therefore, in *Hofer v Kevitt*

[1007] Du Toit, F. (2007), 'South African Trust Law: Principles and Practice', 2nd Edition, LexisNexis, Butterworths, at page 18.
[1008] *Crookes NO v Watson* 1956 1 SA 277 (A), at 284.
[1009] *Crookes NO v Watson* 1956 1 SA 277 (A), at 286.
[1010] *Crookes NO v Watson* 1956 1 SA 277 (A), at 305.
[1011] *Crookes NO v Watson* 1956 1 SA 277 (A).
[1012] *Hofer v Kevitt NO* 1998 1 SA 382 (SCA).
[1013] *Hofer v Kevitt NO* 1998 1 SA 382 (SCA).
[1014] *Hofer v Kevitt NO* 1998 1 SA 382 (SCA).
[1015] *Hofer v Kevitt NO* 1998 1 SA 382 (SCA). See also Geach, W.D. and Yeats, J. (2007), 'Trusts: Law and Practice', First Edition, Juta and Company Ltd, at pages 149-150.
[1016] *Hofer v Kevitt NO* 1998 1 SA 382 (SCA). See also Geach, W.D. and Yeats, J. (2007), 'Trusts: Law and Practice', First Edition, Juta and Company Ltd, at pages 149-150.
[1017] Geach, W.D and Yeats, J (2007), 'Trusts: Law and Practice', 1st Edition, Juta and Company, at 149-150.

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NO,[1018] Van Coller AJA held that any amendments following acceptance by the beneficiaries of their contract could only be made with the consent of all parties to the contract and the parties now included the beneficiaries. Geach and Yeats comments on the case *Hofer v Kevitt NO*[1019] and states the following:

> 'This decision could be interpreted to mean that the founder of an *inter vivos* trust is free to make changes to an *inter vivos* trust at any time by agreement with the trustees. But if the beneficiaries, either vested or discretionary, have accepted the benefits that have or may accrue to them in terms of the trust deed then the beneficiaries become part of that contract … and any variations or amendments thereto can only be made with their approval.'[1020]

The next question to consider is whether the *inter vivos* trust can be described as having a legal nature *sui generis*. In *Badenhorst v Badenhorst,*[1021] Combrinck AJA referred to *Braun v Blann and Botha NNO*[1022] with approval in identifying the *inter vivos* trust as an institution *sui generis*. As mentioned above, the *inter vivos* trust is an agreement and all the rules of the law of contract are applicable. In *Estate Kemp v McDonald's Trustees*[1023] the court accepted the testamentary trust in South Africa, but identified it with a *fideicommissum* and equated a trustee with a fiduciary. It was only with the authoritative judgment in *Braun v Blann and Botha NNO*,[1024] that the *inter vivos* trust was regarded as a legal institution *sui generis.* Olivier states that it is still not clear whether the testamentary trust is regulated by the trust law or by the law of succession, particularly when it comes to the rules of interpretation and the amendment of the trust document.[1025]

The ownership and control of trust property may provide further insight into the legal nature of the trust. The ownership, control and management of the trust property and the vesting of it, will depend on the trust structure applicable and the powers given to the trustees.[1026] In this regard, if the structure corresponds with that of the *bewind* trust, the ownership of the trust property is vested in the beneficiaries.[1027] However, the same does not apply to control and management.[1028] In terms of a *bewind* trust, the fact that all the beneficiaries hold all the shares, and therefore the ownership, does not mean that the control also vests in them.[1029] In terms of a *bewind* trust, the trustees are

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[1018] *Hofer v Kevitt NO* 1998 1 SA 382 (SCA).
[1019] *Hofer v Kevitt NO* 1998 1 SA 382 (SCA).
[1020] Geach, W.D. and Yeats, J. (2007), 'Trusts: Law and Practice', 1st Edition, Juta and Company, at 150.
[1021] *Badenhorst v Badenhorst* 2006 2 SA 255 (SCA), at paragraph 8.
[1022] *Braun v Blann and Botha NNO* 1984 2 SA 850 (A) at 859E–H.
[1023] *Estate Kemp v McDonald's Trustees* 1915 AD 491, at 494.
[1024] *Braun v Blann and Botha NNO* 1984 2 SA 850 (A) at 859E.
[1025] Olivier, P.A. (1990), 'Trust Law and Practice', First Edition, De Jager-Haum Publishers, at pages 20-38.
[1026] Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at pages 6 and 9.
[1027] Olivier, P.A. (1990), 'Trust Law and Practice', First Edition, De Jager-Haum Publishers, at page 108.
[1028] Du Toit, F. (2007), 'South African Trust Law: Principles and Practice', Second Edition, LexisNexis, Butterworths, at page 4.
[1029] Olivier, P.A. (1990), 'Trust Law and Practice', First Edition, De Jager-Haum Publishers, at page 108.

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administrators of the trust and in that capacity they also have control.[1030] On the other hand, in terms of the trust in the narrow sense, ownership and management of the trust property are vested in the trustees for purposes of administration, but the trustees have no beneficial interest in it.[1031] In addition, depending on any conditions imposed or rights reserved by the founder, control will normally vest with the trustees.[1032] In *Land and Agricultural Bank of South Africa v Parker*,[1033] Cameron JA refers to certain types of business trusts which have developed in which functional separation between control and enjoyment is entirely lacking, and stated that where ownership and control vest with the trustees, the beneficiaries only have a right in *persona* against the trustees to claim the income or capital due to them under the trust. The court held that what is due to them will depend on whether they have vested rights, and in most of the private business trusts of this kind, the beneficiaries will have vested rights.[1034] However, it is possible to create a business trust where the rights of beneficiaries are not vested but merely contingent, for example where the trustees have discretionary powers to decide not only how, but also whether to pay income or distribute capital to the beneficiaries.[1035]

It is submitted, with reference to Cameron *et al*, that a trust 'as a discrete legal institution,[1036] is a legal entity' that persists in time for two reasons.[1037] Cameron *et al* states the following:

> 'First, by rule of real subrogation when trust assets earn income or are exchanged for other assets, whatever is acquired with the trust property or its proceeds becomes itself trust property. Secondly, the principle of succession in trusteeship ensures continuity in administration be effecting a mechanism for replacing trustees. But though the trust is a persistent entity, neither the separation of trust assets from the trustee's personal property nor the other rules mentioned make the trust a juristic person.'[1038]

[1030]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at pages 6-9 and 106 and 272.

[1031]See *Estate Kemp v McDonald's Trustee* 1915 AD 491. See also *SIR v Rosen* 1971 1 SA 172 (A).

[1032]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' 5th Edition, Juta and Company Ltd, at pages 141 and 579-580.

[1033]*Land and Agricultural Bank of South Africa v Parker* 2005 2 SA 77 (SCA) at 88A–B.

[1034]*Land and Agricultural Bank of South Africa v Parker* 2005 2 SA 77 (SCA) at 88A–B.

[1035]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at pages 141 and 579-580.

[1036]*Rosner v Lydia Swanepoel Trust* 1998 (2) SA 123 (W) at 128D-E, as per Goldstein J.

[1037]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' 5th Edition, Juta and Company, at page 72. See *CIR v Friedman NO* 1993 (1) SA 353 (A) at 370-371.

[1038]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company, at page 72. See *CIR v Friedman NO* 1993 (1) SA 353 (A) at 370-371.

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Du Plessis states that several theorists have argued that the trust property is owned by the trust estate itself, which would mean that the trust was a juristic person.[1039] However, this has been rejected by South African courts which have confirmed that a trust is not a juristic person and does not have juristic personality, except as provided for in statute.[1040]

(c) The Essentials of a Valid Trust

According to Oguttu, in South African law there are five basic essentials for the formation of a valid trust.[1041] Cameron *et al* summarises these five essential requirements by stating that for a valid trust to be created the founder must intend to create one, he must express his intention in a mode appropriate to create an obligation, the property subject to the trust must be defined with reasonable certainty, the trust object, which may either be personal or impersonal must be defined with reasonable certainty and finally, the trust object must be lawful.[1042]

Firstly, the founder must intend to create a trust. However, a distinction should be drawn between the intention to create a trust in the strict or narrow sense and the intention to create a *bewind* trust.[1043] In *Goodricke and Son (Pty) Ltd v Registrar of Deeds, Natal*[1044] and *Pezzutto v Dreyer*,[1045] the court in both cases held that intention is one of the determining factors to distinguish between a business trust and an ordinary partnership.[1046] The intention to create an *inter vivos* trust must be shared by the founder and the prospective trustee.[1047] As mentioned in paragraphs 3.1.2(a) and 3.1.2(b) of this chapter, an *inter vivos* trust is one created during the lifetime of the founder and is usually created by way of an agreement between the founder and the trustees. This is usually clear from the trust deed signed by the parties. However, the mere use of the words ‘trust or ‘trustee’ are not conclusive and the intention to create a trust has to be inferred from the circumstances and all the words used.[1048] It was also discussed above that an *inter vivos* trust may also take the form of

[1039] Du Plessis, I. (2014), ‘A South African Perspective On Some Critical Issues Regarding The OECD Model Tax Convention On Income And On Capital, With Special Emphasis On Its Application To Trusts’, Dissertation presented for Doctor of Laws degree: Faculty of Law at Stellenbosch University, December 2014, at page 18.
[1040] Du Plessis, I. (2014), ‘A South African Perspective On Some Critical Issues Regarding The OECD Model Tax Convention On Income And On Capital, With Special Emphasis On Its Application To Trusts’, Dissertation presented for Doctor of Laws degree: Faculty of Law at Stellenbosch University, December 2014, at page 18.
[1041] Oguttu, A.W. (2012), ‘Offshore trusts and income tax avoidance: the lures and pitfalls from a South African perspective’, International Journal of Private Law, 5(4), at pages 406-438.
[1042] Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), ‘Honoré’s South African Law of Trusts,’ Fifth Edition, Juta and Company Ltd, at pages 117-118. See also Oosthuisen, M.J. (1988), ‘Suid-Afrikaanse Handelsreg’, 3rd Edition, Volume 2, Perskor Publishers, Pretoria, at 601.
[1043] Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), ‘Honoré’s South African Law of Trusts,’ Fifth Edition, Juta and Company Ltd, at page 118.
[1044] *Goodricke and Son (Pty) Ltd v Registrar of Deeds, Natal* 1974 1 SA 404 (N).
[1045] *Pezzutto v Dreyer* 1992 3 SA 379 (A).
[1046] See also *Thorpe v Trittenwein* 2007 2 SA 172 (SCA) at 177C–E.
[1047] Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), ‘Honoré’s South African Law of Trusts,’ Fifth Edition, Juta and Company Ltd, at page 119.
[1048] Cameron, E, De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), ‘Honoré’s South African Law of Trusts,’ 5th Edition, Juta and Company, at pages 119-120. *Coetzee NO v Universiteit Stellenbosch* 1959 (2)

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an oral agreement, but that such an oral trust will not be regarded as a trust for purposes of the Trust Property Control Act 57 of 1988 and will be governed by the common law.[1049] According to Du Toit, an *inter vivos* trust may be contrasted with a testamentary trust which is created in the will of the testator; and the will must comply with all the requirements for a valid will.[1050] Oosthuizen[1051] and Cameron *et al*[1052] both argue that In the case of a testamentary trust, it is not always that easy to determine the founder's intention, especially when it becomes necessary to distinguish between a *bewind* trust and a trust in the narrow sense; and that the all the rules for the interpretation would apply in this regard.[1053] In this regard, Cameron *et al* states the following:[1054]

> 'When ... donor uses words that are held to be merely precatory, so that an intention to create a trust is lacking, the effect depends on whether the testator or donor intended to benefit the person to whom the property was given. If the intention to benefit was present, the supposed trust is disregarded and the legatee or donee takes free of any burden.[1055] If, on the other hand, the person to whom the property is given is not intended to be a beneficiary, the gift is invalid and may be recovered by the founder or his estate.[1056] If the intention to create a trust is lacking because the trustee is insufficiently independent, the maxim that the real transaction prevails over the apparent one (plus *valet quod agitur*) applies[1057] and the transaction is construed as agency, partnership, sale, innominate contract, etc, according to the intention of the parties.'[1058]

Secondly, the founder's intention must be expressed appropriately to create an obligation.[1059] According to Cameron *et al*, the relevant obligation is either the obligation on the trustee to administer the trust property for the trust object, or the obligation on the founder to do what is needed so that the property is administered by the trustee.[1060] In the case where a trustee has not been appointed, has not accepted office, or has been appointed, but has not yet taken control of the trust property,

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SA 172 (C) at 175E-F. See *Cowen v Estate Cowen* 1932 CPD 39. *Harter v Epstein* 1953 (1) SA 287 (A) at 297.

[1049]Section 1 of the Trust Property Control Act 57 of 1988 defines a trust as: 'an arrangement … by virtue of a trust instrument … A trust instrument is, in turn, defined as a written agreement or a testamentary writing or a court order according to which a trust was created'. See also *Deedat v The Master* 1995 2 SA 337 (A) at 384.

[1050]Du Toit, F. (2007), 'South African Trust Law: Principles and Practice', Second Edition, Butterworths, at 8.

[1051]Oosthuisen, M.J. (1988), 'Suid-Afrikaanse Handelsreg', 3rd Edition, Volume 2, Perskor Publishers, at 602.

[1052]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at pages 118-120.

[1053]See also *Coetzee NO v Universiteit Stellenbosch* 1959 (2) SA 172 (C) at 175E-F. See also *Cowen v Estate Cowen* 1932 CPD 39. See also *Harter v Epstein* 1953 (1) SA 287 (A) at 297.

[1054]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at page 137.

[1055]*Ex parte Bruton NO* 1970 4 SA 154 (E) at 158. See also *Ex parte Kemp* 1940 WLD 26 at 33. See also *Arkell v Carter* 1971 3 SA 243 (R).

[1056]*Re Estate Grayson* 1937 AD 96, at 99-100. See also *Harter v Epstein* 1953 1 SA 287 (A).

[1057]Commonly referred to the 'substance over form' principle.

[1058]See *Pretorius v CIR* 1986 1 SA 238 (A).

[1059]Oguttu, A.W. (2012), 'Offshore trusts and income tax avoidance: the lures and pitfalls from a South African perspective', International Journal of Private Law, 5(4), at pages 406-438.

[1060]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at page 138.

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the relevant obligation is the one on the founder to enable the trustee to administer the trust property. For example, the founder may be obliged to transfer property to the trustees.[1061] Furthermore, a trust created *inter vivos* by contract will not be valid unless it is bilateral and the contract creating the obligation is valid.[1062] In addition, it has to comply with all the requirements of a valid contract. For a trust to exist, the founder must either have handed over control of the trust property by a legally valid mode of transfer, which creates an obligation or have obliged him/herself, for instance, by contract to hand it over or he must be bound in some other way, for instance, by statute or court order to do so.[1063] In the absence of a juristic act that imposes an obligation of the appropriate kind, no trust is created and the purported disposition has no legal effect.[1064] Therefore, the requirements for the creation of a trust are those necessary for the creation of the obligation on which the existence of the trust depends.[1065]

Thirdly, the trust property must be defined with sufficient certainty, otherwise no trust is created.[1066] It may consist of any asset or group of assets, movable or immovable, corporeal or incorporeal, such as a farm, furniture, shares, a copyright or the assets of a business.[1067] However, if no property is located in the trustee, then only a trust in the wide sense occurs.[1068] According to Cameron *et al*, if the description of the property is ambiguous, the ambiguity is, in the case of a contract, resolved by recourse to such extrinsic evidence as is admissible for the purpose.[1069] In these matters the intention

[1061]Du Toit, F. (2007), 'South African Trust Law: Principles and Practice', Second Edition, LexisNexis, Butterworths, at 29.
[1062]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at pages 143 and 673.
[1063]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at page 6.
[1064]See Oguttu, A.W. (2012), 'Offshore trusts and income tax avoidance: the lures and pitfalls from a South African perspective', International Journal of Private Law, 5(4), at pages 406-438. See also Coetzee, J.P. (2006), ''n Kritiese Ondersoek na die Aard en Inhoud van Trustbegunstigdes se Regte ingevolge die Suid-Afrikaanse Reg', Doctoral Dissertation, University of South Africa, April 2006. Translated: 'A Critical Investigation into the Nature and Content of Rights of Beneficiaries in terms of the South African Law of Trusts', at pages 135-143.
[1065]De Waal, M.J. (2000), 'The Core Elements of the Trust: Aspects of the English, Scottish and South African Trusts compared', The South African Law Journal, at pages 548-571. Also, if the trust is created by will, codicil or other testamentary writing, the formalities prescribed by the Wills Act 7 of 1953 must be complied with. If it is created by antenuptial contract, registration in terms of the Deeds Registries Act 47 of 1937 are relevant.
[1066]Oguttu, A.W. (2012), 'Offshore trusts and income tax avoidance: the lures and pitfalls from a South African perspective', International Journal of Private Law, 5(4), at pages 406-438.
[1067]Oosthuisen, M.J. (1988), 'Suid-Afrikaanse Handelsreg', 3rd Edition, Volume 2, Perskor Publishers, at 603.
[1068]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at pages 146-147. See also Coetzee, J.P. (2006), ''n Kritiese Ondersoek na die Aard en Inhoud van Trustbegunstigdes se Regte ingevolge die Suid-Afrikaanse Reg', Doctoral Dissertation, University of South Africa, April 2006. Translated: 'A Critical Investigation into the Nature and Content of Rights of Beneficiaries in terms of the South African Law of Trusts', at pages 135-143.
[1069]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at pages 146-147. See also Coetzee, J.P. (2006), ''n Kritiese Ondersoek na die Aard en Inhoud van Trustbegunstigdes se Regte ingevolge die Suid-Afrikaanse Reg', Doctoral Dissertation, University of South Africa, April 2006. Translated: 'A Critical Investigation into the Nature and Content of Rights of Beneficiaries in terms of the South African Law of Trusts', at pages 135-143.

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of the founder is decisive.[1070] However, it is still a requirement that the founder should actually be divested or be bound to divest himself at least of the legal proprietary power over the trust property.[1071]

Fourthly, the trust object must be defined with reasonable certainty and it must be lawful.[1072] In *Peterson and Another NNO v Claassen* and Others,[1073] Bozalek J distinguishers between the object and the purpose of a trust and states the following:

> 'Whilst it is correct that one of the essentials for the creation of a valid trust is that the trust object must be lawful, it does not follow, however, in my view, that a trust is void if it is created with a fraudulent, illegal or immoral purpose … There is, in my view, a material difference between the object of a trust and the purpose thereof.'[1074]

According to Oosthuizen, the object can be personal or impersonal[1075] and may consist in the benefit of one or more named or ascertainable persons or classes of person, including juristic persons and trustees on behalf of other trusts and/or for one or more impersonal objects such as the education or the development of the community at large or a specific group of individuals.[1076] In *Deedat v The Master*,[1077] it was held that if the person or class for whose benefit the trust is intended is not named or determinable, the trust fails for want of a certain object. Furthermore, in the case of a *bewind* trust, the object has to be the benefit of the beneficiaries and not, for example, the acquiring of a piece of land as is required for the object of a company.[1078] Cameron *et al* argues that the latter could for the purposes of the *bewind* trust only form an ancillary object or specific power given to the trustees.[1079] In *Marks v Estate Gluckman,*[1080] it was held that if the trust object fails or because the object is

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[1070]Oguttu, A.W. (2012), 'Offshore trusts and income tax avoidance: the lures and pitfalls from a South African perspective', International Journal of Private Law, 5(4), at pages 406-438.

[1071]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at pages 147-148 and 268-269. Also, a mistake in the description of trust property can be corrected on the principle that a mistaken description does not prejudice. See also De Waal, M.J. (2000), 'The Core Elements of the Trust: Aspects of the English, Scottish and South African Trusts compared', The South African Law Journal, at pages 6 and 548-571.

[1072]Oguttu, A.W. (2012), 'Offshore trusts and income tax avoidance: the lures and pitfalls from a South African perspective', International Journal of Private Law, 5(4), at pages 406-438. See also *Peterson and Another NNO v Claassen* and Others 2006 5 SA 191 (CPD) at 196G.

[1073]*Peterson and Another NNO v Claassen* and Others 2006 5 SA 191 (CPD).

[1074]*Peterson and Another NNO v Claassen* and Others 2006 5 SA 191 (CPD) at 197B.

[1075]A trust for an impersonal object can be valid only if it is charitable or for the public benefit. In this regard, the object need not be expressed with the precision otherwise required for a trust with a personal object See Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at pages 161-177.

[1076]Oosthuisen, M.J. (1988), 'Suid-Afrikaanse Handelsreg', 3rd Edition, Vol 2, Perskor Publishers, at 604-605.

[1077]*Deedat v The Master* 1995 2 SA 377 (A) at 383E–384B.

[1078]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at page 151.

[1079]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at page 151.

[1080]*Marks v Estate Gluckman* 1946 AD 289, at 301.

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insufficiently defined, the trust itself falls away.[1081] In *Die Meester v Meyer,*[1082] it was held that if only part of the trust object fails, the remainder, if separable, is nevertheless valid. Furthermore, the trust object of a personal trust is also determined by the specific power of appointment conferred on the trustees.[1083] Therefore, if the trust derogates from the rights of the owner of the trust property, as in the case of a *bewind* trust, the restrictions it contains must be imposed in the interest of a person other than the owner otherwise it constitutes a nude prohibition,[1084] in which case the restrictions are unenforceable and the beneficiaries may insist on administering the property themselves to the exclusion of the trustee.[1085] For example, in the case of a *bewind* trust where all the beneficiaries contribute to the trust fund and also hold a vested right in it.[1086]

Finally, the trust object must be lawful. In *Administrators, Estate Richards v Nichol*,[1087] the court confirmed the essential requirements for the formation of a valid trust. In *Peterson and Another NNO v Claassen and Others*,[1088] Bozalek J stated as follows:

> 'Whilst it is correct that one of the essentials for the creation of a valid trust is that the trust object must be lawful, it does not follow, however, in my view, that a trust is void if it is created with a fraudulent, illegal or immoral purpose … There is, in my view, a material difference between the object of a trust and the purpose thereof. The object is openly proclaimed and ascertainable and all parties who have dealings with that trust will be held to have knowledge of the trust's object. In the present case, the objects of the three new trusts … were entirely lawful, the primary object being in each case 'om bates en inkomste te bekom en aan te wend tot uiteindelike voordeel van die begunstigde'. By contrast, where a trust is formed for an illegal or unlawful purpose, this knowledge is jealously guarded by those who harbour such purpose. This is but one reason, although an important one, why the purpose of a trust, where it is an illegal or immoral purpose but is known only to the founder and to the trustees, cannot be equated, in all circumstances, with that trust's (lawful) object.'[1089]

Du Plessis refers to Du Toit[1090] where the latter argues that there are two further 'elements' which are auxiliary to the five requirements listed above.[1091] According to Du Plesiss, these elements are:

[1081]See also Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at page 171.
[1082]*Die Meester v Meyer* 1975 2 SA 1 (T).
[1083]Oguttu, A.W. (2012), 'Offshore trusts and income tax avoidance: the lures and pitfalls from a South African perspective', International Journal of Private Law, 5(4), at pages 406-438.
[1084]Referred to as a nudum praeceptum, which was earlier mentioned in paragraph (c) above.
[1085]Olivier, P.A. (1990), 'Trust Law and Practice', First Edition, De Jager-Haum Publishers, at 109.
[1086]Olivier, P.A. (1990), 'Trust Law and Practice', First Edition, De Jager-Haum Publishers, at 109.
[1087]*Administrators, Estate Richards v Nichol* 1996 4 SA 253 (C).
[1088]*Peterson and Another NNO v Claassen* and Others 2006 5 SA 191 (CPD).
[1089]*Peterson and Another NNO v Claassen* and Others 2006 5 SA 191 (CPD) at 197B-E.
[1090]Du Toit, F. (2007), 'South African Trust Law: Principles and Practice', 2nd Edition, Butterworths.
[1091]Du Plessis, I. (2014), 'A South African Perspective On Some Critical Issues Regarding The OECD Model Tax Convention On Income And On Capital, With Special Emphasis On Its Application To Trusts', Dissertation

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> '(i) If the settlor makes over trust property to the trust, the settlor must divest himself or herself of control over the trust property in favour of the trustee and the trustee should function free from any control by the settler … (ii) There must be a separation between control over the trust property by the trustee and enjoyment of the benefits associated with the trust by the beneficiaries.'[1092]

Du Plessis also refers to Cameron *et al*,[1093] by stating that the latter authors refer to element (i) mentioned by Du Toit[1094] as forming part of requirement (i) discussed above, namely the intention to create a trust.[1095] According to Cameron *et al*, if the founder fails to confer the required independence on the trustee, or does not have the intention to vest property in the trustee, the intention to create a trust may be absent.[1096] Nevertheless, these auxiliary elements mentioned by Du Plessis will not be discussed, other than to note that Du Plesssis argues that although these elements are not requirements for the formation of a valid trust, a failure to comply with these elements may lead to the conclusion that no valid trust was formed or that a trust must fail.[1097]

(d) The Distinguishing Features of a Bewind Trust

The *bewind* trust, as mentioned in 3.1.2(a) above, is derived from Roman-Dutch law. The term '*bewind'* arrives from Dutch law (*bewind*) and Roman-Dutch law (*bewindhebber*).[1098] Its practical application in the Netherlands arose when the ownership of property was disposed of (usually by will) to a named beneficiary, but the control of that property was vested in the hands of a *bewindvoerder* usually because the beneficiary was considered too young or otherwise incompetent

presented for the degree of Doctor of Laws in the Faculty of Law at Stellenbosch University, December 2014, at pages 22-23.

[1092] Du Plessis, I. (2014), 'A South African Perspective On Some Critical Issues Regarding The OECD Model Tax Convention On Income And On Capital, With Special Emphasis On Its Application To Trusts', Dissertation presented for Doctor of Laws degree: Faculty of Law at Stellenbosch University, December 2014, at page 22.

[1093] Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at page 118.

[1094] Du Toit, F. (2007), 'South African Trust Law: Principles and Practice', 2nd Edition, Butterworths.

[1095] Du Plessis, I. (2014), 'A South African Perspective On Some Critical Issues Regarding The OECD Model Tax Convention On Income And On Capital, With Special Emphasis On Its Application To Trusts', Dissertation presented for Doctor of Laws degree: Faculty of Law at Stellenbosch University, December 2014, at page 22.

[1096] Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Company Ltd, at page 118.

[1097] Du Plessis, I. (2014), 'A South African Perspective On Some Critical Issues Regarding The OECD Model Tax Convention On Income And On Capital, With Special Emphasis On Its Application To Trusts', Dissertation presented for Doctor of Laws degree: Faculty of Law at Stellenbosch University, December 2014, at page 22.

[1098] Shawe, T. (2013), 'Vesting in a bewind trust', Ghostdigest, 17th October 2013, Pretoria. Available at www.ghostdigest.co.za/articles/vesting-in-a-bewind-trust/54437, accessed in May 2015.

to administer it him/herself.[1099] The *bewindvoerder* manages the assets for the benefit of a beneficiary, but it is the beneficiary and not the *bewindvoerder* who is the owner of the assets.[1100] Therefore, a *bewind* trust is a trust where the founder makes a bequest to the beneficiaries and vests the administration of the assets in the trustees. The beneficiaries acquire ownership of the assets, while the trustees only have the administrative control thereof. In a *bewind* trust the beneficiary is protected in the case of the insolvency of the *bewindvoerder*, as the assets do not form part of the latter's estate.[1101]

It must be noted that this paragraph will simply highlight the salient features of a *bewind* trust.[1102] Nevertheless, Du Plessis refers to Koppenol-Laforce and Kottenhagen[1103] and states that:

> 'the *bewind* is a form of fiduciary administration, but it may only be used in certain limited family-related situations'.[1104]

It is submitted that this is not the case in South Africa, as the *bewind* form is not limited to certain family-related matters, but also applied as a legal vehicle to conduct business, for instance it is used to structure private equity funds in South Africa. For example, Davis describes the private business trust in South Africa, as a small, closely knit group of individuals carrying on business, albeit by way of investment or more active trading, through the medium of a trading trust.[1105] According to Davis, this type of business trust has as its basic structure, either a *bewind* or the trust in the narrow sense.[1106] According to Van der Westhuizen, it will have the *bewind* structure when the beneficiaries provide the trust capital themselves, either in cash or by the guaranteeing of loans made against the security of their own property, in return for which each of them receives a share certificate as proof of his pro rata interest in the venture, and as proof of his vested right in the trust capital.[1107] Van der Westhuizen further points out that where the beneficiaries have vested rights and the same persons who are beneficiaries are also controlling the trust as trustees, there are very little, if any, differences

[1099]See De Waal, M.J. (2006), 'Comparative Succession Law', in Reimann, M. and Zimmermann, R. (2006), 'The Oxford Handbook of Comparative Law', Oxford University Press, 1088, at page 1092.
[1100]See De Waal, M.J. (2006), 'Comparative Succession Law', in Reimann, M. and Zimmermann, R. (2006), 'The Oxford Handbook of Comparative Law', Oxford University Press, 1088, at page 1092.
[1101]Kortmann, S. and Verhagen, H. (1999), 'National Report for the Netherlands', in Hayton, D., Kortmann, S. and Verhagen, H. (1999), 'Principles of European Trust Law', Kluwer Law International, 195, at pages 199.
[1102]Some of the salient features of the *bewind* trust have already been discussed in the preceding paragraphs.
[1103]Koppenol-Laforce, M.E. and Kottenhagen, R.J.P. (1998), 'The Institution of the Trust and Dutch Law', in Hondius, E. (1998), 'Netherlands Reports to the Fifteenth International Congress of Comparative Law', Intersentia Rechtswetenschappen, 137, at page 200.
[1104]Du Plessis, I. (2014), 'A South African Perspective On Some Critical Issues Regarding The OECD Model Tax Convention On Income And On Capital, With Special Emphasis On Its Application To Trusts', Dissertation presented for Doctor of Laws degree: Faculty of Law at Stellenbosch University, December 2014, at page 53.
[1105]Davis, D.M. (1986), 'Trading Trust: Its Validity and Use in South Africa', The Taxpayer, April 1986, at 70.
[1106]Davis, D.M. (1986), 'Trading Trust: Its Validity and Use in South Africa', The Taxpayer, April 1986, at 70.
[1107]Van Der Westhuizen, W.M. (1997), 'Wills and Trusts', Service Issue Two, Butterworths, at page 8.

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between this kind of venture and the ordinary partnership.[1108] In *Pezzutto v Dreyer*,[1109] Smalberger JA held that:

> 'In essence ... a partnership is carrying on a business (to which each of the partners contributes) in common for the joint benefit of the parties with a view to making a profit.'[1110]

In *Estate Kemp and Others v McDonald's Trustees*,[1111] the court held that the trust structure determines the ownership, control and management of the trust property and the vesting of it. In addition, the court held that if the structure corresponds with that of the trust in the narrow sense, ownership, management and control of the trust property are vested in the trustees for administration purposes, but the trustees have no beneficial interest in it.[1112] However, this depends on any conditions imposed or rights reserved by the founder.[1113] According to Honoré *et al* and Olivier, if the trust structure corresponds with that of the *bewind* form, namely where contributing beneficiaries are involved, the ownership of the trust property is vested in the beneficiaries.[1114] However, the same does not apply to control and management. The fact that the whole body of beneficiaries holds all the assets, and therefore the ownership, does not of necessity mean that the full control also vests in them.[1115] In this regard, the trustees are only administrators of the trust and in that capacity they also have control. In the *bewind* trust the ownership is conferred upon the beneficiaries and a trustee is appointed merely to administer the trust property; and the wording of the conferment in the trust deed is usually indicative of the ownership of the trust property.[1116] Therefore, the provisions contained in the trust deed with regard to the aspects of vesting, vested rights, suspensive and resolutive conditions are critical in determining the dominium of the trust property.[1117]

As mentioned above, the ownership of the assets in a *bewind* trust vests in the beneficiaries and such assets do not form part of the trustee's estate. As the person vested with the control of the assets, on the other hand, the trustee(s) have the power to dispose of them, but owe fiduciary duties to the beneficiaries.[1118] Where a private equity fund is structured as a *bewind* trust, the investor

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[1108]Van Der Westhuizen, W.M. (1997), 'Wills and Trusts', Service Issue Two, Butterworths, at pages 8-9.
[1109]*Pezzutto v Dreyer* 1992 3 SA 379 (AD).
[1110]*Pezzutto v Dreyer* 1992 3 SA 379 (AD) at paragraph 33.
[1111]*Estate Kemp and Others v McDonald's Trustee*, 1915 AD 491, at 498-499.
[1112]*Estate Kemp and Others v McDonald's Trustee*, 1915 AD 491, at 498-499.
[1113]Honoré, T. and Cameron, E. (1992), 'Honoré's South African Law of Trusts,' Fourth Edition, Lansdowne, Juta and Company Ltd, at pages 4-6 and 158. See also Olivier, P.A. (1990), 'Trust Law and Practice', First Edition, De Jager-Haum Publishers, at page 108.
[1114] Honoré, T. and Cameron, E. (1992), 'Honoré's South African Law of Trusts,' Fourth Edition, Lansdowne, Juta and Company Ltd, at pages 4-6 and 158. See also Olivier, P.A. (1990), 'Trust Law and Practice', First Edition, De Jager-Haum Publishers, at page 108.
[1115]See Van Der Westhuizen, W.M. (1997), 'Wills and Trusts', Service Issue Two, Butterworths, at page 14.
[1116]Van Der Westhuizen, W.M. (1997), 'Wills and Trusts', Service Issue Two, Butterworths, at page 11.
[1117]Van Der Westhuizen, W.M. (1997), 'Wills and Trusts', Service Issue Two, Butterworths, at page 11.
[1118]Du Toit, F. (2007), 'The Fiduciary Office of Trustee and the Protection of Contingent Trust Beneficiaries', Stellenbosch Law Review, 3, at pages 469-482.

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participants as beneficiaries will directly own the assets held by the trust in undivided shares, according to the participation ratio in which they participate in the trust assets. In a *bewind* trust, the beneficiaries remain the direct co-owners of the underlying assets of the trust as opposed to having the rights to share in a proportionate part of the income or capital of the trust.[1119] The benefit of using a *bewind* trust is ostensibly that gains and losses arise directly in the hands of the beneficiaries. This follows from the fact that they actually own the underlying assets of the trust.

In *SARS v Dyefin Textiles (Pty) Ltd,*[1120] the court held that the trust in question bore all the hallmarks of a trust, properly called, where the assets of the trust vest in the trustees rather than the case of a *bewind* trust where the founder of the trust makes a gift or bequest directly to a beneficiary but vests the control of the assets in a trustee or administrator.[1121] Furthermore, the court held that the essence of a trust was that the trustees undertook the obligations of administering the assets and certain discretionary powers were conferred upon them, including the power to terminate the trust and distribute its assets.[1122] Based on the facts of the case the court held that the trustees did not have the beneficial ownership of the assets in respondent but nevertheless they were under an obligation to hold them and transfer them to a third party if directed to do so by respondent's directors, which did not imply that at all material times respondent was in reality the beneficial owner of the shares.[1123]

The operation of a *bewind* trust was described more fully in the matter of *Bafokeng Tribe v Impala Platinum Limited* as follows:[1124]

> 'A *bewind* trust was created in terms whereof the ownership of the land vested in the Tribe, but control in the trustee. The trustee acts as nominee of the Tribe for the function of acquiring ownership for it, and as trustee for the object of acquiring control'.[1125]

The law with regard to trust does not therefore impede the *bewind* trust structure. Nevertheless, as mentioned in paragrapgh 3.1.2(a) above, private equity funds that are structured as trusts typically use *bewind* and not discretionary trusts.

[1119]Kortmann, S. and Verhagen, H. (1999), 'National Report for the Netherlands', in Hayton, D., Kortmann, S. and Verhagen, H. (1999), 'Principles of European Trust Law', Kluwer Law International, 195, at pages 199.
[1120]*SARS v Dyefin Textiles (Pty) Ltd*, 2002 (4) SA 606 (N) at 611.
[1121]During the tax years 1994 and 1995 ending on 30 June of each year the taxpayer made unsecured long-term loans to one of its shareholders, namely the Dyefin Share Trust ('the Trust'). These loans remained unpaid at the end of the taxpayer's subsequent respective tax year-ends. In terms of sections 64C(2) and 64C(3)(*a*) of the Income Tax Act 58 of 1962, the Commissioner deemed these loans to have been dividends distributed to the Trust and thus attracting liability for secondary tax on companies ('STC'). The taxpayer objected.
[1122]*SARS v Dyefin Textiles (Pty) Ltd*, 2002 (4) SA 606 (N) at 611.
[1123]*SARS v Dyefin Textiles (Pty) Ltd*, 2002 (4) SA 606 (N) at 611.
[1124]*Bafokeng Tribe v Impala Platinum Limited*, 1999 (3) SA 517 (BH) at 541-542.
[1125]The court cited Honoré, T. and Cameron, E. (1992), 'Honoré's South African Law of Trusts,' Fourth Edition, Lansdowne, Juta and Company Ltd, at 166; and *Braun v Blann and Botha NNO* 1984 (2) *SA* 850 (A) at 864 G-H.

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(e) Tax Considerations

At the outset it is noted that it is not the intention of this paragraph to undertake a comprehensive analysis of the taxation of trusts, as well as the tax treatment of underlying portfolio interests because such an analysis is beyond the scope of this thesis.[1126] The purpose of this paragraph is twofold. Firstly it will highlight the general taxation principles relating to the *bewind* trust. Secondly, it will discuss the view taken by the South African Revenue Service ('SARS') that the acquisition of the beneficial rights in a trust is subject to transfer duty.

General Taxation Provisions

All South African residents are taxed on their worldwide income and non-residents are subject to income tax on income derived from a South African source.[1127] In the context of a *bewind* trust this means that the income is taxed in the hands of the beneficiaries, while the income of discretionary trusts is taxed in the hands of the trust. The reason for this distinction is that in the case of the *bewind* trust, as discussed above, the trust has the power to manage the assets(s) on behalf of the beneficiary who owns it. Since the beneficiary owns the asset(s), any income or capital gain arising on the use or disposal of the asset(s) vests in the beneficiary.[1128] Therefore, the investors (beneficiaries) in a *bewind* trust are taxed in their hands individually.[1129]

South African investors will be required to include income generated in respect of the underlying assets of the private equity fund in their gross income and will be taxed in accordance with the tax regime applicable to such investors.[1130] In addition, in terms of Section 10(1)(k)(i) of the Income Tax Act 58 of 1962, dividend income on shares in South African companies will be exempt from income tax in both South African and non-South African investors' hands, subject to the deeming provisions contained in sections 8E and 8EA of the Income Tax Act No 58 of 1962.[1131] In terms of section 1 of the Income Tax Act 58 of 1962, non-South African investors will only be required to include income generated in respect of the underlying assets in their gross income if the income is from a South

[1126]With regard to the latter (in the context of a private equity fund), brief reference is made later in this paragraph to *African Life Investment Corporation (Pty) Ltd v SIR* (1969) 4 SA 259 (A), *CIR v Nussbaum* 1996 (4) SA 1156 (A), 58 SATC 283, 1996 Taxpayer 150, and *ITC 1412* (1983) 48 SATC 157. The brief discussion relates to the proceeds from the realisation of the shares in the investee company which can be said to be of a capital nature resulting in the return to the investors being liable to the lower capital gains tax.
[1127]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at page 870.
[1128]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894.
[1129]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894.
[1130]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894.
[1131]Sections 8E and 8EA of the Income Tax Act 58 of 1962, deems the dividends on certain shares containing debt-like characteristics to be income in the hands of the recipient.

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African source, such as interest on loans applied in South Africa and dividends on shares in South African companies.[1132] In terms of section 10(1)(h) of the Income Tax Act 58 of 1962, any interest income should be exempt from income tax in the non-South African investors' hands, unless it is a natural person investor who has been physically present in South Africa for more than one hundred and eighty three days in the twelve-month period during which the interest was received, or if the non-South African investor has a permanent establishment in South Africa.[1133] Any dividends declared by a South African company or interest from a South African source that is paid to a non-South African resident investor will be subject to dividends withholding tax and interest withholding tax.[1134]

In terms of section 25B of the Income Tax Act 58 of 1962, subject to section 7, read together with relevant revenue practice notes, SARS accepts that where there is a *bewind* trust the allowances flow through and can be set off against other income.[1135] Section 25B is the predominant section in the Income Tax Act 58 of 1962 relating to the taxation of trusts.[1136] Section 25B provides that the income of the trust is taxed either in the trust or in the hands of the beneficiaries. Thus, if the income does not vest in the beneficiaries the trust is taxed on it; and if the income does vest in the beneficiaries, they (the beneficiaries) are taxed on it.[1137] There is no ring-fencing and the investor in the trust will enjoy the tax benefits directly. There is effectively a tax at source and a measure of limited liability.[1138] In addition, there are no adverse tax accrual consequences for the investors (provided that the income earned by the trust is declared within the year in which it is earned).[1139] In addition, the general principles of South African tax law applicable to a trust provide that the trust

[1132]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894.
[1133]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894.
[1134]This will be subject to certain exemptions and any available treaty relief. Both dividends withholding tax and interest withholding tax will be levied at a rate of fifteen percent. See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894. See also Haupt, P. (2015), 'Notes on South African Income Tax', 34th edition, at pages 592-661.
[1135]Section 25B is subject to section 7, where section 7 applies it prevails over section 25B. Section 7 is an anti-avoidance provision aimed at taxing, in the hands of the donor, any income which have resulted from a donation or similar disposition.
[1136]Section 25B of the Income Tax Act 58 of 1962, read together with section 7(1), essentially codified the conduit-pipe principle first articulated in South African common law.
[1137]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894.
[1138]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894.
[1139]These income tax consequences may, however, be superseded by the deeming provisions relating to trust income as set out in section 7 of the Income Tax Act 58 of 1962. In this regard, if a resident makes a gratuitous disposal to either a local or offshore trust, section 7 may attribute the retained income derived by the trust from such gratuitous disposition to that resident. Section 7 of the Income Tax Act 58 of 1962 provides several anti-avoidance measures, which deem someone other than the person who receives income or to whom income accrues, to be entitled to the income. See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894.

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income paid by the trust to an investor in the year it is accrued retains its original character in the hands of the beneficiary, and is thus taxed in the investors hands in accordance with the principles applicable to that character of income.[1140] Section 25B(1) of the Income Tax Act 58 of 1962 states that any amount received by or accrued to or in favour of any person during any year of assessment in his/her capacity as a trustee of a trust, to the extent to which such amount has been received for the immediate or future benefit any ascertained beneficiary who has a vested interest to that amount during that year, this shall be deemed to be an amount that has accrued to the beneficiary of the trust.[1141]

Furthermore, section 25B(2) of the Income Tax Act 58 of 1962 provides that where a beneficiary has acquired a vested right to any amount in consequence of the exercise by the trustee of a discretion vested in him/her in terms of the trust deed of the trust, agreement or will of a deceased person, that amount would be deemed to have been derived for the benefit of that beneficiary.[1142] Therefore, in terms of section 25B of the Income Tax Act 58 of 1962, the trust would be transparent for tax purposes, with any amounts to which the beneficiary have a vested interest, or amounts to which the beneficiary acquires a vested interest as a result of the exercise by the trustee of the discretion to vest the amount in the beneficiary, deemed to be amounts that accrue directly to the beneficiaries.[1143]

Nevertheless, if the private equity fund's investment activities are liable to income tax, the realisation of gains on the disposal of shares will be subject to tax in South Africa, provided the investors in the fund and the investments by the fund are all local. In the context of a private equity fund, realisation gains are usually treated as being of a capital nature even where the relevant shares were not held for a period of three years before the date of disposal and therefore do not qualify for the deemed capital treatment.[1144] Capital Gains Tax ('CGT') was introduced into the Income Tax Act 58 of 1962 on October 2001. It applies to all sales of capital assets on or after that date.[1145] The basic principle is that if a capital gain asset is sold at a profit, the profit is subject to CGT, and if it is sold at a loss, the capital loss can be set off against other capital profits. If there are no other capital profits in the year, the capital loss is carried forward to the next year.[1146] Except for shares sold after being held

[1140]Section 25B read together with section 7(5) of the Income Tax Act 58 of 1962. See also Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894.
[1141]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894.
[1142]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894.
[1143]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894.
[1144]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894.
[1145]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.
[1146]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South

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for three years, in which case section 9C of the Income Tax Act 58 of 1962 applies, there are no rules for when the sale of an asset is subject to normal tax and when it is subject to the tax on capital gains.[1147] If the sale of an asset is subject to normal tax, namely it is a sale in the course of a scheme of profit-making, then the CGT rules do not apply.[1148] In addition, paragraph 80 of the Eighth Schedule to the Income Tax Act 58 of 1962 provides that where a capital gain is determined in respect of the vesting by a trust of an asset in a beneficiary who is a resident,[1149] the gain must be disregarded for purposes of calculating the aggregate capital gain or loss of the trust, and must be taken into account for the purposes of calculating the aggregate capital gain or loss of the beneficiary to whom that asset was so disposed.[1150] Paragraph 80 of the Eighth Schedule to the Income Tax Act 58 of 1962 has the effect of making the trust tax transparent and attributing capital gains and losses directly in the beneficiaries.[1151]

In the context of a private equity fund, a further consideration with regard to CGT is when investors leave or new investors enter a private equity fund structured as a *bewind* trust. As discussed above in detail, the investors in the private equity fund set up as a *bewind* trust are the trust beneficiaries, who own the underlying trust assets but relinquish control of the assets to the trustees who, in turn, appoint a private equity firm to identify and make investments.[1152] As the investors are direct part owners of the trust assets, if new investors are introduced after the fund has already made investments, the old investors will dispose of a portion of their interest in the fund assets. As the disposal will be to a new investor and a beneficiary of the trust, it will be to a connected person, which means that it will be deemed to take place at market value on the date that the new investor becomes a beneficiary of the trust.[1153] Again, where an investor enters the fund as a beneficiary of the trust, the old investors may have a CGT liability even though they do not receive any proceeds from the new investor joining the fund, but only in respect of the part of the trust assets disposed of.[1154] Nevertheless, the SARS approach stated in the CGT Guide is not law and a court could choose not to follow this approach.

African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.

[1147]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.

[1148]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.

[1149]Other than persons contemplated in paragraph 62(a) to (e) of the Eighth Schedule, or a person who acquires the asset as an equity instrument as contemplated in section 8C(1) of the Income Tax Act 58 of 1962.

[1150]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894.

[1151]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894.

[1152]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894.

[1153]See South African Revenue Services ('SARS') (2012), 'Interpretation Note No: 67 on the Income Tax Act 58 of 1962', 1st November 2012.

[1154]See South African Revenue Services ('SARS') (2012), 'Interpretation Note No: 67 on the Income Tax Act 58 of 1962', 1st November 2012.

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In the context of a private equity fund, the proceeds from the realisation of the shares in the investee company can be said to be of a capital nature resulting in the return to the investors being liable to the lower capital gains tax. In this regard, *African Life Investment Corporation (Pty) Ltd v SIR*[1155] established the general principal that shares should be acquired for better or for worse or, relatively speaking, for keeps that is only to be disposed of if some unusual, unexpected or some special circumstance warranting or inducing disposal, intervenes. In *CIR v Nussbaum*[1156] the court acknowledged the fact that a taxpayer would be saddled with a 'formidable and difficult onus'. This would especially be the case if, in addition to the main purpose of receiving income from dividends, there would be a secondary intention of disposing of the shares with a view to yielding a profit whenever it is deemed expedient. However, in *ITC 1412*[1157] it was held that the fact that a taxpayer may foresee the possibility of eventually disposing of the shares will not in itself render the asset something other than capital. In this context, the most important test employed by the courts in deciding whether or not the proceeds arising from the disposal of shares or income or capital is the intention with which the shares were acquired.[1158]

Nevertheless, trusts may essentially be transparent for tax purposes and where the beneficiaries of the trust have a vested interest in the trust, or where the trustees distribute the capital of the trust or the income generated by the trust assets to the beneficiaries, the provisions of section 25B of the Income Tax Act 58 of 1962 and paragraph 80 of the Eighth Schedule to the Income Tax Act 58 of 1962 would be applicable.

Transfer Duty

In terms of section 2(1) of the Transfer Duty Act 40 of 1949, transfer duty is payable on the value of any property acquired by any person by way of a transaction or in any other manner. Section 2(1) of the Transfer Duty Act 40 of 1949, reads as follows:

> '(1) Subject to the provisions of section 9, there shall be levied for the benefit of the National Revenue Fund a transfer duty (hereinafter referred to as the duty) on the value of any property (which value shall be determined in accordance with the provisions of sections 5, 6, 7 and 8) acquired by any person on or after the date of commencement of this Act by way of a transaction or in any other manner, or on the amount by which the value of any property

[1155] *African Life Investment Corporation (Pty) Ltd v SIR* (1969) 4 SA 259 (A).
[1156] *CIR v Nussbaum* 1996 (4) SA 1156 (A), 58 SATC 283, 1996 Taxpayer 150.
[1157] *ITC 1412* (1983) 48 SATC 157.
[1158] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023. See Haupt, P. (2015), 'Notes on South African Income Tax', 34th edition, at pages 693-694.

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is enhanced by the renunciation, on or after the said date, of an interest in or restriction upon the use or disposal of that property, at the rate of.'

A 'transaction' is defined in terms of section 1 of the Transfer Duty Act 40 of 1949 as:

'(a) ... an agreement whereby one party thereto agrees to sell, grant, donate, cede, exchange, lease or otherwise dispose of property to another, or any act whereby any person renounces any interest or restriction in his favour upon the use or disposal of property'.

According to Divaris and Stein, the term 'property' in terms of section 1 of the Transfer Duty Act 40 of 1949 means any right in or to property, whether it is movable or immovable, corporeal or incorporeal and embraces only rights that are vested in the taxpayer and would not include contingent rights or rights in which the taxpayer does not have ownership or that may accrue upon the happening of certain events.[1159] Both Louro and Green are of the view that a disposal of these rights and the acquiring of same by a person falls within the definitions of 'transaction' and 'property', causing transfer duty to be levied on the acquisition of these rights.[1160] In *SIR v Estate Rhode-Knight*,[1161] it was held that in order to determine whether transfer duty is payable on the disposal of an interest in the trust is whether a beneficiary has acquired a right in the trust property or not. This court held that the word 'acquired' in section 2(1) of the Transfer Duty Act 40 of 1949 does not refer to the acquisition of ownership, but rather to the right to obtain ownership.[1162] The consequence is that transfer duty is payable when a person obtains an enforceable right to acquire ownership in future and not when the ownership is obtained.[1163]

According to Van Der Westhuizen, the nature of a trust and the rights of the beneficiaries determine whether a person purchasing an interest in a trading trust is liable for transfer duty.[1164] For instance, in the trust in a narrow sense, the ownership and control of the trust property vests in the trustees in their capacity as trustees whereas in the trust in a wide sense (*bewind* trust), ownership vests in the beneficiaries, but control vests in the trustees. When a person acquires the rights of a beneficiary in a trust the liability for transfer duty depends on whether the beneficiaries have a real right; a right to acquire the ownership of property; or a personal right.[1165] If it is the latter, then it appears as if no transfer duty is payable, but the possibility of donations tax does exist.[1166] When ownership vests in

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[1159] Divaris, C. and Stein, M. (2003), 'Silke on South African Income Tax', 11th Memorial Edition, Juta and Company, at 23.3.
[1160] Louro, J. (1986), 'Don't trust the trust when you buy it', Butterworths Property Law Digest, 1/1986, at 23. Green, R. (1997), 'The cession of an interest in a trust and transfer duty', De Rebus 763.
[1161] *SIR v Estate Rhode-Knight* 1974 (1) SA 253 (A).
[1162] *SIR v Estate Rhode-Knight* 1974 (1) SA 253 (A).
[1163] Green, R. (1997), 'The cession of an interest in a trust and transfer duty', De Rebus 763.
[1164] Van Der Westhuizen, W.M. (1997), 'Wills and Trusts', Service Issue Two, Butterworths, at page 75.
[1165] *SIR v Estate Rhode-Knight* 1974 (1) SA 253 (A).
[1166] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 27, at pages 870-894.

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the trustees the beneficiaries do not have an immediate right to the trust property itself, or to acquire ownership of the property in future, and merely have a personal right against the trustee that the trust be properly managed for their benefit.[1167] The result is that when beneficiaries under a trust in a narrow sense transfer their interests in the trust, the right to obtain property is not disposed of to the purchaser; while on the other hand, such a transfer by beneficiaries under a *bewind* trust will constitute a disposal of property thus attracting transfer duty.[1168] It is submitted, that it terms of a *bewind* trust, the beneficiaries are the owners of the immovable property and therefore have a real right in the property as defined in terms of section 1 of the Transfer Duty Act 40 of 1949, which will attract transfer duty when a beneficiary disposes of his/her interest.

(f) The Termination, Variation and Revocation of a Trust

As previously mentioned, a critical characteristic of the private equity business model is the pre-determined, fixed life period of a private equity fund. Therefore, a private equity fund structured as a trust will be terminated at some point. According to Cameron *et al*, the revocation of a trust is the process by which the founder with or without the concurrence of the trustees and beneficiaries brings to an end a trust which has already been set up.[1169] Cameron *et al*, also defines variation as consisting in the alteration of the terms of a trust by the founder, the trustees, the beneficiaries, the court or some combination of these.[1170] Furthermore, termination is the discharge of a trust by one of these agencies or by statute or operation of law.[1171] The statutory powers conferred upon the court is in terms of the provisions of the Trust Property Control Act 57 of 1988, which empowers the court to order the variation or termination of a trust if the court is of the opinion that the facts comply with the stipulations of section 13 of the Trust Property Control Act 57 of 1988. Section 13 of the Trust Property Control Act 57 of 1988 reads as follows:

> 'If a trust instrument contains any provision which brings about consequences which in the opinion of the court the founder of a trust did not contemplate or foresee and which-
> (a) hampers the achievement of the objects of the founder; or
> (b) prejudices the interests of beneficiaries; or
> (c) is in conflict with the public interest,

[1167] Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at pages 486-489.
[1168] Van Der Westhuizen, W.M. (1997), 'Wills and Trusts', Service Issue Two, Butterworths, at page 75.
[1169] Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at page 491. See also Van Der Merwe, N.J. and Rowland, C.J. (1990), 'Die Suid-Afrikaanse Erfreg', Sixth Edition, Van der Walt, Pretoria, at pages 376-377.
[1170] Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at page 491. See also Van Der Merwe, N.J. and Rowland, C.J. (1990), 'Die Suid-Afrikaanse Erfreg', Sixth Edition, Van der Walt, Pretoria, at pages 376-377.
[1171] Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at page 491.

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the court may, on application of the trustee or any person who in the opinion of the court has a sufficient interest in the trust property, delete or vary any such provision or make in respect thereof any order which such court deems just, including an order whereby particular trust property is substituted for particular other property, or an order terminating the trust.'

In terms of the definition above, if a trust instrument contains any provision which brings about consequences which in the opinion of the court the founder of the trust did not contemplate or foresee and which (a) hampers the achievement of the objects of the founder; or (b) prejudices the interest of beneficiaries; or (c) is in conflict with the public interest, the court may, on application of the trustee or any person who in the opinion of the court has a sufficient interest in the trust property, make in respect thereof any order which such court deems just, including an order terminating the trust.[1172] According to Cameron *et al*, section 13 of the Trust Property Control Act 57 of 1988 increased the court's power to vary trust provisions and includes a power not merely to vary the trust but to bring it to an end.[1173] Cameron *et al* states that:

'Under s 13 criteria both subjective … and objective … must be satisfied before the court can intervene. The legislature has set a middle course between two extremes. It might have dispensed with the subjective criterion. The court might have been given power to vary trust provisions whenever it considered it in the public interest or that of the beneficiaries to do so, even if the founder foresaw or contemplated the circumstances that made it undesirable to adhere to the original provisions … At the other extreme the legislature might have kept closely to the common law and insisted that necessity or something akin to it should be present before the court has jurisdiction to vary the trust.'[1174]

Furthermore, the South African Law Commission's Report on the Review of the Law of Trusts did not recommend that wide powers to vary trust provisions be given to the court; nor the right of the founder, the trustee and beneficiaries to vary a trust be changed.[1175] In this regard, the Report stated the following:

'The Court already has a common-law power to vary the trust provisions if a change in circumstances not foreseen by the founder has made the carrying out of the purpose of the trust 'practically impossible or utterly unreasonable'. The Commission recommends that this power be

[1172]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' 5th Edition, Juta and Co. Ltd, at page 517.
[1173]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' 5th Edition, Juta and Co. Ltd, at page 517.
[1174]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' 5th Edition, Juta and Co. Ltd, at pages 517-518.
[1175]South African Law Commission, 'Report on the Review of the Law of Trusts', Project 9, June 1987, at 43-48.

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> extended to all cases where the provisions of a trust instrument bring about consequences which the founder did not contemplate or foresee and which hamper the achievement of the objects of the founder or prejudice the interests of beneficiaries or are in conflict with the public interest.'[1176]

Section 13 of the Trust Property Control Act 57 of 1988 was applied in *In re Heydenrych Testamentary Trust and Others*.[1177] In this case the applicant, in its capacity as administrator of three charitable testamentary trust instruments, brought an *ex parte* application for the deletion of discriminatory provisions regarding the potential beneficiaries of such trust funds. The provisions in question discriminated directly on the grounds of race and gender insofar as they restricted the allocation of scholarships to boys from the white population group and by requiring that at least fifty percent of the recipients of the scholarships were boys of British descent.[1178] In this case, Goliath J held that section 13 of the Trust Property Control Act 57 of 1988 empowers a court to delete or vary provisions in a trust instrument that bring about consequences that the founder of the trust did not contemplate or foresee and which either (a) hamper the achievements of the objects of the founder; (b) prejudice the interests of the beneficiaries; or (c) are in conflict with the public interest.[1179] In *In re Heydenrych Testamentary Trust and Others,*[1180] the testators had executed the relevant wills before the advent of democracy and the introduction of the South African Constitution and, therefore, the court reasoned, they would not have foreseen that the allocation of scholarships by the trusts on a discriminatory basis would be rendered unconstitutional and unlawful, or that the charitable purpose of the trusts would be hampered by the discriminatory conditions imposed. The court in *In re Heydenrych Testamentary Trust and Others*[1181] referred with approval to earlier decisions in which similar discriminatory provisions in testamentary trusts were declared invalid. One of these decisions was *Ex Parte President of the Conference of The Methodist Church of Southern Africa NO: In re William Marsh Will Trust*,[1182] in which the court held that a clause in a trust deed that restricted the benefits of a home for destitute children to white children was contrary to the public interest. Another such decision was *Minister of Education and Another v Syfrets Trust Ltd NO and Another*,[1183] in which the court considered the limitation of bursaries to candidates of European descent and found that this constituted indirect discrimination based on race and colour. Accordingly, Goliath J concluded, the terms of the testamentary trusts had to be varied to remove the discriminatory provisions.[1184] Nevertheless, Cameron *et al* argues that the court's common law powers remain

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[1176] South African Law Commission, 'Report on the Review of the Law of Trusts', Project 9, June 1987, at paragraph 12.19. See also *Ex parte Watling* 1982 1 SA 936 (C) at 940H. See *Ex parte Sidelsky* 1983 4 SA 598 (C) at 601E.
[1177] *In re Heydenrych Testamentary Trust and Others* 2012 (4) SA 103 (WCC).
[1178] *In re Heydenrych Testamentary Trust and Others* 2012 (4) SA 103 (WCC).
[1179] *In re Heydenrych Testamentary Trust and Others* 2012 (4) SA 103 (WCC).
[1180] *In re Heydenrych Testamentary Trust and Others* 2012 (4) SA 103 (WCC).
[1181] *In re Heydenrych Testamentary Trust and Others* 2012 (4) SA 103 (WCC).
[1182] *Ex Parte President of the Conference of The Methodist Church of Southern Africa NO: In re William Marsh Will Trust* 1993 2 SA 697 (C).
[1183] *Minister of Education and Another v Syfrets Trust Ltd NO and Another* 2006 4 SA 205 (C).
[1184] *In re Heydenrych Testamentary Trust and Others* 2012 (4) SA 103 (WCC).

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intact, despite the statutory powers given by section 13 of the Trust Property Control Act 57 of 1988.[1185]

In terms of common law, an *inter vivos* trust will terminate when the trust deed stipulates it will terminate.[1186] This can be after the lapse of time or at the happening of a future event or it can be left to the discretion of the trustees to terminate the trust.[1187] An *inter vivos* trust is in any case regulated by the law of contract as discussed above; therefore it is advisable not to limit the discretion of the trustees regarding the termination of a trust.[1188] When a trust is terminated the destination of the remaining trust property, if any, depends on the mode of termination.[1189] If the beneficiaries have brought it to an end they are entitled to direct how the property should be distributed.[1190] If the founder has revoked the trust by virtue of a unilateral power of revocation or with the concurrence of the trustee, he/she is entitled to recover the trust property by *condictio*.[1191] Nevertheless, in any other case of termination of a trust *inter vivos* the provisions, if any, of the trust instrument apply, but in default of such provisions the founder or his successors may recover the trust property by *condictio*, unless the founder intended to part permanently with any claim to the property, or he or his successors have since the commencement of the trust waived any such claim, in which case the property vests in the state as *bona vacantia.*[1192]

The revocation of the trust is usually dependent on one or more events as defined in the trust instrument.[1193] For example, such an event can be the death of a named person, the attainment of a specified age by a beneficiary, a fixed date mentioned in the trust deed, or a provision that the trust is to continue indefinitely until the trustees resolve to terminate it.[1194] In *Ex parte Estate Vincent,*[1195]

[1185]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at page 519.
[1186]Olivier, P.A. (1990), 'Trust Law and Practice', First Edition, De Jager-Haum Publishers, at pages 264-277.
[1187]Olivier, P.A. (1990), 'Trust Law and Practice', First Edition, De Jager-Haum Publishers, at pages 264-277. The rule against perpetuities in Anglo-American law, which limits the duration of a trust, is not applicable in South African law where a trust can continue indefinitely. South African courts and authorities on the topic have not made a clear distinction between the *inter vivos* trust and the testamentary trust as far as the perpetuity of the trust is concerned. See also Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at pages 55, 125–127, 170, 587–588. See also Honoré, T. and Cameron, E. (1992), 'Honoré's South African Law of Trusts,' Fourth Edition, Lansdowne, Juta and Company Ltd, at pages 42, 102–104, 513–514.
[1188]Olivier, P.A. (1990), 'Trust Law and Practice', First Edition, De Jager-Haum Publishers, at pages 264-277. See also Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at pages 55, 125–127, 170, 587–588.
[1189]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at page 491.
[1190]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at pages 506-512.
[1191]Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at pages 492-503.
[1192]Honoré, T. and Cameron, E. (1992), 'Honoré's South African Law of Trusts,' Fourth Edition, Lansdowne, Juta and Company Ltd, at page 467.
[1193]Olivier, P.A. (1990), 'Trust Law and Practice', First Edition, De Jager-Haum Publishers, at pages 264-277.
[1194]Olivier, P.A. (1990), 'Trust Law and Practice', First Edition, De Jager-Haum Publishers, at pages 264-277.
[1195]*Ex parte Estate Vincent* 1964 2 SA 99 (C).

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the court highlighted that as far as the testamentary trust is concerned, there is also no limit to the time at which an interest in the capital of the trust fund may be made to vest in the beneficiaries. Therefore, in *Ex parte Estate Vincent*[1196] the court held that the founder of a trust was entitled to give capital to his great-grandchildren. In addition, the principle of perpetuity was affirmed in the majority decision in *CIR v Sive's Estate*.[1197] In this case the testator bequeathed the residue of his estate to his children in equal shares, provided that as regard half of each share the trustees had the entire discretion to decide whether the whole or any portion should be paid to a child entitled thereto and, if the trustees decided to make payments to them, when they were to be made.[1198] In the same manner the trustees were to pay each child so much of the income derived from his share as they might deem fit.[1199] The court held that the testator did not intend to vest any portion of capital or income in his children, so that they did not have a vested interest on which estate duty was payable.[1200] The decision also implies that a trust can be valid though the trustees have a discretion indefinitely to postpone the distribution of both income and capital.[1201]

The Trust Property Control Act 57 of 1988 does not provide for any formalities or specific control measures to be complied with when a trust is terminated.[1202] Termination itself does not also terminate the trusteeship.[1203] The duties to the trustees' office may continue to exist and prior to termination, all liabilities will have to be paid and trust property distributed according to the trust instrument.[1204] Furthermore, the office comes to an end only when the trustee has duly disposed of all the trust property.[1205] It is only after the Master of the High Court is satisfied and confirms that the trustee has duly disposed of all the trust property, will the trustees really have discharged their obligations.[1206] In this regard, the Master of the High Court may require reasons for termination or the original resolutions terminating the trust by the trustees, as well as the original letters of authority together with confirmation that the beneficiaries under trust have received their benefits.[1207]

[1196] *Ex parte Estate Vincent* 1964 2 SA 99 (C). See also *Ex parte Heyman* 1937 CPD 282. See also *Ex parte Estate Graaff* 1947 4 SA 496 (C).
[1197] *CIR v Sive's Estate* 1955 1 SA 249 (A).
[1198] *CIR v Sive's Estate* 1955 1 SA 249 (A).
[1199] *CIR v Sive's Estate* 1955 1 SA 249 (A).
[1200] *CIR v Sive's Estate* 1955 1 SA 249 (A).
[1201] *CIR v Sive's Estate* 1955 1 SA 249 (A). As mentioned in earlier, the rule against perpetuities in Anglo-American law, which limits the duration of a trust, is not applicable in South African law where a trust can continue indefinitely. See also Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at pages 125–126, 599 and 601.
[1202] Honoré, T. and Cameron, E. (1992), 'Honoré's South African Law of Trusts,' Fourth Edition, Lansdowne, Juta and Company Ltd, at page 183.
[1203] Honoré, T. and Cameron, E. (1992), 'Honoré's South African Law of Trusts,' Fourth Edition, Lansdowne, Juta and Company Ltd, at page 183.
[1204] Honoré, T. and Cameron, E. (1992), 'Honoré's South African Law of Trusts,' Fourth Edition, Lansdowne, Juta and Company Ltd, at page 183.
[1205] Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' Fifth Edition, Juta and Co. Ltd, at pages 226-227.
[1206] Honoré, T. and Cameron, E. (1992), 'Honoré's South African Law of Trusts,' Fourth Edition, Lansdowne, Juta and Company Ltd, at pages 183 and 467.
[1207] Honoré, T. and Cameron, E. (1992), 'Honoré's South African Law of Trusts,' Fourth Edition, Lansdowne, Juta and Company Ltd, at pages 183 and 467.

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Furthermore, in *Crookes NO v Watson*,[1208] the court held that where the beneficiaries have accepted any benefit prior to the termination of the trust, they have to be a party to the resolution to terminate the trust, despite the trust deed stipulating otherwise. Nevertheless, in the case of a private equity fund, the trust is established for a fixed term and the termination of the trust will come about by the expiration of that term. Typically in such trust agreements, there will be many examples of express clauses which expand the available grounds for termination, variation and revocation.

3.1.3 Conclusion

It is submitted that there are no major advantages or disadvantages of the *bewind* trust structure over the *en commandite* partnership structure for private equity funds, where the investors and investments are all South Africans. The preferred private equity fund structure will depend more on the commercial and other legal considerations. As for *bewind* trusts, it appears that the critical factor separating a trust from a partnership is the degree of independence that the trustees enjoy. The analysis of *bewind* trusts identifies certain matters which a court would take into account in any such analysis. Among them are (a) do the beneficiaries have the right to elect the trustees?; (b) may the beneficiaries remove the trustees from office at any time without cause, and fill the vacancies caused by such removal?; (c) do the beneficiaries have the right to amend or terminate the trust?; and (d) do the beneficiaries have the right to direct the actions of the trustees?[1209] While an affirmative answer to any one of these questions would not necessarily undo a trust, it is important that the principle of trustee independence not be eroded, whether directly or indirectly (for example, through an investment committee). Both the internal and external conduct of the trust should be carefully regulated to avoid the erosion of trustee independence. In this regard, the presence of at least one experienced independent trustee who has the respect and trust of the investors is critical. As mentioned earlier, paragraphs 3.2 to 3.5 of this chapter will provide a comparison of the private equity fund structures used in the US, UK, Australia, and Canada.

3.2. Organisational Form in the US

In chapter one it was mentioned that private equity funds in the US are structured as closed-end investment vehicles, which are typically organised as limited partnerships or limited liability companies.[1210] According to Black, Delaware law is preferred amongst the private equity industry participants in the US to organise private equity funds because limited partnerships and limited liability companies for large, complex transactions are often formed in Delaware and fund investors

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[1208] *Crookes NO v Watson* 1956 1 SA 277 (A). See also *Hofer v Kevitt NO* 1998 1 SA 382 (SCA).

[1209] See *Coetzee v Peet Smith Trust and Other* 2003 (5) SA 674 (T); and *SARS v Dyefin Textiles (Pty)* Ltd 2002 (4) SA 606 (N) at 611; See also Cameron, E., De Waal, M., Wunsh, B., Solomon, P and Kahn, E. (2002), 'Honoré's South African Law of Trusts,' 5th edition, Juta and Co. Ltd, at paragraph 3.3.2.

[1210] Naidech, S.W. (2011), 'Private Equity Fund Formation', Practice Note: Chadbourne and Parke LLP, published by Practical Law Company, at pages 1-5.

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are familiar with the jurisdiction.[1211] A further reason why private equity industry participants prefer Delaware is because it has specialized courts for business entities, which have the relevant expertise in economic and governance issues.[1212] In addition, Delaware has a well developed common-law regime governing limited partnerships and limited liability companies, which is generally considered the more sophisticated of the US States.[1213] More importantly though, is that Delaware has an efficient administrative process; and Delaware statutory and common law provides for extensive freedom of contract.[1214] This contractual flexibility will be discussed below as one of the key features of limited partnerships and limited liability companies.

The nature and structure of each individual limited partnership and limited liability company are largely dependent on the contents of the operating agreement which affords the parties to such an agreement a wide discretion in drafting such an agreements.[1215] It must be noted that this discussion will not consider all US state and federal regulations, including securities law issues, tax, liability, and other issues required for the structuring of a private equity fund in the US. Such a discussion is beyond the scope of this thesis. However, this discussion will in addition include a brief analysis of the application of fiduciary duties in limited partnerships and limited liability companies in the US. The legal principle of fiduciary duties will be discussed more fully in chapter three as part of the importance of corporate governance in relation to the private equity participants. The purpose of introducing such an analysis in this paragraph is to highlight that statutes, for example the Delaware Revised Uniform Limited Partnership Act, imposes duties on the private equity firm to act efficiently, honestly and fairly, effectively extending duties of a fiduciary nature from the private equity firm to investors. However, while the legal fiduciary duties cannot be contracted out of, the terms of the relevant trust deed or partnership deed may amend or modify such duties to provide for terms agreed between the investors and the private equity firm. Nevertheless, this paragraph will primarily provide a broad analysis of the salient features of the limited partnership and limited liability company as the preferred legal forms that house private equity funds in the US.

Limited Partnership

[1211]Black, L.S. (2007), 'Why Corporations Choose Delaware', Delaware Department of State Division of Corporations, at pages 1-10.
[1212]Black, L.S. (2007), 'Why Corporations Choose Delaware', Delaware Department of State Division of Corporations, at pages 1-10. See also Spangler, T. (2012), 'The Law of Private Investment Funds', Second Edition, OUP Oxford, at chapter 3, paragraph D and chapter 6, paragraph D.
[1213]Black, L.S. (2007), 'Why Corporations Choose Delaware', Delaware Department of State Division of Corporations, at pages 1-10.
[1214]Black, L.S. (2007), 'Why Corporations Choose Delaware', Delaware Department of State Division of Corporations, at pages 1-10. See also Naidech, S.W. (2011), 'Private Equity Fund Formation', Practice Note: Chadbourne and Parke LLP, published by Practical Law Company, at pages 1-5.
[1215]Lewis, W.A. (2013), 'Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies', Fordham Law Review, Volume 82, Issue 2, Article 20, 1017, at pages 1027-1028.

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Limited partnerships in the US are governed by the Uniform Limited Partnership Act of 1976.[1216] The federal government of the US does not have specific statutory law governing the establishment of partnerships.[1217] Instead, each of the fifty states as well as the District of Columbia has its own statutes and common law that govern partnerships.[1218] These states largely follow common-law principles of partnerships whether a general partnership or a limited partnership.[1219] In the absence of applicable federal law, the National Conference of Commissioners on Uniform State Laws issues non-binding model laws, referred to as the Uniform Act, in which to encourage the adoption of uniformity of partnership law into the states by their respective legislatures.[1220] This includes the Uniform Partnership Act of 1976 and the Uniform Limited Partnership Act.[1221] Despite the US Federal Government not having a specific statutory law for establishing partnerships, it has an extensive statutory scheme for the taxation of partnerships in terms of the Internal Revenue Code.[1222] The Delaware statute governing limited partnerships is Delaware Revised Uniform Limited Partnership Act which the can be found in Chapter 17 of Title 6 of the Delaware Code.[1223] In terms of section 15-101(11) of the Delaware Revised Uniform Limited Partnership Act, a limited partnership is a partnership having two or more persons, including one or more general partners and one or more limited partners. The Delaware Revised Uniform Limited Partnership Act covers, *inter alia* laws relating to the formation, and relationship among the partners of a limited partnership and distributions and withdrawal.[1224]

As stated previously in chapter one, a large proportion of private equity funds in the US are organised as partnerships because of the tax benefits associated with pass-through entities.[1225] According to Altman and Raju, the only significant benefit of the corporate form as a private equity vehicle is the

[1216]The Uniform Limited Partnership Act, which includes its 1976 revision called the Revised Uniform Limited Partnership Act, is a uniform act that regulates business partnerships in US States. The Uniform Limited Partnership Act was promulgated in 1916 and the most recent revision in 2001.
[1217]See Manesh, M. (2012), 'Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs', Journal of Corporation Law, 37(3), at pages 555-619. See also Altman, P.M. and Raju, S.M. (2005), 'Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law', The Business Lawyer, at pages 1469-1485.
[1218]Lewis, W.A. (2013), 'Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies', Fordham Law Review, Volume 82, Issue 2, Article 20, 1017, at pages 1025-1028.
[1219]Lewis, W.A. (2013), 'Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies', Fordham Law Review, Volume 82, Issue 2, Article 20, 1017, at pages 1025-1028.
[1220]Lewis, W.A. (2013), 'Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies', Fordham Law Review, Volume 82, Issue 2, Article 20, 1017, at pages 1025-1028.
[1221]Lewis, W.A. (2013), 'Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies', Fordham Law Review, Volume 82, Issue 2, Article 20, 1017, at pages 1025-1028.
[1222]The Internal Revenue Code is Title 26 of the United States Code wherein Subchapter K of Chapter 1 creates tax consequences for partnerships.
[1223]The Delaware Administrative Code is the official version of the regulations for the State of Delaware.
[1224]Available at http://delcode.delaware.gov/title6/c015/, accessed in June 2015.
[1225]Callison, J.W. and Sullivan, M.A. (2012), 'Partnership Law and Practice: General and Limited Partnerships', Clark Boardman Callaghan, at 1:2. See also Steele, M.T. (2009), 'Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies', American Business Law Journal, 46(2), at pages 221-242.

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limited liability it provides the private equity fund's investors.[1226] Limited liability is also achieved through the use of a limited partnership with a general partner (private equity firm) that is also organised as a limited partnership or a limited liability entity.[1227] The primary benefit of the partnership form is that there is no federal income tax at the entity level; that is, the fund as an entity pays no federal income taxes on capital gains or other income.[1228] A partnership generally is treated for tax purposes as a pass-through entity, which means that the general partner and the limited partners will be allocated their proportionate share of the fund's income, gains, losses and expenses for reporting on their own income tax returns based upon the characterisation of the items at the fund level, for example, ordinary income or capital gain.[1229] If the private equity fund is organized as a limited partnership, gains from the sale of the fund's portfolio investments are taxed only once and, if the fund's partners are individuals and the portfolio investment has been held for more than one year, at preferential long-term capital gain tax rates.[1230] On the other hand, the fund had been organised as a corporation rather than as a partnership or treated as a corporation for tax purposes, the gains would be taxed twice.[1231] For example, upon the realisation of a portfolio investment, the fund, if organized as a corporation, would pay federal income taxes on capital gains at the applicable corporate tax rate, followed by taxation at the shareholder level upon the distribution of the net gains as a dividend.[1232]

In the US the limited liability of the limited partners in a limited partnership is predominantly based on the premise that such limited partners should not be in the control of the business. The control of the business is the function of the general partner and should the limited partners be engaged in the control of the business then the limited partners could be subject to the general liability of a general

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[1226]Altman, P.M. and Raju, S.M. (2005), 'Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law', The Business Lawyer, at pages 1469-1485.
[1227]Smith, C.B. and Anderson, R.D. (2006), 'Limited partnerships: legal aspects of organization, operation, and dissolution', Arlington, VA: Bureau of National Affairs, Corporate practice series, No 24-4th.
[1228]Section 7704(b) of the US Internal Revenue Code of 1986. The Internal Revenue Code of 1986 is the domestic portion of federal statutory tax law in the United States, published in various volumes of the United States Statutes at large, and separately as Title 26 of the United States Code ('USC'). Other federal tax law is contained in other titles of the United States Code, such as Title 11 (relating to bankruptcy) and Title 19 (Customs Duties). It is organized topically, into subtitles and sections, covering income tax, payroll taxes, estate taxes, gift taxes, and excise taxes; as well as procedure and administration. Its implementing agency is the Internal Revenue Service.
[1229]Persuad, A.N. and Atkinson, A. (2012), 'Private Equity Funds: Legal Analysis of Structural, ERISA, Securities and Other Regulatory Issues', chapter 47 in Investment Adviser Regulation, 3rd Edition, by Kirsch, C.E., at page 47-10.
[1230]Persuad, A.N. and Atkinson, A. (2012), 'Private Equity Funds: Legal Analysis of Structural, ERISA, Securities and Other Regulatory Issues', chapter 47 in Investment Adviser Regulation, 3rd Edition, by Kirsch, C.E., at page 47-10.
[1231]Persuad, A.N. and Atkinson, A. (2012), 'Private Equity Funds: Legal Analysis of Structural, ERISA, Securities and Other Regulatory Issues', chapter 47 in Investment Adviser Regulation, 3rd Edition, by Kirsch, C.E., at page 47-11.
[1232]Lewis, W.A. (2013), 'Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies', Fordham Law Review, 82(2), Article 20, 1017, at pages 1025-1028. See also Ribstein, L.E. (2004), 'Fiduciary duties and limited partnership agreements', Suffolk University Law Review, 37, at 927.

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partner.[1233] Steele states that what constituted control for this purpose was largely interpreted by the courts based on very specific facts.[1234] Specific provisions were included in state statutes specifying activities in which limited partners could engage without being deemed to participate in the control of the business.[1235] For example, section 17-303(b)(1) and (2) of the Delaware Revised Uniform Limited Partnership Act, Chapter 17 of Title 6 of the Delaware Code includes specific provisions for activities by a limited partner which do not constitute control.[1236] It reads as follows:

> '(b) A limited partner does not participate in the control of the business within the meaning of subsection (a) of this section by virtue of possessing or, regardless of whether or not the limited partner has the rights or powers, exercising or attempting to exercise 1 or more of the following rights or powers or having or, regardless of whether or not the limited partner has the rights or powers, acting or attempting to act in 1 or more of the following capacities:
>
> (1) To be an independent contractor for or to transact business with, including being a contractor for, or to be an agent or employee of, the limited partnership or a general partner, or to be an officer, director or stockholder of a corporate general partner, or to be a partner of a partnership that is a general partner of the limited partnership, or to be a trustee, administrator, executor, custodian or other fiduciary or beneficiary of an estate or trust which is a general partner, or to be a trustee, officer, advisor, stockholder or beneficiary of a business trust or a statutory trust which is a general partner or to be a member, manager, agent or employee of a limited liability company which is a general partner;
>
> (2) To consult with or advise a general partner or any other person with respect to any matter, including the business of the limited partnership, or to act or cause a general partner or any other person to take or refrain from taking any action, including by proposing, approving, consenting or disapproving, by voting or otherwise, with respect to any matter, including the business of the limited partnership.'

The Delaware statute contains provisions specifically designed to protect the limited liability of the limited partner interests held by persons having interests in or operating the general partner.[1237] In effect, the Delaware statute reduces the liability of limited partners to an extent approaching the

[1233] Steele, M.T. (2009), 'Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies', American Business Law Journal, 46(2), at pages 221-242.

[1234] Steele, M.T. (2007), 'Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies', Delaware Journal of Corporate Law, 32(1), at pages 1-32.

[1235] Steele, M.T. (2009), 'Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies', American Business Law Journal, 46(2), at pages 221-242.

[1236] Steele, M.T. (2009), 'Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies', American Business Law Journal, 46(2), at pages 221-242.

[1237] See section 17-303(b)(1) and (2) of the Delaware Revised Uniform Limited Partnership Act, Chapter 17 of Title 6 of the Delaware Code. See also Manesh, M. (2012), 'Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs', Journal of Corporation Law, 37(3), at pages 555-619.

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limited liability of shareholders in the corporate form.[1238] According to Persuad, in a limited partnership the general partner, as a rule, remains personally liable to third parties for the debts and obligations of the limited partnership.[1239] However, private equity fund partnership agreements typically provide for indemnification of the general partner by the partnership. Accordingly, the value of the indemnity is limited to partnership assets, although generally fund agreements permit commitments to be drawn down, and often obligate limited partners to return some or all distributions received from the fund to fund the indemnity or other claims against the partnership.[1240] The partnership agreement may also limit the general partner's liability to claims by the limited partners or the partnership through exculpation provisions.[1241] Typically, these provisions provide that the general partner will not be liable to the partnership or the other partners, except for fairly serious actions or omissions such as fraud, gross negligence, bad faith or intentional misconduct.[1242] Such conduct will also, typically, prevent the general partner from obtaining indemnification under the terms of the partnership agreement.[1243] The Delaware statute affords the parties broad authority by contract to define the liabilities of the general partner to the partnership and the other partners, to provide for indemnification, and to expand, restrict or eliminate the fiduciary duties of the general partner, the limited partners and other persons, except that the implied contractual covenant of good faith and fair dealing may not be eliminated. [1244] The general partner will also typically be organized using a limited liability entity, or a series of limited liability entities.[1245] To further limit liability, the general partner will typically invest only a small portion of its funds as the general partner and will contribute the majority through a limited partner interest.[1246] Liability may be further reduced where

[1238]Manesh, M. (2012), 'Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs', Journal of Corporation Law, 37(3), at pages 555-619.

[1239]Persuad, A.N. and Atkinson, A. (2012), 'Private Equity Funds: Legal Analysis of Structural, ERISA, Securities and Other Regulatory Issues', chapter 47 in Investment Adviser Regulation, 3rd Edition, by Kirsch, C.E., at page 47-16.

[1240]Persuad, A.N. and Atkinson, A. (2012), 'Private Equity Funds: Legal Analysis of Structural, ERISA, Securities and Other Regulatory Issues', chapter 47 in Investment Adviser Regulation, 3rd Edition, by Kirsch, C.E., at pages 47:16- 47:19.

[1241]Altman, P.M. and Raju, S.M. (2005), 'Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law', The Business Lawyer, at pages 1469-1485. See also Callison, J.W. and Sullivan, M.A. (2012), 'Partnership Law and Practice: General and Limited Partnerships', Clark Boardman Callaghan, at 1:2.

[1242]Ribstein, L.E. (2004), 'Fiduciary duties and limited partnership agreements', Suffolk University Law Review, 37, at 927. See also Manesh, M. (2012), 'Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs', Journal of Corporation Law, 37(3), at pages 555-619.

[1243]Steele, M.T. (2009), 'Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies', American Business Law Journal, 46(2), at pages 221-242.

[1244]See sections 17-403(b), 108, and 1101(d) and (f) of the Delaware Revised Uniform Limited Partnership Act, Chapter 17 of Title 6 of the Delaware Code.

[1245]Steele, M.T. (2009), 'Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies', American Business Law Journal, 46(2), at pages 221-242.

[1246]See Lewis, W.A. (2013), 'Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies', Fordham Law Review, Volume 82, Issue 2, Article 20, 1017, at pages 1025-1028.

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a limited partner or a group of limited partners forms a corporation, a limited partnership, or a limited liability company to hold the limited partner interest in the fund.[1247]

Limited Liability Company

According to Lewis, the limited liability company is a hybrid form of organisation possessing some attributes of a partnership and some attributes of a corporation.[1248] It combines the pass-through tax benefits of a partnership with the limited liability of a corporation.[1249] Limited liability companies in the US are governed by the Uniform Limited Liability Company Act, which includes a 2006 revision called the Revised Uniform Limited Liability Company Act.[1250] The Delaware Limited Liability Company Act regulates limited liability companies with regard to Delaware and can be found in Chapter 18 of Title 6 of the Delaware Code.[1251] The Delaware Limited Liability Company Act provides laws relating to the formation, management, governance, mergers and dissolution of limited liability companies.[1252] However, limited liability companies are largely governed by contract and Delaware allows a limited liability company to contract out of many of the statutory requirements by providing otherwise in the limited liability company agreement.[1253]

According to Persuad, the attractiveness of limited liability companies was significantly enhanced by a favourable US Internal Revenue Service ruling in 1988 that allowed a limited liability company to be taxed as a partnership.[1254] In terms of section 301.7701-3(b)(1) of the US Treasury,[1255] a limited liability company with two or more members is, in general, automatically taxed as a partnership,

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[1247]Persuad, A.N. and Atkinson, A. (2012), 'Private Equity Funds: Legal Analysis of Structural, ERISA, Securities and Other Regulatory Issues', chapter 47 in Investment Adviser Regulation, 3rd Edition, by Kirsch, C.E., at page 47-16 to 47-19.

[1248]Lewis, W.A. (2013), 'Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies', Fordham Law Review, Volume 82, Issue 2, Article 20, 1017, at pages 1026.

[1249]Lewis, W.A. (2013), 'Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies', Fordham Law Review, Volume 82, Issue 2, Article 20, 1017, at pages 1026-1027.

[1250]The Uniform Limited Liability Company Act was originally promulgated in 1995 and amended in 1996 and 2006. By 1997, all fifty states and the District of Columbia had adopted a statute permitting the use of the limited liability company form. It is a uniform act proposed by the National Conference of Commissioners on Uniform State Laws for the governance of limited liability companies by US states.

[1251]Balouziyeh, J.M. (2013), 'A Legal Guide to United States Business Organizations: The Law of Partnerships, Corporations, and Limited Liability Companies', Springer Science and Business Media, at pages 33-41; 99-101.

[1252]Balouziyeh, J.M. (2013), 'A Legal Guide to United States Business Organizations: The Law of Partnerships, Corporations, and Limited Liability Companies', Springer Science and Business Media, at pages 33-41; 99-101.

[1253]Balouziyeh, J.M. (2013), 'A Legal Guide to United States Business Organizations: The Law of Partnerships, Corporations, and Limited Liability Companies', Springer Science and Business Media, at pages 33-41; 99-101.

[1254]Persuad, A.N. and Atkinson, A. (2012), 'Private Equity Funds: Legal Analysis of Structural, ERISA, Securities and Other Regulatory Issues', chapter 47 in Investment Adviser Regulation, 3rd Edition, by Kirsch, C.E., at page 47-19.

[1255]Treasury Regulations are the tax regulations issued by the US Internal Revenue Service (IRS), a bureau of the United States Department of the Treasury. These regulations are the Treasury Department's official interpretations of the Internal Revenue Code and are one source of US federal income tax law.

achieving pass-through status limited liability companies are designed, by statute, to be extremely flexible. For example, the Delaware Limited Liability Company Act is modeled on the Delaware Revised Uniform Limited Partnership Act, and the two statutes contain substantially identical wording.[1256] A limited liability company can be structured to resemble a limited partnership in its operations, with management authority and control over the business of the company vested in a manager or managing member who plays an operational role similar to that of a general partner in a limited partnership, while the non-managing members can be given rights and obligations similar to those of limited partners.[1257] However, neither managers nor members of a limited liability company are personally liable for the debts of the limited liability company, unless they otherwise agree, unlike the limited partnership, which requires at least one general partner who will be personally liable for the obligations of the partnership.[1258] Therefore, the primary characteristics of limited liability companies are that they are taxed as partnerships, members and managers all enjoy limited liability, and the relationship of the members, managers, and entity is governed by the operating agreement.[1259] According to Ribstein and Keatinge, limited liability companies combine corporate limited liability with partnership tax and governance flexibility.[1260]

As stated above the primary advantage of using a limited partnership or limited liability company as a fund vehicle is that they both are ‘pass-through’ entities for US federal income tax purposes. Secondly, both these legal forms provide investors in the private equity fund, with limited liability. Thirdly, both these legal vehicles are generally very flexible business entities. According to Naidech, the US state limited partnership and limited liability company statutes mentioned above are typically default statutes, which allow many of the statutory provisions that would otherwise apply to be overridden, modified or supplemented by the specific terms of the limited partnerships or limited liability company agreement.[1261] This flexibility allows partners in a limited partnerships and members of a limited liability company to structure a wide variety of economic and governing arrangements.[1262] According to Lewis, the nature and structure of each individual limited partnerships and limited liability companies are largely dependent on the operating agreement.[1263]

[1256]Lewis, W.A. (2013), ‘Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies’, Fordham Law Review, Volume 82, Issue 2, Article 20, 1017, at pages 1026-1027.
[1257]Lewis, W.A. (2013), ‘Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies’, Fordham Law Review, Volume 82, Issue 2, Article 20, 1017, at pages 1026-1027.
[1258]Manesh, M. (2012), ‘Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs’, Journal of Corporation Law, 37(3), at pages 555-619.
[1259]Manesh, M. (2012), ‘Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs’, Journal of Corporation Law, 37(3), at pages 555-619.
[1260]Ribstein, L.E. and Keatinge, R.R. (2004), ‘Ribstein and Keatinge on Limited Liability Companies’, Volume 2, Thomson West Publishers, at 2.02.
[1261]Naidech, S.W. (2011), ‘Private Equity Fund Formation’, Practice Note: Chadbourne and Parke LLP, published by Practical Law Company, at pages 1-5.
[1262]Naidech, S.W. (2011), ‘Private Equity Fund Formation’, Practice Note: Chadbourne and Parke LLP, published by Practical Law Company, at pages 1-5.
[1263]Lewis, W.A. (2013), ‘Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies’, Fordham Law Review, Volume 82, Issue 2, Article 20, 1017, at pages 1027-1028.

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A case that deals with the application of the operating agreement and fiduciary duties in such limited liability vehicles is *Gatz Properties LLC v Auriga Capital Corporation.*[1264] In *Gatz Properties LLC v Auriga Capital Corporation*,[1265] the Delaware Supreme Court affirmed the Delaware Court of Chancery's decision in *Auriga Capital Corporation v Gatz Properties*.[1266] In *Auriga Capital Corporation v Gatz Properties*, the Court of Chancery held that a controlling member and manager of a limited liability company breached his fiduciary duties to the company's minority members because the process by which he purchased the limited liability company from the minority members did not result in the payment of a fair price under the fairness standard of review.[1267] In *Gatz Properties LLC v Auriga Capital Corporation,* the Supreme Court stated that the question of whether the default standard under the Delaware Limited Liability Company Act is that a manager owes fiduciary duties to the members of a limited liability company remains unanswered and should not have been addressed by the lower court.[1268] Furthermore, until this question is answered definitively, members of limited liability companies should clearly state in the limited liability company agreement whether and to what extent the company managers or controlling persons should have any fiduciary duties to the members.[1269]

This case arose out of the 2009 sale of Peconic Bay LLC. Peconic Bay LLC was a Delaware limited liability company, owned by Gatz Proprties LLC and a number of minority shareholders. Peconic Bay LLC was formed by the Gatz Properties LLC for the purpose of leasing and developing a golf course on property owned by the Gatz family.[1270] The limited liability company agreement for Peconic Bay designated Gatz Properties as the manager. Gatz Properties was in turn managed and controlled by William Gatz. In 1998, Peconic Bay entered into a long-term sublease with a national golf course operator. By 2005, Gatz was aware that the golf course operator intended to exercise its early termination right in 2010 and hired an appraiser who valued the land at $10.1 million with golf course improvements and at $15 million as vacant land available for development. In 2007, Gatz was approached by RDC Golf Group with an offer to acquire the long-term sublease. Although Gatz

[1264] *Gatz Properties LLC v Auriga Capital Corporation* 2012, 59 A. 3d 1206, Delaware Supreme Court.
[1265] *Gatz Properties LLC v Auriga Capital Corporation* 2012, 59 A. 3d 1206, Delaware Supreme Court.
[1266] *Auriga Capital Corporation v Gatz Properties,* 2012, 40 A.3d 839, Delaware Court of Chancery.
[1267] *Auriga Capital Corporation v Gatz Properties,* 2012, 40 A.3d 839, Delaware Court of Chancery. See also Strine, L.E. and Travis, L.J. (2014), 'The Siren Song of Unlimited Contractual Freedom', Harvard Law School John M. Olin Center Discussion Paper No. 789, 1st August 2014.
[1268] *Gatz Properties LLC v Auriga Capital Corporation* 2012, 59 A. 3d 1206, Delaware Supreme Court. See also Strine, L.E. and Travis, L.J. (2014), 'The Siren Song of Unlimited Contractual Freedom', Harvard Law School John M. Olin Center Discussion Paper No. 789, 1st August 2014.
[1269] *Gatz Properties LLC v Auriga Capital Corporation* 2012, 59 A. 3d 1206, Delaware Supreme Court. See also Strine, L.E. and Travis, L.J. (2014), 'The Siren Song of Unlimited Contractual Freedom', Harvard Law School John M. Olin Center Discussion Paper No. 789, 1st August 2014.
[1270] *Gatz Properties LLC v Auriga Capital Corporation* 2012, 59 A. 3d 1206, Delaware Supreme Court. Condon, C. (2012), 'Fiduciary Duties as Default Standard Under Limited Liability Company Act', Harvard Law School Forum on Corporate Governance and Financial Regulation, December 2012. Available at http://corpgov.law.harvard.edu/2012/12/22/fiduciary-duties-as-default-standard-under-limited-liability-company-act/, accessed in June 2015.

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refused to provide due diligence materials to RDC Golf Group, RDC Golf Group submitted two proposals, each of which was rejected by the Peconic Bay members. In response to a request from the minority members that Gatz determine RDC Golf Group's interest in a deal at $6 million, Gatz told RDC Golf Group that an offer 'well north of $6 million' would be required to continue discussions.[1271] RDC Golf Group indicated it was willing to proceed on those terms, but Gatz failed to respond and told the minority members that negotiations had broken off without informing them of RDC Golf Group's continued interest. Gatz then offered the minority members approximately $700,000 for their interests in Peconic Bay, which the minority members rejected. For the next year, Gatz pursued a course of action that led to a sale of Peconic Bay as a distressed asset in a poorly run auction. Gatz was the only bidder at the auction and purchased Peconic Bay for $50,000 cash plus assumption of its debt, yielding proceeds to the minority members well below what they would have received had Peconic Bay been sold to RDC Golf Group in the previously proposed transactions. The minority members sued for money damages based on, among other things, breach of fiduciary and contractual duties.[1272]

The Supreme Court upheld the Chancery Court's decision regarding Gatz's liability for breach of fiduciary duty; however, it based its decision solely on contractual grounds and not on the existence of any default fiduciary duties under Delaware's limited liability company statute.[1273] In determining that Gatz owed fiduciary duties to the minority members of Peconic Bay, the Supreme Court reviewed the contract interpretation issues.[1274] The Supreme Court interpreted the relevant limited liability company agreement provision, which required agreements between Peconic Bay and related parties to be on terms and conditions no less favourable than those that could be obtained from 'arms-length third parties', to be the 'contractual equivalent of the entire fairness equitable standard of conduct'.[1275] Under this standard, Gatz was required to establish the fairness of the transaction since his acquisition of Peconic Bay had not been approved by the informed vote of the holders of two-thirds of the interests in Peconic Bay held by unconflicted members, as required in terms of the limited liability company agreement.[1276] After reviewing the Chancery Court's factual findings, the Supreme Court was satisfied that Gatz had failed to carry his burden of proof and held that Gatz had violated his contractual fiduciary duties based on, among other things, his refusal to negotiate with

[1271] *Gatz Properties LLC v Auriga Capital Corporation* 2012, 59 A. 3d 1206, Delaware Supreme Court.
[1272] *Gatz Properties LLC v Auriga Capital Corporation* 2012, 59 A. 3d 1206, Delaware Supreme Court. See also Coetzee, L. and Van Tonder, J.L. (2014), 'The fiduciary relationship between a company and its directors', Obiter, 35(2), at 285-315.
[1273] *Gatz Properties LLC v Auriga Capital Corporation* 2012, 59 A. 3d 1206, Delaware Supreme Court.
[1274] See also Marks, C.P. (2014), 'Piercing the Fiduciary Veil', Lewis and Clark Law Review, 19.
[1275] *Gatz Properties LLC v Auriga Capital Corporation* 2012, 59 A. 3d 1206, Delaware Supreme Court. Condon, C. (2012), 'Fiduciary Duties as Default Standard Under Limited Liability Company Act', Harvard Law School Forum on Corporate Governance and Financial Regulation, December 2012. Available at http://corpgov.law.harvard.edu/2012/12/22/fiduciary-duties-as-default-standard-under-limited-liability-company-act/, accessed in June 2015.
[1276] *Gatz Properties LLC v Auriga Capital Corporation* 2012, 59 A. 3d 1206, Delaware Supreme Court. Condon, C. (2012), 'Fiduciary Duties as Default Standard Under Limited Liability Company Act', Harvard Law School Forum on Corporate Governance and Financial Regulation, December 2012.

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RDC Golf Group and his subsequent sale of Peconic Bay to himself at an unfair price in a flawed auction.[1277] The Supreme Court also upheld the Chancery Court's finding that Gatz was not entitled to the benefit of the exculpation and indemnification provisions in the limited liability company agreement because he acted in bad faith and made wilful misrepresentations to the minority members.[1278] Nevertheless, the key issue at hand as stated by the Supreme Court was that whether the managers and controllers of a limited liability company are subject to default fiduciary duties under the Delaware Limited Liability Company Act is an issue about which 'reasonable minds could differ'.[1279] The Supreme Court also noted that it was unnecessary for the Chancery Court to decide '*sua sponte* the default fiduciary duty issue' because the dispute over the application of fiduciary standards was determinable solely by reference to the limited liability company agreement and no litigant had asked the Chancery Court to decide this issue as a matter of statutory law.[1280] Condon states that for these reasons, among others, the Supreme Court in *Gatz Properties LLC v Auriga Capital Corporation*,[1281] held that the Chancery Court's 'statutory pronouncements must be regarded as dictum without any precedential value'.[1282] Lewis argues as follows:

> 'Both statutes provide only the contours of the entities, giving parties the 'broadest possible discretion in drafting their ... agreements.' In addition, both the Delaware Limited Liability Company Act and Delaware Revised Uniform Limited Partnership Act explicitly incorporate the principle of freedom of contract. The statutes read, 'It is the policy of [the LLC Act] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.' This means that Delaware courts will enforce the product of the parties' negotiations, as long as the provision does not conflict with statutory requirements. In other words, 'the operative document is the limited partnership [or limited liability company] agreement and the statute merely provides the 'fall-back' or default provisions where the partnership [or limited liability company] agreement is silent.'[1283]

[1277] *Gatz Properties LLC v Auriga Capital Corporation* 2012(59)(A) 3d 1206, Delaware Supreme Court. Condon, C. (2012), 'Fiduciary Duties as Default Standard Under Limited Liability Company Act', Harvard Law School Forum on Corporate Governance and Financial Regulation, December 2012.
[1278] *Gatz Properties LLC v Auriga Capital Corporation* 2012 (59)(A)3d 1206, Delaware Supreme Court. Condon, C. (2012), 'Fiduciary Duties as Default Standard Under Limited Liability Company Act', Harvard Law School Forum on Corporate Governance and Financial Regulation, December 2012.
[1279] *Gatz Properties LLC v Auriga Capital Corporation* 2012, 59 A. 3d 1206, Delaware Supreme Court. Condon, C. (2012), 'Fiduciary Duties as Default Standard Under Limited Liability Company Act', Harvard Law School Forum on Corporate Governance and Financial Regulation, December 2012.
[1280] *Gatz Properties LLC v Auriga Capital Corporation* 2012, 59 A. 3d 1206, Delaware Supreme Court. Condon, C. (2012), 'Fiduciary Duties as Default Standard Under Limited Liability Company Act', Harvard Law School Forum on Corporate Governance and Financial Regulation, December 2012.
[1281] *Gatz Properties LLC v Auriga Capital Corporation* 2012, 59 A. 3d 1206, Delaware Supreme Court.
[1282] Condon, C. (2012), 'Fiduciary Duties as Default Standard Under Limited Liability Company Act', Harvard Law School Forum on Corporate Governance and Financial Regulation, December 2012.
[1283] Lewis, W.A. (2013), 'Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies', Fordham Law Review, Volume 82, Issue 2, Article 20, 1017, at pages 1027-1028.

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Therefore, where limited partnership or limited liability agreements are silent as to whether fiduciary duties apply, such duties will be presumed to apply.[1284] That leaves three issues, which will be discussed more fully in paragraph 2 of chapter three, namely, what specific duties are owed; second, who is charged with such duties; and third, to whom are the duties owed.[1285] Nevertheless, it is evident from the above discussion, that the choice of the organisational form for the investment entity in the US is a critical step in the formation of a successful private equity fund. Despite a fund being structured as a corporation, partnership or limited liability company in the US, corporations typically are not used because partnerships and limited liability companies provide a significant tax advantage by avoiding entity-level taxation.

3.3 Organisational Form in the UK

In the UK, there are three types of partnership available in terms of UK law; namely the general partnership;[1286] the limited partnership;[1287] and the limited liability partnership.[1288] However, the limited partnership registered in terms of the Limited Partnerships Act of 1907 is the most commonly used legal vehicle for private equity funds.[1289] A limited partnership established in terms of the Limited Partnerships Act of 1907 in the UK does not have legal personality separate from its partners.[1290] Limited partnerships established in terms of the Limited Partnerships Act of 1907, should not be confused with limited liability partnerships, which are established in terms of the Limited Liability Partnership Act of 2000.[1291] Such limited liability partnerships are not typically used to structure private equity funds in the UK because one key disadvantage is that income and capital gains derived from the underlying partnership investments are not tax exempt and do not possess the tax pass-through feature of the limited partnership registered in terms of the Limited Partnerships Act of 1907.[1292] It must be noted that this paragraph will not discuss the differences between these two statutes, and will concentrate on the salient features of the predominant form which is registered

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[1284]Coetzee, L. and Van Tonder, J.L. (2014), 'The fiduciary relationship between a company and its directors', Obiter, 35(2), at pages 285-315.
[1285]Coetzee, L. and Van Tonder, J.L. (2014), 'The fiduciary relationship between a company and its directors', Obiter, 35(2), at pages 285-315.
[1286]See Partnership Act of 1890.
[1287]See Limited Partnerships Act of 1907.
[1288]See Limited Liability Partnership Act 2000.
[1289]Barry, B. (2011), 'England and Wales', in Private Equity in 33 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages, at page 67.
[1290]Barry, B. (2011), 'England and Wales', in Private Equity in 33 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages, at page 67.
[1291]Burdett, J., Kumar, P. and Pople, Z. (2013), 'The Limited Partnership: A Fresh Look at a Trusted Model', Practical Law Publishing Limited, July 2013, at pages 1-7. A 'partnership' in terms of section 11 of the Limited Liability Partnerships Act of 2000 is now considered a separate legal person and is deemed to have legal personality. It allows limited liability for general trading debts, but individual partners cannot limit personal liability for negligence. It was introduced to allow some protection against large negligence actions, where the risks were felt to be excessive.
[1292]Burdett, J., Kumar, P. and Pople, Z. (2013), 'The Limited Partnership: A Fresh Look at a Trusted Model', Practical Law Publishing Limited, July 2013, at pages 1-7.

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in terms of the Limited Partnerships Act of 1907.[1293] Nevertheless, the limited partnership is the predominant legal vehicle used by private equity firms to structure private equity funds because it affords investors' limited liability; it is tax transparent; and it offers a great deal of organisational flexibility so that the specific requirements of individual investors can be accommodated.[1294]

Limited Liability

A limited partner's (investor) liability in a limited partnership is limited to the amount of capital contributed by such limited partner provided that it does not become involved in the management of the partnership.[1295] If he does, he forfeits his limited liability status. In addition, a limited partner must make a contribution of capital of cash or property immediately upon entry into partnership in terms of section 4(2) of the Limited Partnership Act of 1907, and it does not matter that the limited partner's contribution is nominal.[1296] However, once the capital is contributed to the partnership there is no requirement for it to be retained by the limited partners and it may be divided between some or all of the partners as agreed.[1297] The partners are free to increase or decrease the partnership's capital, subject to compliance with registration requirements in terms of section 9(1)(b) of the Limited Partnership Act 1907.[1298] However, in terms of section 4(3) of the Limited Partnership Act 1907, a limited partner's withdrawal of capital while he remains a member of the partnership renders him liable for the debts and obligations of the partnership up to the amount which he has received back.[1299] Nevertheless, the freedom to agree the terms of a partnership for the limited partnership is

[1293]See The Law Commission and the Scottish Law Commission, (1997), 'Limited Partnership Act', The Law Commission (Consultation Paper No 161) and the Scottish Law Commission (Consultation Paper No 118), Joint Consultation Paper, London: The Stationery Office, November 1997, at page 4 states: 'The limited partnership performs a different role from that of the limited liability partnership … [Limited Liability Partnerships Act 2000] The LLP is designed as a business vehicle for professional or trading partnerships. It enables partners, who are actively involved in the business of their partnership, to limit their liability for the partnership's debts and obligations. [Unlike the limited partnership, which offers limited liability only to the partners who are not actively involved in the business] Although it is treated as a partnership, it is subject to accounting and other rules closer to those of a company. The LLP was introduced in response to concerns by professional practitioners about their possible exposure to massive claims for damages arising from the alleged negligence of one or more of their partners. [See, for example, *ADT Limited v Binder Hamlyn* 1996 BCC 808] Following an initiative by two large accountancy firms to introduce a limited liability partnership based in Jersey, the DTI published a consultation paper on the LLP in 1997. The Limited Liability Partnerships Act 2000 was enacted in July 2000.'

[1294]Burdett, J., Kumar, P. and Pople, Z. (2013), 'The Limited Partnership: A Fresh Look at a Trusted Model', Practical Law Publishing Limited, July 2013, at pages 1-2.

[1295]In terms of section 6(1) of the Limited Partnership Act of 1907.

[1296]In *Dickson v MacGregor* 1992 S.L.T. (Land Ct.) 83 and *MacFarlane v Falfield Investments Ltd* 1996 SC 14 it was £10.

[1297]The Law Commission and the Scottish Law Commission, (1997), 'Limited Partnership Act', The Law Commission (Consultation Paper No 161) and the Scottish Law Commission (Consultation Paper No 118), Joint Consultation Paper, London: The Stationery Office, November 1997, at page 11.

[1298]The Law Commission and the Scottish Law Commission, (1997), 'Limited Partnership Act', The Law Commission (Consultation Paper No 161) and the Scottish Law Commission (Consultation Paper No 118), Joint Consultation Paper, London: The Stationery Office, November 1997, at page 11.

[1299]The Law Commission and the Scottish Law Commission, (1997), 'Limited Partnership Act', The Law Commission (Consultation Paper No 161) and the Scottish Law Commission (Consultation Paper No 118), Joint Consultation Paper, London: The Stationery Office, November 1997, at page 11.

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a key feature of the Limited Partnership Act 1907.[1300] For instance, despite the restriction on the liability of limited partners, with respect to third parties, to the amount of his/her contribution, agreement may be reached between the partners that, as between themselves, any trading losses of the partnership will be divided without limitation.[1301]

A limited partnership does, however, require the presence of at least one general partner who has, in terms of section 4(2) under the Limited Partnership Act of 1907 Act, unlimited exposure for the liabilities of the partnership. Section 4(2) of the Limited Partnerships Act of 1907 reads as follows:

> 'A limited partnership must consist of one or more persons called general partners, who shall be liable for all debts and obligations of the firm, and one or more persons to be called limited partners, who shall at the time of entering into such partnership contribute thereto a sum or sums as capital or property valued at a stated amount, and who shall not be liable for the debts or obligations of the firm beyond the amount so contributed.'

The investors will become limited partners and the general partner is typically a newly incorporated limited liability company or another limited partnership, in order to limit its liabilities as general partner, and delegates its investment management responsibilities to a private equity firm that is authorised by the UK Financial Conduct Authority ('FCA').[1302] In the UK, like South Africa, a private equity firm that manages a private equity fund will require regulatory authorisation and/or licensing in order to be able to carry out its activities lawfully. In the UK, the private equity firm will typically need to apply to the FCA.[1303] Therefore, a private equity firm that manages a private equity fund structured as a limited partnership is responsible for safeguarding and administering the limited partnership's investments provided it has permission from the FCA to carry on that particular regulated activity.[1304] Nevertheless, the duties of the private equity firm that manages the limited

[1300]The Law Commission and the Scottish Law Commission, (1997), 'Limited Partnership Act', The Law Commission (Consultation Paper No 161) and the Scottish Law Commission (Consultation Paper No 118), Joint Consultation Paper, London: The Stationery Office, November 1997, at page 10.

[1301]The Law Commission and the Scottish Law Commission, (1997), 'Limited Partnership Act', The Law Commission (Consultation Paper No 161) and the Scottish Law Commission (Consultation Paper No 118), Joint Consultation Paper, London: The Stationery Office, November 1997, at page 10. The Commission Report made reference to case *Reed v Young* 1986 1 WLR 649, where the court gave effect to such an agreement, in a tax context. The House of Lords held that while the limited partner's liability to creditors is limited to the amount of his contribution, the limited partner may incur greater trading losses for which tax relief could be claimed. Subsequently, the Income and Corporation Taxes Act 1988, section 117 restricted loss relief to the amount which that partner have at risk in the partnership, thereby reversing *Reed v Young* 1986 1 WLR 649 for tax purposes.

[1302]See UK: Law Commission, (2013), 'Law Commission: Fiduciary Duties of Investment Intermediaries: A Consultation Paper', Consultation Paper No 215: Great Britain Law Commission Consultation, The Stationery Office, at chapter 8.

[1303]See discussion in paragraph 4 of this chapter regarding licensing and regulatory requirements of a private equity firm.

[1304]Barry, B. (2011), 'England and Wales', in Private Equity in 33 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages, at page 67.

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partnership will be set out in a management contract/operating agreement, similar to that which was discussed in paragraph 3.2 of this chapter and which will be discussed further in this chapter.

As mentioned above, the Limited Partnership Act of 1907 provides that a limited partner shall not be liable for the debts and obligations of the limited partnership beyond the amount of its capital contribution, unless the limited partner takes part in the management of the partnership's business, in which event it will be liable for the debts and obligations incurred while he so takes part in the management as though he were a general partner. Section 6(1) of the Limited Partnerships Act 1907 reads as follows:

> 'A limited partner shall not take part in the management of the partnership business, and shall not have power to bind the firm: Provided that a limited partner may by himself or his agent at any time inspect the books of the firm and examine into the state and prospects of the partnership business, and may advise with the partners thereon. If a limited partner takes part in the management of the partnership business he shall be liable for all debts and obligations of the firm incurred while he so takes part in the management as though he were a general partner.'

The Limited Partnership Act of 1907 does not define what constitutes 'management' for this purpose, although there is a statutory right for limited partners to inspect the books of the partnership and examine into, and consult with the general partner on, the state and prospects of the partnership business.[1305] It is generally accepted that a limited partner's rights under a typical private equity limited partnership agreement, including participation by a representative of the limited partner on the limited partnership's advisory committee or similar body, do not result in it taking part in the management, and in practice the private equity fund's legal advisors will usually issue a legal opinion to this effect.[1306] Without derogating from the discussion at hand, it is important to note that advisory boards composed of limited partner representatives are a common feature of many private equity funds in the UK. The positions on such advisory boards are usually occupied by limited partners making a significant capital commitment or having a strategic alignment with the private equity fund.[1307] The role of the advisory board will vary from one private equity fund to another and will usually be set out in detail in the relevant limited partnership agreement.[1308] According to Burdett *et al*, broadly speaking, advisory boards will typically review and approve conflicts of interest; waive restrictions incumbent on the private equity firm (general partner) in terms of the limited partnership

[1305] Hudson, M. (2014), 'Funds: Private Equity, Hedge and All Core Structures', First Edition, The Wiley Finance Series, John Wiley and Sons, at paragraph 2.2.4.
[1306] Barry, B. (2011), 'Fund Formation: England and Wales', in Private Equity in 33 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages, at page 68.
[1307] Burdett, J., Kumar, P. and Pople, Z. (2013), 'The Limited Partnership: A Fresh Look at a Trusted Model', Practical Law Publishing Limited, July 2013, at page 3.
[1308] Burdett, J., Kumar, P. and Pople, Z. (2013), 'The Limited Partnership: A Fresh Look at a Trusted Model', Practical Law Publishing Limited, July 2013, at page 3.

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agreement; consent to certain matters set out in the limited partnership agreement; and review valuation methodologies adopted by the private equity firm (general partner).[1309]

It may be argued that by being on the advisory board, a limited partner will have greater access to more detailed information about the private equity fund and its management, which may have implications for its limited liability status. It was mentioned above that in terms of section 6(1) of the Limited Partnership Act of 1097, this limited liability can be lost if the investor participates in the management of the partnership. Therefore careful consideration needs to be applied to ensure that activities by limited partners are not considered 'management'. A prudent approach would be to define the parameters of 'management' in order to understand what activities an investor can undertake without losing the crucial limited liability status.[1310] The risk to the limited partner for losing its limited liability status is that it becomes liable for all debts and obligations of the partnership that are incurred while it takes part in the management. This includes all the partnership liabilities that arise during its period of management.[1311]

According to Burdett *et al*, investors in a limited partnership must exercise caution because there are no clear rules in relation to what constitutes 'management' in terms of the Limited Partnership Act of 1907.[1312] The Limited Partnership Act of 1907 does not contain any express provisions as to what behaviour constitutes involvement in management.[1313] Investors in a UK limited partnership have had to rely on common sense and limited guidance from court decisions on factors that will be taken into account.[1314] In *Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) and Others*, the court commented on what would constitute 'management' of the partnership by the limited partners.[1315] This was also discussed in *Inversiones Frieira SL and another v Colyzeo Investors II LP and another*, where Norris J held that merely seeking information about the partnership's affairs is clearly not involvement in management and that the key issue is what the limited partners do with the information that it obtains.[1316] In the situation where a limited partner examines information and confers with other limited partners or expresses to the general partner view about the performance of the partnership and/or future

[1309]Burdett, J., Kumar, P. and Pople, Z. (2013), 'The Limited Partnership: A Fresh Look at a Trusted Model', Practical Law Publishing Limited, July 2013, at page 3.
[1310]Hudson, M. (2014), 'Funds: Private Equity, Hedge and All Core Structures', First Edition, The Wiley Finance Series, John Wiley and Sons, at paragraph 2.2.4.
[1311]Hudson, M. (2014), 'Funds: Private Equity, Hedge and All Core Structures', First Edition, The Wiley Finance Series, John Wiley and Sons, at paragraph 2.2.4.
[1312]Burdett, J., Kumar, P. and Pople, Z. (2013), 'The Limited Partnership: A Fresh Look at a Trusted Model', Practical Law Publishing Limited, July 2013, at page 6.
[1313]Clark, G.L. and Monk, A.H. (2014), 'The geography of investment management contracts: the UK, Europe, and the global financial services industry', Environment and Planning A, 46(3), at pages 531-549.
[1314]Clark, G.L. and Monk, A.H. (2014), 'The geography of investment management contracts: the UK, Europe, and the global financial services industry', Environment and Planning A, 46(3), at pages 531-549.
[1315]*Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) and Others* 2012 EWHC 3259 (Comm).
[1316]*Inversiones Frieira SL and another v Colyzeo Investors II LP and another* 2011 EWHC 1762 (Ch).

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direction of the partnership, the limited partner does not become involved in management.[1317] However, if the limited partner intends to participate in the decision making process by requiring notice of individual decisions and the ability to make representations about individual decisions, or if it seeks to scrutinize and comment on the operational business decisions made by the general partner, then the limited partner risks becoming involved in the management.[1318]

Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) and Others,[1319] was a UK High Court decision dealing with a pension fund's action against a fund manager. In this case, the High Court has ruled largely against a group of institutional investors on preliminary issues in proceedings brought against the fund manager and general partner of an infrastructure fund alleging breach of investment mandate.[1320] The ruling is of interest not only for its consideration of the investment mandate allegations but also for its acknowledgment that, in certain circumstances, investors in a partnership vehicle may be able to pursue claims against a fund manager by bringing an action on behalf of the fund itself.[1321] In *Certain Limited Partners in Henderson PFI Secondary Fund II LLP v Henderson PFI Secondary Fund II LP*,[1322] the fundamental allegation was that the fund did not invest exclusively or principally in private finance initiative concession companies, as the investors allege it was required to do, but instead acquired a corporate group which also held interests in other types of assets, exposing them to substantial losses. In a preliminary hearing, the court was called upon to rule on whether the investors could bring claims against the fund manager and general partner as derivative actions.[1323] This meant the investors standing in the place of the general partner to bring an action on behalf of the fund. At the preliminary hearing, the court was called upon to interpret the relevant contractual documents with respect to the scope of the investment mandate and the fund manager's liability. The court held against the general partner that the investors were not entitled to pursue derivative claims.[1324] In this case, the court held that derivative claims will only be available where there are 'special circumstances'.[1325] The categories of 'special circumstances' have never been defined but a claimant must be able to show that it has a legitimate interest in the relief being claimed

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[1317] *Inversiones Frieira SL and another v Colyzeo Investors II LP and another* 2011 EWHC 1762 (Ch).
[1318] *Inversiones Frieira SL and another v Colyzeo Investors II LP and another* 2011 EWHC 1762 (Ch).
[1319] *Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) and Others* 2012 EWHC 3259 (Comm).
[1320] Clark, G.L. and Monk, A.H. (2014), 'The geography of investment management contracts: the UK, Europe, and the global financial services industry', Environment and Planning A, 46(3), at pages 531-549.
[1321] De Dier, S. (2013), 'Friends with Benefits?! A Comparative View on Legal Standing to Challenge Board Decisions', European Company and Financial Law Review, 10(3).
[1322] *Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) and Others* 2012 EWHC 3259 (Comm).
[1323] *Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) and Others* 2012 EWHC 3259 (Comm).
[1324] *Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) and Others* 2012 EWHC 3259 (Comm).
[1325] *Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) and Others* 2012 EWHC 3259 (Comm).

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and that an injustice would arise if the relief was not able to be pursued.[1326] Cooke J, in *Certain Limited Partners in Henderson PFI Secondary Fund II LLP v Henderson PFI Secondary Fund II LP,* applied the test and refused to allow derivative claims against the general partner on the basis that there was no bar to the claimants suing the general partner under the partnership agreement in their individual capacities as the majority of them were in fact doing, alongside the derivative claims.[1327] There was therefore 'no need and no room for a derivative claim'.[1328]

With regard to the fund manager, the court ruled that there were sufficient 'special circumstances' to permit derivative claims.[1329] The 'special circumstances' in this case arose from the general partner's conflict of interest in being a sister company of the fund manager, so that there was in reality no way the partnership would bring an action against the fund manager unless the existing general partner was replaced under the mechanism for doing so in the partnership agreement.[1330] Cooke J also rejected the defendants' argument that permitting derivative claims in a partnership context would run contrary to the statutory framework, given the prohibition in the Limited Partnership Act of 1907 on limited partners participating in the management of the partnership business.[1331] However, Cooke J accepted that, if the claimants did elect to bring such claims, section 6(1) of the Limited Partnership Act of 1907 would operate so as to require them to forfeit their limited liability status for as long as they were participating in the management of partnership business by pursuing the claims. In this regard, the claimants were unsuccessful in arguing that such liability should be limited to debts directly linked to the pursuit of the claims. Rather, it was held that they would be liable for all debts and obligations incurred by the partnership during the period in which they were pursuing the claims in the place of the general partner, in exactly the same way the general partner would have been.[1332] Furthermore, all of the contractual interpretation issues were determined in favour of the defendant fund managers, including a finding that the relevant corporate acquisition was within the scope of permissible investments. Cooke J also rejected the defendants' argument that permitting derivative claims in a partnership context would run contrary to the statutory framework, given the prohibition in the Limited Partnership Act of 1907 on limited partners participating in the management of the partnership business. However, Cooke J accepted that, if the claimants did elect to bring such claims, section 6(1) of the Limited Partnership Act of 1907 would

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[1326] Clark, G.L. and Monk, A.H. (2014), 'The geography of investment management contracts: the UK, Europe, and the global financial services industry', Environment and Planning A, 46(3), at pages 531-549.
[1327] *Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) and Others* 2012 EWHC 3259 (Comm).
[1328] *Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) and Others* 2012 EWHC 3259 (Comm).
[1329] *Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) and Others* 2012 EWHC 3259 (Comm).
[1330] *Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) and Others* 2012 EWHC 3259 (Comm).
[1331] *Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) and Others* 2012 EWHC 3259 (Comm).
[1332] *Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) and Others* 2012 EWHC 3259 (Comm).

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operate so as to require them to forfeit their limited liability status for as long as they were participating in the management of partnership business by pursuing the claims.[1333] The court held that bringing proceedings constitutes 'managing' the business and its assets. In this regard, the claimants were unsuccessful in arguing that such liability should be limited to debts directly linked to the pursuit of the claims. Rather, it was held that they would be liable for all debts and obligations incurred by the partnership during the period in which they were pursuing the claims in the place of the general partner, in exactly the same way the general partner would have been.[1334] The decision in *Certain Limited Partners in Henderson PFI Secondary Fund II LLP v Henderson PFI Secondary Fund II LP*, highlights the difficulties in bringing derivative claims against fund managers where the investment vehicle is a limited partnership and the contractual relationship is between the fund manager and the general partner, particularly the loss of limited liability for a limited partner seeking to pursue such a claim.[1335]

Tax Transparent

The limited partnership is tax-transparent for UK tax purposes.[1336] Tax transparency means that the limited partnership is not a taxable entity for the purposes of UK income tax, capital gains tax or corporation tax. The key feature is that there is no taxation at the fund level and instead, the partners are taxed on their individual income and capital gains derived from the underlying portfolio investments, thereby avoiding double taxation and ensuring that there is no penalty for investing via a fund vehicle.[1337] The transparent treatment of partnerships means that tax exemptions will not apply to the private equity fund itself, however the partners may qualify for exemptions depending on their individual circumstances.[1338] Furthermore, no organisational taxes are payable on the establishment of the private equity fund, although consideration should be had if an investor contributes an asset, rather than cash, to the limited partnership.[1339] This does not often happen in practice, however if the investor does make a taxable disposal on the contribution, the limited

[1333] *Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) and Others* 2012 EWHC 3259 (Comm).
[1334] *Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) and Others* 2012 EWHC 3259 (Comm).
[1335] Burdett, J., Kumar, P. and Pople, Z. (2013), 'The Limited Partnership: A Fresh Look at a Trusted Model', Practical Law Publishing Limited, July 2013, at page 6.
[1336] Innes, D., Lewin-Smith, G., and Raven, D. (2012), 'Fund Formation: United Kingdom', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 321-326.
[1337] Innes, D., Lewin-Smith, G., and Raven, D. (2012), 'Fund Formation: United Kingdom', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 321-326.
[1338] Spangler, T. (2012), 'The Law of Private Investment Funds', Second Edition, Oxford University Press, at chapter 3, paragraphs A-C.
[1339] Spangler, T. (2012), 'The Law of Private Investment Funds', Second Edition, Oxford University Press, at chapter 3, paragraphs A-C.

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partnership may be liable for Value Added Tax and stamp taxes, which will depend on the nature of the asset contributed and the structuring of the contribution.[1340]

Limited Partnership's Organisational Flexibility

According to Burdett *el al*, the partnership offers organisational flexibility that allows the specific requirements of individual investors to be accommodated.[1341] In a private company the shareholders of the same class have to be treated equally, however the partners in a partnership can set the rules on matters such as how the profits are shared, how interests in the partnership are transferred and how the business is to be conducted, which can be reflected in the limited partnership agreement.[1342] For example, section 6(2) of the Limited Partnership Act of 1907, states that upon the bankruptcy or insolvency of the limited partner there will be no automatic dissolution of the limited partnership. Section 6(2) of the Limited Partnerships Act 1907 reads as follows:

> 'A limited partnership shall not be dissolved by the death or bankruptcy of a limited partner, and the lunacy of a limited partner shall not be a ground for dissolution of the partnership by the court unless the lunatic's share cannot be otherwise ascertained and realised.'

Therefore, in practice the terms of the limited partnership agreement will usually provide that, upon the bankruptcy or insolvency of the general partner, a specified majority of limited partners can elect whether or to continue the limited partnership with a new general partner and therefore the terms of the limited partnership agreement are determinative.[1343] A further example of the contractual flexibility of a limited partnership is in terms of the structuring of an investor's commitment to the limited partnership.[1344] Section 4(3) of the Limited Partnership Act of 1907 stipulates that an investor's capital may not be returned prior to the termination of the limited partnership. Section 4(3) of the Limited Partnerships Act 1907 reads as follows:

> 'A limited partner shall not during the continuance of the partnership, either directly or indirectly, draw out or receive back any part of his contribution, and if he does so draw out or receive back any such part shall be liable for the debts and obligations of the firm up to the amount so drawn out or received back.'

[1340] Spangler, T. (2012), 'The Law of Private Investment Funds', Second Edition, Oxford University Press, at chapter 3, paragraphs A-C.
[1341] Burdett, J., Kumar, P. and Pople, Z. (2013), 'The Limited Partnership: A Fresh Look at a Trusted Model', Practical Law Publishing Limited, July 2013, at page 2.
[1342] Burdett, J., Kumar, P. and Pople, Z. (2013), 'The Limited Partnership: A Fresh Look at a Trusted Model', Practical Law Publishing Limited, July 2013, at page 2.
[1343] Hudson, M. (2014), 'Funds: Private Equity, Hedge and All Core Structures', First Edition, The Wiley Finance Series, John Wiley and Sons, at paragraph 2.2.4.
[1344] Section 4(3) of the Limited Partnership Act of 1907.

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For this reason, an investor's commitment to the limited partnership is typically structured predominantly by way of a non-interest bearing loan, for example 99.99 percent of the commitment amount together with a small portion of capital 0.01 percent of the commitment amount, since loans repaid during the life of the partnership are not liable under the Limited Partnership Act of 1907 to be repaid.[1345] In addition, the limited partnership agreement will also typically determine the rights of the investors to remove the general partner or any rights arising upon a change of control of the general partner.[1346] According to Barry, the limited partnership agreement will also typically allow the general partner to assign its interest in the limited partnership to an entity in the same corporate group, for example to facilitate a restructuring.[1347] However, an assignment outside its corporate group would generally require the approval of a specified majority of limited partners.[1348] The position of any private equity firm that manages the private equity limited partnership will be determined in accordance with the terms of the management agreement.[1349]

A further example of the contractual flexibility of a limited partnership relates to the circumstances in which a limited partner's liability for future debts ends. The Limited Partnership Act 1907 does not make clear the circumstances in which a limited partner's liability for future debts ends.[1350] The provisions touching on this issue are the prohibition of withdrawal of the limited partner's contribution,[1351] and the provision that the death or bankruptcy of a limited partner does not dissolve the partnership,[1352] neither of which is stated to be subject to agreement to the contrary.[1353] The implication seems to be that the liability, up to the contribution, continues indefinitely. However, the better view may be that these matters, as between the partners, are subject to the general power to settle 'mutual rights and duties' by agreement.[1354] Nevertheless, where the partners agree and as

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[1345]Innes, D., Lewin-Smith, G., and Raven, D. (2012), 'Fund Formation: United Kingdom', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 321-326.

[1346]Hudson, M. (2014), 'Funds: Private Equity, Hedge and All Core Structures', First Edition, The Wiley Finance Series, John Wiley and Sons, at paragraph 2.2.4.

[1347]Barry, B. (2011), 'Fund Formation: England and Wales', in Private Equity in 33 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages, at page 68.

[1348]Barry, B. (2011), 'Fund Formation: England and Wales', in Private Equity in 33 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at page 68. See also Innes, D., Lewin-Smith, G., and Raven, D. (2012), 'Fund Formation: United Kingdom', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 321-326.

[1349]Barry, B. (2011), 'Fund Formation: England and Wales', in Private Equity in 33 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages, at page 68.

[1350]The Law Commission and the Scottish Law Commission, (1997), 'Limited Partnership Act', The Law Commission (Consultation Paper No 161) and the Scottish Law Commission (Consultation Paper No 118), Joint Consultation Paper, London: The Stationery Office, November 1997, at pages 12-13.

[1351]Section 4(3) of the Limited Partnership Act of 1907.

[1352]Section 6(2) of the Limited Partnership Act of 1907.

[1353]The Law Commission and the Scottish Law Commission, (1997), 'Limited Partnership Act', The Law Commission (Consultation Paper No 161) and the Scottish Law Commission (Consultation Paper No 118), Joint Consultation Paper, London: The Stationery Office, November 1997, at pages 12-13.

[1354]See section 7 of the Limited Partnership Act of 1907. See also the Law Commission and the Scottish Law Commission, (1997), 'Limited Partnership Act', The Law Commission (Consultation Paper No 161) and the Scottish Law Commission (Consultation Paper No 118), Joint Consultation Paper, London: The Stationery Office, November 1997, at pages 12-13.

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long as the change in the partnership is duly registered, the liability of a former limited partner for future debts and obligations may come to an end on his retirement, irrespective that he may have had his/her contribution returned, however he/she and will remain liable for debts incurred before his/her retirement.[1355]

In order to better understand the legal relationship between the investors and the managers, it is important to look at the rights and duties of the partners in a limited partnership.[1356] According to Burdett *et al*, there are three basic sources of the rights and duties of partners in a limited partnership; namely, common law duties;[1357] statutory duties;[1358] and contractual duties in terms of the limited partnership agreement.[1359] However, it must be noted that it is beyond the scope of this paragraph to undertake a legal analysis of the three sources of rights and duties of partners in a limited partnership. Nevertheless, it is worth noting that statutory duties arise not only under UK partnership law, but also as a result of other applicable laws that may be imposed on partners as a result of the activities they undertake for the partnership. For example the FCA Principles for Businesses, which are mentioned below and more fully discussed in paragraph 4 of this chapter.[1360] The important consideration though is that the general partner has an obligation to manage the partnership business and will be subject to various fiduciary obligations, mostly notably the duty to act in good faith.[1361] According to Spangler, such duties may be expanded or restricted by contract in accordance with the terms of the limited partnership agreement.[1362] According to Hudson, any contractual

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[1355]See also the Law Commission and the Scottish Law Commission, (1997), 'Limited Partnership Act', The Law Commission (Consultation Paper No 161) and the Scottish Law Commission (Consultation Paper No 118), Joint Consultation Paper, London: The Stationery Office, November 1997, at pages 12-13.
[1356]United Kingdom: Law Commission, (2013), 'Law Commission: Fiduciary Duties of Investment Intermediaries: A Consultation Paper', Consultation Paper No 215: Great Britain Law Commission Consultation, The Stationery Office, at chapter 8.
[1357]Partnership Act of 1890 and the rules of equity and of common law apply to limited partnerships, except as they are inconsistent with the express provisions of the Limited Partnership Act of 1907. Chapter 3 of this thesis will submit that a fiduciary relationship arises under common law where A and B agree that A will act on behalf of, or for the benefit of, B in circumstances that give rise to a relationship of trust and confidence, with reference to *Bristol and West Building Society v Mothew* 1996 All ER 698. See also *O'Donnell v Shanahan* 2009 EWCA Civ 751. See also United Kingdom: Law Commission, (2013), 'Law Commission: Fiduciary Duties of Investment Intermediaries: A Consultation Paper', Consultation Paper No 215: Great Britain Law Commission Consultation, The Stationery Office. See also *Armitage v Nurse 1997 2 All ER 705*. See also *BBGP Managing General Partner Ltd v Babcock & Brown Global Partners* 2010 EWHC 2176 (Ch).
[1358]The Partnership Act of 1890 codifies certain of the common law fiduciary duties applicable to partners. These provisions apply by default unless varied by the consent of all partners, either expressly or implied from a course of dealing. In relation to limited partnerships, the scope of common law duties of the Partnership Act of 1890 and the Limited Partnership Act of 1907 can be successfully limited in the limited partnership agreement.
[1359]Burdett, J., Kumar, P. and Pople, Z. (2013), 'The Limited Partnership: A Fresh Look at a Trusted Model', Practical Law Publishing Limited, July 2013, at page 3.
[1360]Also in terms of many securities laws and regulations, for example, the Alternative Investment Fund Managers' Directive (2011/61/EU) and the Markets in Financial Instruments Directive (2004/39/EC), there are further requirements for entities in management roles, whether as manager or general partner, to act honestly, fairly and in the interests of the fund, and to manage conflicts of interest.
[1361]Spangler, T. (2012), 'The Law of Private Investment Funds', Second Edition, Oxford University Press, at chapter 6, paragraphs A-I.
[1362]Spangler, T. (2012), 'The Law of Private Investment Funds', Second Edition, Oxford University Press, at chapter 6, paragraphs A-I.

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narrowing of the fiduciary duties of the general partner must be clearly expressed and will be narrowly construed by the English courts.[1363] Hudson further states that the duties and obligations of the private equity firm the manages the private equity limited partnership will be set out in its management agreement; and where the private equity firm is FCA authorised, it must comply with the FCA Principles for Businesses, which are a general statement of the fundamental obligations of such persons under the UK regulatory system.[1364] The Principles cover, for example, integrity, skill, care and diligence, management and control, financial prudence, customers' interests and conflicts of interest.[1365] Nevertheless, according to Burdett *et al*, the organisational flexibility, together with tax transparency and limited liability have contributed to the limited partnership's popularity as the predominant form for structuring private equity funds in the UK.

3.4 Organisational Form in Australia

The most common legal structure used in Australia to structure private equity funds is the closed-ended Collective Investment Vehicle ('CIV') or more commonly referred to as a unit trust.[1366] It takes the legal form of a trust and is typically used by funds targeting buyouts of companies or businesses with assets exceeding A$250 million.[1367] This vehicle is not commonly used in any of the jurisdictions discussed in this chapter, and in particular, contains concepts foreign to many South African investors.[1368] In an attempt to attract more foreign investors, Australian policy makers have introduced the venture capital limited partnership ('VCLP') regime[1369] and the early stage venture capital limited partnership ('ESVCLP') regime.[1370] A VCLP is used by private equity funds targeting smaller investments with assets of up to A$250 million whereas a ESVCLP is used by private equity funds targeting smaller investments with assets of up to A$50 million.[1371] In Australia, either of the

[1363]Hudson, M. (2014), 'Funds: Private Equity, Hedge and All Core Structures', First Edition, The Wiley Finance Series, John Wiley and Sons, at paragraph 2.2.4.
[1364]Hudson, M. (2014), 'Funds: Private Equity, Hedge and All Core Structures', First Edition, The Wiley Finance Series, John Wiley and Sons, at chapter 12.
[1365]Accessed at https://fshandbook.info/FS/html/FCA/PRIN/2/1, at June 2015. It must also be noted at this point of the discussion, that English law recognises the concept of negligence; however it have no concept of gross negligence as distinct from ordinary negligence. Despite English courts having on various occasions been required to construe contracts that include the phrase gross negligence, the contractual test for excluding the exculpation and indemnification of a general partner in the limited partnership agreement for a UK private equity fund will typically be based on gross negligence rather than ordinary negligence.
[1366]Cumming, D.J. (2010), 'Private Equity: Fund Types, Risks and Returns, and Regulation', Kolb Series in Finance, Essential Perspectives, published by John Wiley and Sons, Inc., Hoboken, New Jersey, 2010.
[1367]Australian Private Equity and Venture Capital Association Limited (AVCAL), (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Ltd Report, April 2014.
[1368]Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', in Private Equity in 29 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at page 6.
[1369]Venture Capital Limited Partnerships regime was introduced in 2002 under the Venture Capital Act 2002 and Taxation Laws Amendment (Venture Capital) Act 2002.
[1370]Early Stage Venture Capital Limited Partnerships regime was introduced in 2007 under the Tax Laws Amendment (2007 Measures No. 2) Act 2007.
[1371]Australian Government: The Board of Taxation (2011), 'Review of Taxation Arrangements under the Venture Capital Limited Partnership Regime: A Report to the Assistant Treasurer', The Board of Taxation, June 2011. Available at www.taxboard.gov.au., accessed at May 2015.

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above structures may be used for structuring a private equity fund, and choosing the most appropriate fund structure will depend upon a number of factors, such as the size of the fund; the investment strategy; the sector, industry and stage of development of target portfolio entities; and the tax resident status and level of sophistication of the target investor group.[1372] The Australian laws that regulate fund structures in Australia are complex and it is beyond the scope of this thesis to comprehensively detail all material aspects of the relevant laws. This discussion will provide a broad analysis of the available fund structures and paragraph 2.1.(c) of chapter four will highlight the key legislated tax concessions that are available to investors and fund managers of each of these fund structure types.

Collective Investment Vehicle

As mentioned above, the most common legal structure to house a private equity fund in Australia is the CIV structured as a closed-ended unit trust. Private equity funds structured as CIV unit trusts are either managed by the trustee or have the investment management functions outsourced to a private equity firm, which is done in terms of a contractual relationship created between the unitholders (investors and beneficiaries) and the trustee (legal holder of the property and manager) under a trust deed or constitution.[1373] The trustee generally has the right to deal with the assets of the trust on a discretionary basis for the benefit of investors, and often appoints a management entity within the structure, such as a private equity firm, to advise the trustee. Investors in the unit trust obtain units and have rights and obligations governed by the unit trust deed.[1374] The unit trust is not a separate legal entity and the trustee contracts on behalf of the trust, subject to a contractual term generally limiting liability of the trustee to the assets of the trust.[1375]

It is important to note that Australian trust law is derived from, and largely continues to follow, English trust law, as modified by State and Commonwealth legislation.[1376] CIV unit trusts are generally fixed trusts where the beneficiaries and their respective interests are identified by their holding units much in the same way as shares are issued to shareholders of a company.[1377] The beneficiaries are usually called unitholders. [1378] Fixed trusts are in essence trusts where the trustee holds the trust assets for

[1372]Australian Private Equity and Venture Capital Association Limited (AVCAL), (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Ltd Report, April 2014.
[1373]Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', Private Equity in 29 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 6-12.
[1374]Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', Private Equity in 29 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 6-12.
[1375]Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', Private Equity in 29 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 6-12.
[1376]Bryan, M. and Vann, V. (2012), 'Equity and Trusts in Australia', 1st Edition, Cambridge University Press, at 208-337.
[1377]Bryan, M. and Vann, V. (2012), 'Equity and Trusts in Australia', 1st Edition, Cambridge University Press, at 208-337.
[1378]Bryan, M. and Vann, V. (2012), 'Equity and Trusts in Australia', 1st Edition, Cambridge University Press, at 208-337.

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the benefit of specific beneficiaries in certain fixed proportions. [1379] In such a case the trustee does not have to exercise a discretion since each beneficiary is entitled to his or her fixed share of the capital and income of the trust.[1380] Beneficiaries/investors can transfer their interests in the trust by transferring their units to a buyer.[1381] There are no limits in terms of Australian trust law on the number of units/unitholders, however, for tax purposes the tax treatment can vary depending on the size and activities of the trust.[1382] Furthermore, in the case of trusts, it is typical to provide in the trust deed that beneficiaries will not be liable for any amount beyond the amount subscribed to the trust or which they are legally obliged to subscribe.[1383] There is Australian case law that suggests that the liability of beneficiaries may be excluded by express provision in the trust deed, provided the loss did not arise from a breach of trust committed by the trustee at the request or instigation of the beneficiary in circumstances that would entitle the trustee to hold the interest of that beneficiary as security against personal liability of the trustee for that loss.[1384] In *McLean v Burns Philp Trustee Company Pty Ltd*, the court confirmed that the potential personal liability of beneficiaries for the debts of a trust could be excluded by a clause which limited the trustee's right of recourse to assets of the trust, except where this would be contrary to public policy.[1385] However, the court held that a clause in the deed of a public unit trust which excluded the trustee's right of indemnity against the beneficiaries was not contrary to public policy.[1386]

Nevertheless, a trustee is personally liable for the debts of the trust as the trust assets and liabilities are legally those of the trustee.[1387] For this reason if there are significant liabilities that could arise, a limited liability (private) company is often used as trustee.[1388] However, the trustee is entitled to use the trust assets to satisfy those liabilities as the trustee has a right of indemnity and a lien over them for this purpose.[1389] A trustee must act in the best interests of beneficiaries and must avoid conflicts of interest.[1390] The trust deed will *inter alia* set out in detail the type of investments the trustee can

[1379]Bryan, M. and Vann, V. (2012), 'Equity and Trusts in Australia', 1st Edition, Cambridge University Press, at 208-337.
[1380]Bryan, M. and Vann, V. (2012), 'Equity and Trusts in Australia', 1st Edition, Cambridge University Press, at 208-337.
[1381]Bryan, M. and Vann, V. (2012), 'Equity and Trusts in Australia', 1st Edition, Cambridge University Press, at 208-337.
[1382]Bryan, M. and Vann, V. (2012), 'Equity and Trusts in Australia', 1st Edition, Cambridge University Press, at 208-337.
[1383]See Cassidy, J. (2006), 'Concise Corporations Law', 1st Edition, Federation Press, at pages 21-23.
[1384]See Cassidy, J. (2006), 'Concise Corporations Law', 1st Edition, Federation Press, at pages 21-23.
[1385]*McLean v Burns Philp Trustee Company Pty Ltd* 1985 9 ACLR 926.
[1386]*McLean v Burns Philp Trustee Company Pty Ltd* 1985 9 ACLR 926. See also Cassidy, J. (2006), 'Concise Corporations Law', Fifth Edition, Federation Press, at pages 21-23.
[1387]Latimer, P. (2012), 'Australian Business Law 2012', CCH Australian business law series, 31st Edition, at pages 659-764.
[1388]Latimer, P. (2012), 'Australian Business Law 2012', CCH Australian business law series, 31st Edition, at pages 659-764.
[1389]Latimer, P. (2012), 'Australian Business Law 2012', CCH Australian business law series, 31st Edition, at pages 659-764.
[1390]Moffat, G, Bean, G, Probert, R. (2009), 'Trusts Law: Text & Materials, 5th Edition Cambridge University Press at 1-115.

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make and the type of businesses the trustee can invest in.[1391] The trustee must exercise powers in accordance with the deed and this is why deeds tend to be lengthy and complex so that the trustee has maximum flexibility.[1392] Any legally competent person, including a company, can act as a trustee.[1393] Two or more entities can be trustees of the same trust and a company can act as trustee, provided that its constitution allows it; and can therefore assist with limited liability and perpetual succession.[1394] There are strengths and weaknesses associated with trusts in the current context, however, at this point it must be noted that it is not the intention of this part to provide a legal analysis of the Australian law of trusts, but rather to provide an analysis of the salient features of the various legal vehicles used to structure private equity funds in Australia.

Private equity funds structured as CIV unit trusts are not subject to restrictions on the class of asset in which the fund may make an investment, restrictions on the amount of such investments, any rules regarding compulsory diversification of the investment portfolio or the total fund size.[1395] CIV unit trusts are tax flow-through vehicles, which mean that income, profits, gains and losses of the trust flow-through to the unit holders who are then taxed according to their respective tax status.[1396] However, certain of the key legislated tax concessions that are available to investors and the fund manager of an ESVCLP or a VCLP, are not available in respect of a CIV.[1397] In this regard, on 11th May 2010 the Australian Tax Authority ('ATO') released rulings indicating it will treat income from the disposal of assets by private equity funds on revenue account, namely taxing it as ordinary income.[1398] However, the ATO ruled that if the CIV qualifies as a Managed Investment Trust ('MIT') then it can elect to treat qualifying assets on capital account, namely taxing it as capital gains.[1399] The introduction of the MIT tax framework was part of the ATO's review of the tax treatment of CIVs and to consider whether including a broader range of tax flow-through vehicles should be permitted, consistent with the Government's objective of developing Australia as a leading financial centre.[1400]

[1391] Moffat, G, Bean, G, Probert, R. (2009), 'Trusts Law: Text & Materials, 5th Edition Cambridge University Press at 1-115.
[1392] Moffat, G, Bean, G, Probert, R. (2009), 'Trusts Law: Text & Materials, 5th Edition Cambridge University Press at 1-115.
[1393] Moffat, G, Bean, G, Probert, R. (2009), 'Trusts Law: Text & Materials, 5th Edition Cambridge University Press at 1-115.
[1394] Moffat, G, Bean, G, Probert, R. (2009), 'Trusts Law: Text & Materials, 5th Edition Cambridge University Press at 1-115.
[1395] Maarbani, S. (2011), 'Establishing a new Venture Capital or Private Equity Fund', PricewaterhouseCoopers, 1st September 2011, at page 1.
[1396] Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', 2nd edition, Elsevier Inc., at paragraph 9.6.5.
[1397] Paragraph 2.1.(c) in chapter four.
[1398] Australian Government: The Board of Taxation (2011), 'Review of Taxation Arrangements under the Venture Capital Limited Partnership Regime: A Report to the Assistant Treasurer', The Board of Taxation, June 2011. Available at www.taxboard.gov.au, accessed in May 2015.
[1399] The MIT rules were introduced in June 2010, defined under s9 of the Corporations Act, 2001. See Chapter 5C of the Corporations Act of 2001. See also Australian Private Equity and Venture Capital Association Limited (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014.
[1400] Australian Private Equity and Venture Capital Association Limited (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014.

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A CIV may qualify as a MIT if the trust meets all of the required criteria. The criteria are that the CIV has a manager which is an Australian resident with an Australian financial services licence; the trust must not control a trading business; is listed or widely held; and invests in passive investments, such as rent, debt or equity.[1401] If the trust qualifies as a MIT, it can elect to treat qualifying assets on capital account.[1402] MITs also have the benefit of a reduced level of withholding tax.[1403]

Venture Capital and Early Stage Venture Capital Limited Partnerships

The VCLP regime was introduced to increase foreign investment in the Australian venture capital sector by offering a more familiar legal structure, namely the limited partnership, coupled with favourable tax benefits. A VCLP is a separate legal entity and can contract on this basis.[1404] As evident from the introductory paragraph 1 of this chapter, the use of VCLPs has been limited to venture capital and midmarket private equity funds because of the restrictions on the types of investments that VCLPs can make. For example, the investment must be in shares or options in a company or units in a trust; the target must generally be an operating entity, the head company of a consolidated group or a holding company formed specifically for the purpose of making the investment; and the target must not have total assets, including goodwill of more than A$250 million.[1405] It should be noted that it is desirable that a VCLP use an incorporated limited partnership.[1406] Innovation Australia[1407] (the 'Board') regulates venture capital funds registered as a VCLP.[1408] Registration as a VCLP entitles a venture capital fund to certain benefits but is conditional upon meeting certain obligations. Registration will be granted if the Board is satisfied that the fund, among other things has (1) been structured as a limited partnership and established in either

[1401]Chapter 5C of the Corporations Act of 2001. Australian Government: The Board of Taxation (2011), 'Review of Taxation Arrangements under the Venture Capital Limited Partnership Regime: A Report to the Assistant Treasurer', The Board of Taxation, June 2011. Available at www.taxboard.gov.au, accessed in May 2015.
[1402]Maarbani, S. (2011), 'Establishing a new Venture Capital or Private Equity Fund', PricewaterhouseCoopers, 1st September 2011, at page 1.
[1403]For a more complete discussion on the taxation of CIV/MIT's, see discussion in chapter four, paragraph 2.1.(c).
[1404]Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', in Private Equity in 29 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 6-12.
[1405]Australian Government, Department of Industry and Science, (2015), 'Overview of Venture Capital Limited Partnerships', at pages 1-2. Available at www.business.gov.au/grants-and-assistance/venture-capital/vclp/Pages/VCLP-Overview.aspx, accessed in June 2015.
[1406]In terms of section 9-1(1)(a) of the Venture Capital Act of 2002. As partnership laws are the responsibility of State and Territory Government's changes to legislation recognising incorporated limited partnerships are required. A number of States and Territories are progressing or have passed relevant legislative changes, such New South Wales.
[1407]Innovation Australia is an independent statutory body established to assist with the administration of the Australian Government's innovation and venture capital programs designed to support industry innovation.
[1408]Available at www.business.gov.au/grants-and-assistance/venture-capital/vclp/Pages/VCLP-IncorporatedLimitedPartnerships.aspx, accessed in June 2015.

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Australia or a foreign country which has a double tax agreement with Australia;[1409] (2) a general partner that is a resident of either Australia, or a foreign country which has a double tax agreement with Australia;[1410] (3) not been structured as part of a bigger fund (or attached to a unit trust) and is stand-alone; (4) a qualifying partnership agreement that: (4)(a) remains in existence for not less than five years and not more than fifteen years; (b) requires partners to contribute capital when required; (c) prohibits the addition of new partners except as provided for in the agreement; (d) prohibits increases in committed capital except as provided for in the agreement; (e) confers on a general partner the right to require partners to contribute their committed capital to the partnership; and (f) includes a plan which outlines its intended investment activities;[1411] (5) access to the skills and resources necessary to implement its investment plan; (7) committed capital of at least $10 million.[1412]

The failure to meet these obligations can result in the loss of registration and a loss of the associated benefits.[1413] VCLPs can only make and hold investments as permitted by the Venture Capital Act 2002 and the Income Tax Assessment Act 1997.[1414] The Board will monitor compliance through examining relevant documents including both the VCLP's quarterly and annual returns.[1415] The Board may also ask for additional information it considers necessary for the purposes of administering the programme. Compliance assessment is also undertaken by the ATO, which receives copies of all VCLP reports submitted to the Board.[1416] The ATO may undertake risk assessment activities to ensure compliance with the legislation under its administration. In the quarterly and annual returns a VCLP is required to declare whether it has complied with the relevant legislation. The Board monitors compliance rigorously and failure to comply could result in sanctions up to and including revocation. The Board expects that the general partner of a VCLP will (a) operate the VCLP in accordance with the relevant legislation; (b) operate the VCLP in accordance with its approved investment plan; (c) maintain an appropriate audit trail and be able to demonstrate legislative compliance; (d) hold all investments in the name of the VCLP; and (e) provide accurate and timely reports to the Board as required by the relevant legislation.[1417]

[1409] In terms of section 9-1(1)(a)(i)-(ii) of the Venture Capital Act of 2002.
[1410] In terms of section 9-1(1)(b) of the Venture Capital Act of 2002.
[1411] In terms of section 9-1(1)(c) and section 11-1(2)(f) of the Venture Capital Act of 2002.
[1412] In terms of section 9-1(1)(d) of the Venture Capital Act of 2002.
[1413] Available at www.business.gov.au/grants-and-assistance/venture-capital/vclp/Pages/VCLP-IncorporatedLimitedPartnerships.aspx, accessed in June 2015.
[1414] In terms of subdivision 118F of the Income Tax Assessment Act 1997. Australian Government, Department of Industry and Science, (2015), 'Overview of Venture Capital Limited Partnerships', at pages 1-2. Available at www.business.gov.au/grants-and-assistance/venture-capital/vclp/Pages/VCLP-IncorporatedLimitedPartnerships.aspx, accessed in June 2015.
[1415] Available at www.business.gov.au/grants-and-assistance/venture-capital/vclp/Pages/VCLP-IncorporatedLimitedPartnerships.aspx, accessed in June 2015.
[1416] Available at www.business.gov.au/grants-and-assistance/venture-capital/vclp/Pages/VCLP-IncorporatedLimitedPartnerships.aspx, accessed in June 2015.
[1417] Available at www.business.gov.au/grants-and-assistance/venture-capital/vclp/Pages/VCLP-IncorporatedLimitedPartnerships.aspx, accessed in June 2015.

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The ESVCLP is essentially an extension of the VCLP regime and was introduced to encourage early stage venture capital investment by offering further taxation advantages, provided the fund only invests in early stage investments and meets certain criteria, which are similar to the restrictions applying to VCLPs.[1418] The most notable difference from the VCLP being that the ESVCLP must have capital commitments of at least $10 million and no more than $100 million from its partners (investors) before it can be registered. A second difference being that the target investment must not have total assets, including goodwill of more than A$50 million.[1419] Since both VCLPs and ESVCLPs are incorporated entities, the limited liability of third-party investors will be respected in the same manner as shareholders in a corporation.[1420] In addition, in both the VCLP and ESVCLP, the general partner has duties arising under the terms of the partnership deed governing the VCLP and ESVCLP.[1421] Furthermore, the Australian Financial Services Licence ('AFSL') imposes duties on the licensed entity, typically a private equity firm to act efficiently, honestly and fairly.[1422] These legal fiduciary duties cannot be contracted out of however the terms of the relevant partnership deed may amend or modify such duties to provide for terms agreed between the investors and the private equity firm.[1423] In terms of the AFSL, the licensed entity needs to remain solvent and have positive net assets to keep its licence.[1424] Nevertheless, Australian private equity funds are generally set up as either MITs or VCLPs. Both are generally flow-through vehicles with respect to the income and profits of the MIT or VCLP being taxed in the hands of the investor. The requirements for a unit trust to be an MIT and for a limited partnership to be a VCLP are prescriptive and extensive.[1425] The failure to meet these requirements can give rise to adverse Australian income tax consequences for investors.[1426]

[1418]Both the VCLP and ESVCLP are more fully discussed in paragraph 2.1.(c) in chapter four.
[1419]Australian Government, Department of Industry and Science, (2015), 'Overview of Venture Capital Limited Partnerships', at pages 1-2. Available at http://www.business.gov.au/grants-and-assistance/venture-capital/vclp/Pages/VCLP-Overview.aspx, accessed in June 2015.
[1420]Australian Government, Department of Industry and Science, (2015), 'Overview of Venture Capital Limited Partnerships', at pages 1-2. Available at www.business.gov.au/grants-and-assistance/venture-capital/vclp/Pages/VCLP-IncorporatedLimitedPartnerships.aspx, accessed in June 2015.
[1421]Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', Private Equity in 29 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 6-12.
[1422]An Australian Financial Services Licence (AFSL) is a licence for any Australian businesses involved in the provision of financial services. It is issued by the Australian Securities and Investments Commission (ASIC) as required by the Corporations Act 2001.
[1423]Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', in Private Equity in 29 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 6-12. This paragraph will not discuss case law in Australia on the subject. However, it is generally accepted that there is no legal distinction to be made between the concepts of negligence and gross negligence. See also Brown, L. (2005), 'Gross negligence in exclusion clauses: is there an intelligible difference from ordinary negligence', Insurance Law Journal, 16, at pages 1-11.
[1424]Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', Private Equity in 29 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 6-12.
[1425]Available at www.business.gov.au/grants-and-assistance/venture-capital/vclp/Pages/default.aspx, accessed in June 2015 and www.business.gov.au/grants-and-assistance/venture-capital/esvclp/Pages/default.aspx, accessed in June 2015.
[1426]See discussion in paragraph 2.1(c) of chapter four for more detailed discussion with regard to the taxation of the CIV, MIT, VCLP and ESVCLP structures.

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3.5 Organisational Form in Canada

The predominant legal vehicle used to structure private equity funds in Canada is a limited partnership.[1427] According to Dolden, a partnership comes into being as a result of an agreement among the partners to carry on business together in a manner that is consistent with the characteristics of partnership.[1428] This agreement may be evidenced by a written partnership agreement, or it may be inferred from the conduct of the parties in their business relationship.[1429] This principle was recognised by the Supreme Court of Canada in *Porter and Sons v Foster and Armstrong*:[1430]

> 'Partnership, it is needless to say, does not arise from ownership "in common, or from joint ownership. Partnership arises from contract, evidenced either by express declaration or by conduct signifying the same thing. It is not sufficient there should be community of interest; there must be contract.'[1431]

Canada has a federal system of government whereby the authority to enact legislation is divided between the federal and the provincial and territorial governments. Each of Canada's ten provinces and three territories has its own legislative scheme for regulating limited partnerships and can therefore vary from jurisdiction to jurisdiction, which are complex and extensive, and beyond the scope of this discussion. Therefore, for example reference will only be made to the British Columbia Limited Partnership Act of 1996, and not any other Canadian provincial limited partnership legislation.[1432]

Nevertheless, limited partnerships are formed under Canadian provincial laws.[1433] The specific characteristics of a limited partnership, such as creation formalities and disclosure of limited partners'

[1427]Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut, C., published: Getting the Deal Through, at pages 28-33.
[1428]Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at page 5.
[1429]Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at page 5.
[1430]*Porter and Sons v Foster and Armstrong* 1926, 2 D.L.R. 340 (S.C.C.).
[1431]*Porter and Sons v Foster and Armstrong* 1926, 2 D.L.R. 340 (S.C.C.), at 341.
[1432]British Columbia Partnership Act of 1996 [R.S.B.C.] Ch. 348. The other provinces/territories of Canada have their own partnership legislation, however similar to the Delaware example which was discussed in paragraph 3.2 of this chapter, the British Columbia Partnership Act of 1996 will be analysed for ease of reference. British Columbia have a well developed common-law regime governing limited partnerships, which is generally considered the more sophisticated of the Canadian provinces and territories. Furthermore, the provisions contained in the British Columbia Partnership Act of 1996 are much the same as the equivalent legislation in most of the other provivces. In addition, it is beyond the scope of this discussion to analyse all the relevant legislation pertaining to limited partnerships in of all the other provinces and territories of Canada.
[1433]Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 28-33.

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names, are dependent on the applicable laws of the province of formation.[1434] A *limited partnership* is not a legal entity separate from its partners under *Canadian* law. In addition, Canadian limited partnerships are fiscally transparent in terms of the Canadian Income Tax Act,[1435] meaning that the gains and losses of the fund flow through to its *limited partners*.[1436] The formation, rights and obligations of limited partnerships in Canada are governed by a combination of staututes,[1437] the common law and the relevant partnership agreement.[1438] A limited partnership is required to have at least one general partner and at least one limited partner.[1439] According to Dolden, a Canadian limited partnership is a special kind of partnership that combines some of the advantages of partnership with those of incorporation.[1440] For example, in British Columbia, the formation of limited partnerships is governed by the Part 3 of the British Columbia Partnership Act of 1996 ('Partnership Act of 1996'). Section 50(1)-(2) of the Partnership Act of 1996 reads as follows:

'(1) … a limited partnership may be formed to carry on any business that a partnership without limited partners may carry on.

(2) A limited partnerships shall consist of (a) one or more persons who are general partners; and (b) one or more persons who are limited partners.'

A limited partnership will only be found to exist where the registration requirements of the Partnership Act of 1996 have been complied with. These requirements are set out in section 51 of the Partnership Act of 1996, which reads as follows:

' (1) A limited partnership is formed when there is filed with the registrar a certificate, signed by each person who is, on the formation of the partnership, to be a general partner.

(2) A certificate shall state

(a) the business name under which the limited partnership is to be conducted,

(b) the general nature of the business carried on or intended to be carried on,

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[1434]The offering of limited partnership interests to investors is subject to applicable Canadian provincial securities laws, prospectus and registration requirements. Typically, private equity limited partnership interests are intended for 'accredited investors', and such interests are not intended to be publicly traded. However, it is not the intention of this paragraph to discuss all matters relating to Canadian securities law, as well as all the related State statutes that regulate partnerships, as it is beyond the scope of this discussion.

[1435]R.S.C., 1985, (5th Suppl).

[1436]Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 28-33.

[1437]This paragraph will refer to the British Columbia Partnership Act of 1996 [R.S.B.C.] Ch. 348, for ease of reference. Other Canadian States have an equivalent statute which are very similar.

[1438]Rubin, P. and Langlois, J. (2009), 'Insolvency Issues and Partnerships', Working with Partnerships Paper 7.1, Continuing Legal Education Society of British Columbia, June 2009, at pages 7.1.7-7.1.8.

[1439]Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 28-33.

[1440]Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at page 13.

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(c) the full name and resident address of each general partner or, in the case of a general partner other than an individual, the name and address in the Province,

(d) the term for which the limited partnership is to exist,

(e) the aggregate amount of cash and the nature and fair value of any other property to be contributed by all of the limited partners,

(f) the aggregate amount of any additional contributions agreed to be made by limited partners and the times at which or events on the happening of which the additional contributions are to be made, and

(g) the basis on which the limited partners are to be entitled to share profits or receive other compensation by way of income on their contributions.'

In addition to the above mentioned registration requirements, section 51(4) of the Partnership Act of 1996 provides that where the partnership agreement contains provisions relating to the times when the contributions of the limited partners are to be returned, the right to admit additional limited partners, or any other matter specified in this provision, these must also be included in the certificate of registration.[1441] Furthermore, section 70 of the Partnership Act of 1996 requires that the certificate of registration must be amended when there are certain specified changes affecting the nature of the partnership business or relating to the composition of the partnership. Section 54 of the Partnership Act of 1996 sets out specific requirements for the maintenance of records relating to the limited partnership. In addition, the limited partnership is required to have a registered office in the Province at which a register stating the name and resident address of each limited partner and the percentage interest of each limited partner in the limited partnership is kept.[1442] Also, a copy of the certificate of limited partnership and the limited partnership agreement, with all amendments, must be kept at the registered office.[1443] These records must be available for inspection by the public. Section 53 of the Partnership Act of 1996 requires that the business name of a limited partnership must end with the words 'Limited Partnership' in full or the French equivalent.[1444] The Partnership Act of 1996 also prohibits the use of the name of a limited partner, either a corporation or individual, in the name of the firm.[1445]

Limited Liability

[1441]See Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at pages 13-15.

[1442]See Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at pages 13-15.

[1443]See Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at pages 13-15.

[1444]See Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at pages 13-15.

[1445]See Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at pages 13-15.

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A general partner's liability in a limited partnership is unlimited, therefore in practice a limited liability corporation is typically formed to act as the general partner.[1446] The liability of a limited partner generally is limited to the amount contributed or agreed to be contributed by such limited partner. However, the protection of limited liability will only be accorded to limited partners where there has been strict compliance with the registration and reporting requirements set out in the Partnership Act of 1996 and the requirements of provisions relating to the partnership name.[1447] The failure to comply with these requirements may result in the limited partnership being deemed to be an ordinary partnership, with the result that the limited partners will be liable, as ordinary partners, for the debts and obligations of the firm.[1448] In *Laplante v Canada*,[1449] the Canadian Tax Court dealt with the requirement of proper registration for the formation of a limited partnership. In this case, the participants in the business had concluded a limited partnership agreement.[1450] The court was satisfied that at the time that the agreement was concluded Laplante had intended to be a limited partner of the business and to have the limited liability status of a limited partner. However, the intended limited partnership was never registered under the relevant legislation.[1451] The court held that despite the intent of the participants in the business, no limited partnership had been formed.[1452] Furthermore, the court further held that where the parties in a business are apparently carrying on a partnership, and the partnership is not registered as a limited partnership, the business will be deemed to be an ordinary partnership.[1453] In *Laplante v Canada*,[1454] the evidence established that Laplante had participated in the management of the business, but the failure to register was held to be sufficient to negate the existence of a limited partnership.

Furthermore, a limited partner may have unlimited liability (similar to that of a general partner) if such limited partner takes part in the control of the business of a limited partnership.[1455] In terms of section 64 of the Partnership Act of 1996,[1456] the limited partner is shielded from liability beyond its contributions unless the limited partner 'takes part in the management of the business'. Section 64 of the Partnership Act of 1996 reads as follows:

[1446]Hudson, M. (2014), 'Funds: Private Equity, Hedge and All Core Structures', First Edition, The Wiley Finance Series, John Wiley and Sons, at paragraph 2.2.4.
[1447]See Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at pages 13-15.
[1448]See Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at pages 13-15.
[1449]*Laplante v Canada* 1995, 1 C.T.C. 2647 (T.C.C.).
[1450]*Laplante v Canada* 1995, 1 C.T.C. 2647 (T.C.C.).
[1451]*Laplante v Canada* 1995, 1 C.T.C. 2647 (T.C.C.).
[1452]*Laplante v Canada* 1995, 1 C.T.C. 2647 (T.C.C.).
[1453]*Laplante v Canada* 1995, 1 C.T.C. 2647 (T.C.C.).
[1454]*Laplante v Canada* 1995, 1 C.T.C. 2647 (T.C.C.).
[1455]Cumming, D.J. (2010), 'Private Equity: Fund Types, Risks and Returns, and Regulation', Kolb Series in Finance, Essential Perspectives, published by John Wiley and Sons, Inc., Hoboken, New Jersey, 2010.
[1456]Partnership Act of 1996 [R.S.B.C.] Ch. 348.

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'A limited partner is not liable as a general partner unless he takes part in the management of the business.'

In this regard Dolden argues that:

'… the limited liability of a limited partner arises out of his or her status as a passive investor. To preserve this status the limited partner must refrain from participating in the management of the business of the limited partnership. This prohibition has been an element of limited partnership since this business vehicle was first recognised in the 19th century. The theory behind the prohibition is that imposing liability upon persons for the acts they undertake deters them from taking undue risks. Following this reasoning, persons who enjoy limited liability should not have the authority to take actions which may affect the risks to which others may be exposed.'[1457]

In *Backman v Canada*,[1458] the Canadian Federal Court of Appeal held that:

'A limited partner does not become liable as a general partner unless, in addition to exercising his rights and powers as a limited partner, he takes part in the control of the business ... In the ordinary case, a limited partnership will consist of a general partner that will control the business and limited partners who will have made financial or other contributions but who will not be actively involved in the business. However, that obviously does not mean that the limited partnership is not carrying on a business. The business is being carried on in common by all the partners, but is controlled by the general partner.'[1459]

It is evident from the above discussion that the prohibition on participation in the management of the limited partnership is the primary risk for loss of limited liability status for limited partners.[1460] The critical issue is what activities would constitute participation in the 'management' of the limited partnership so as to contravene the provisions of section 64 of the Partnership Act of 1996.[1461] However, it should be noted that the equivalent provisions of statutes in several other jurisdictions in Canada state that a limited partner will become liable if he/she participates in the 'control' of the limited partnership.[1462] The distinction between the terms 'management' and 'control' was expressly recognised by the British Columbia Supreme Court in *Nordile Holdings Ltd v Breckenridge*,[1463] where

[1457]See Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at page 19.
[1458]*Backman v Canada* 2000, 1 FCR 555, 1999 CanLII 9371 (FCA).
[1459]*Backman v Canada* 2000, 1 FCR 555, 1999 CanLII 9371 (FCA). The appeal was dismissed at *Backman v Canada* 2001, 1 SCR 367, 2001 SCC 10 (CanLII).
[1460]Philipps, L. (1993), 'The Amazing Three-Headed Limited Partner: Reflections on Old Loopholes and New Jurisprudence', Canadian Business Law Journal, 21(3), at pages 410-428.
[1461]See *Nordile Holdings Ltd v Breckenridge* 1991, 25 A.C.W.S.
[1462]Philipps, L. (1993), 'The Amazing Three-Headed Limited Partner: Reflections on Old Loopholes and New Jurisprudence', Canadian Business Law Journal, 21(3), at pages 410-428.
[1463]*Nordile Holdings Ltd v Breckenridge* 1991, 25 A.C.W.S.

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the issue to be decided was whether the limited partners had participated in the management of the business within the meaning of section 64 of the Partnership Act of 1996.[1464] In this case, Esson CJ stated:

'... Management covers a broader range of activity than control and includes any activity covered by control.'[1465]

However, the Partnership Act of 1996 does contemplate a certain degree of participation by the limited in matters relating to the limited partnership. For example, Section 56 of the Partnership Act of 1996 requires the unanimous consent of the limited partners before a general partner may take the following actions with respect to the partnership, namely: (1) do an act which makes it impossible to carry on the business of the limited partnership; (2) consent to judgment against the limited partnership; (3) possess limited partnership property, for other than a partnership purpose; (4) admit a person as a general partner or admit a person as a limited partner unless the right to do so is given in the certificate; and (5) continue the business of the limited partnership on the bankruptcy, death, retirement, mental incompetence or dissolution of a general partner, unless the right to do so is given in the certificate.[1466] Furthermore, section 58 of the Partnership Act of 1996 also grants certain rights to limited partners in relation to the limited partnership which will not constitute participation in the management of the limited partnership. Section 58 of the Partnership Act of 1996, reads as follows:

'(1) Subject to subsection (2), a limited partner has the same right as a general partner (a) to inspect and make copies of or take extracts from the limited partnership books at all times; (b) to be given, on demand, true and full information of all things affecting the limited partnership and to be given a formal account of partnership affairs whenever the circumstances render it just and reasonable; and (c) to obtain dissolution and winding up of the limited partnership by court order.'

Also, section 60 of the Partnership Act of 1996 provides that a limited partner may conduct independent business with the limited partnership without contravening the 'management' provision in terms section 64 of the Partnership Act of 1996. Section 60(1) of the Partnership Act of 1996 reads as follows:

'A limited partner may lend money to, borrow money from and transact business with the limited partnership.'

[1464] *Nordile Holdings Ltd v Breckenridge* 1991, 25 A.C.W.S. See also Philipps, L. (1993), 'The Amazing Three-Headed Limited Partner: Reflections on Old Loopholes and New Jurisprudence', Canadian Business Law Journal, 21(3), at pages 410-428. See also Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at pages 20-23.
[1465] *Nordile Holdings Ltd v Breckenridge* 1991, 25 A.C.W.S.
[1466] Section 56 of the Partnership Act of 1996.

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A limited partner who enters into the permitted transactions with the limited partnership will have the rights and duties of any other independent person who conducts business with the limited partnership; may take security in the property of the limited partnership; and has the same priority of any other creditor in obtaining repayment of the debt.[1467] However, Dolden argues that this kind of activity should be avoided because it may be regarded as participation in the management of the business.[1468] Furthermore, section 52 of the Partnership Act of 1996 makes provision for a limited partner to also be a general partner in the limited partnership. Section 52 of the Partnership Act of 1996 reads as follows:

'(1) A person may be a general partner and limited partner at the same time in the same limited partnership.

(2) A person who is at the same time a general partner and a limited partner has the same rights and powers and is subject to the same restrictions as a general partner but in respect of his contribution as a limited partner he has the rights against the other partners that he would have had if he were not also a general partner.'

The practical application of section 52 of the Partnership Act of 1996 typically occurs where a general partner agrees to contribute funds as a limited partner because of a lack of capital for the limited partnership.[1469] According to Philipps, limited partnership agreements contain a provision stating that where a limited partner defaults an instalment payment of his or her agreed contribution, a general partner may make the required contribution and thereby assume the defaulting limited partner's interest in the limited partnership.[1470] However, a general partner who has also invested as a limited partner would only be afforded the protection of limited liability with respect to the contribution as a limited partner; as well as entitle such partner to receive his/her allocation of income from the capital contribution before the profits of the limited partnership are distributed to the general partners.[1471] As mentioned above, this kind of activity should be avoided because they create confusion between the roles of general partner and limited partner and may be regarded as participation in the management of the business.[1472]

[1467]Philipps, L. (1993), 'The Amazing Three-Headed Limited Partner: Reflections on Old Loopholes and New Jurisprudence', Canadian Business Law Journal, 21(3), at pages 410-428.
[1468]Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at pages 20-23.
[1469]Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at pages 20-23.
[1470]Philipps, L. (1993), 'The Amazing Three-Headed Limited Partner: Reflections on Old Loopholes and New Jurisprudence', Canadian Business Law Journal, 21(3), at pages 410-428.
[1471]Philipps, L. (1993), 'The Amazing Three-Headed Limited Partner: Reflections on Old Loopholes and New Jurisprudence', Canadian Business Law Journal, 21(3), at pages 410-428.
[1472]Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at pages 20-23.

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It is submitted, that the failure to observe the above mentioned restrictions may result in the loss of a limited partner of his/her limited liability status. Furthermore, section 63 of the Partnership Act of 1996 states that this liability is owed to the partnership itself, and not to creditors, meaning that a limited partner who has not taken part in the management of the partnership is not properly named in an action for obligations undertaken by the partnership, even though the limited partner's initial contribution may be implicated in any award granted in an enforcement of the obligation.[1473] A further distinguishing feature of the limited partnership relates to the manner in which capital is distributed between partners upon dissolution of the partnership.[1474] For example, in terms of a general partnership all partners are entitled to an equal division of their capital contribution, however, in terms of a limited partnership structure, section 73 of the Partnership Act of 1996 provides, unless otherwise agreed, that limited partners have priority over any partnership assets upon dissolution that remain after the satisfaction of the firm's creditors in respect of the limited partner's capital contributions.[1475] For example, in *Re Lehndorff General Partner Ltd,* the practical concern of the court was that creditors of the limited partnership could attempt to enforce their claims as against limited partners who are not named in the stay order, despite the fact that limited partners are only responsible for partnership debts in the amount of their contribution to the partnership.[1476]

Furthermore, a limited partner may be liable for amounts received on account of profits paid out when a partnership is not in a solvent position.[1477] Also, in circumstances where a limited partner has received the return of all or a part of the limited partner's contribution, the limited partner is nevertheless liable to the limited partnership or where the limited partnership is dissolved to its creditors, for any amount not in excess of the amount returned with interest necessary to discharge the liabilities of the limited partnership to all creditors who extended credit or whose claims otherwise arose before the return of contribution.[1478] In addition to the above circumstances, a limited partner could also be liable in circumstances where such limited partner is aware of false statements in the record of limited partners, or if its name is used as part of the limited partnership's name.[1479] According to Dzulynsky *et al*, these circumstances rarely occur in practice.[1480]

[1473]Partnership Act of 1996 [R.S.B.C.] Ch. 348. See also Rubin, P. and Langlois, J. (2009), 'Insolvency Issues and Partnerships', Working with Partnerships Paper 7.1, Continuing Legal Education Society of British Columbia, June 2009, at pages 7.1.7-7.1.8.

[1474]Rubin, P. and Langlois, J. (2009), 'Insolvency Issues and Partnerships', Working with Partnerships Paper 7.1, Continuing Legal Education Society of British Columbia, June 2009, at pages 7.1.7-7.1.8.

[1475]Partnership Act of 1996 [R.S.B.C.] Ch. 348. See Rubin, P. and Langlois, J. (2009), 'Insolvency Issues and Partnerships', Working with Partnerships Paper 7.1, Legal Education Society of British Columbia, June 2009, at pages 7.1.7-7.1.8.

[1476]*Re Lehndorff General Partner Ltd* 1993 O.J. No. 14, 17 C.B.R. (3d) 24 (Ont. Ct. (Gen. Div.) (QL).

[1477]Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 28-33.

[1478]Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 28-33.

[1479]Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 28-33.

[1480]Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 28-33.

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Nevertheless, a key attraction of the limited partnership structure, subject to the provisions of partnership statutes in specific Canadian jurisdictions, and in terms of any partnership agreement; is that the limited partner risks, in the event of the economic failure of the business for which the partnership exists, only losing his/her commitment of capital. In terms of a typical limited partnership, the limited partner remains silent.[1481] However, in terms of most partnership legislation, and to protect the public and keep the partnership transparent, if a limited partner interferes with the running of the business, they risk losing their limited partner status with possible personal exposure to the debts of the partnership.[1482] The general partner remains personally liable for the debts of the partnership but also generally retains exclusive authority to operate and manage the business; whereas the limited partner may be able to access some of the profits of the partnership depending on the terms of the partnership contract and, possibly, a share of the assets of the partnership in the event of dissolution.[1483] Limited partnership agreements vary in their terms as partners try to contractually formalise their arrangement, however most jurisdictions have partnership legislation that sets out the limits of such agreements.[1484] In *Re Lehndorff General Partner Ltd,* Farley J of the Ontario Court wrote:

> 'A limited partnership is a creation of statute, consisting of one or more general partners and one or more limited partners. The limited partnership is an investment vehicle for passive investment by limited partners … It appears to me that the operations of a limited partnership in the ordinary course are that the limited partners take a completely passive role (they must or they will otherwise lose their limited liability protection which would have been their sole reason for choosing a limited partnership vehicle as opposed to an 'ordinary' partnership vehicle) … The limited partners leave the running of the business to the general partner and in that respect the care, custody and the maintenance of the property, assets and undertaking of the limited partnership in which the limited partners and the general partner hold an interest.'[1485]

[1481]See Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at pages 20-23. See also Philipps, L. (1993), 'The Amazing Three-Headed Limited Partner: Reflections on Old Loopholes and New Jurisprudence', Canadian Business Law Journal, 21(3), at pages 410-428.
[1482]See Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2011), 'Fund Formation: Canada', in Private Equity in 33 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 34-39.
[1483]See Rubin, P. and Langlois, J. (2009), 'Insolvency Issues and Partnerships', Working with Partnerships Paper 7.1, Continuing Legal Education Society of British Columbia, June 2009, at pages 7.1.7-7.1.8. See also Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 28-33.
[1484]See Rubin, P. and Langlois, J. (2009), 'Insolvency Issues and Partnerships', Working with Partnerships Paper 7.1, Continuing Legal Education Society of British Columbia, June 2009, at pages 7.1.7-7.1.8. See also Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 28-33.
[1485]*Re Lehndorff General Partner Ltd* 1993 O.J. No. 14, 17 C.B.R. (3d) 24 (Ont. Ct. (Gen. Div.) (QL).

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General Partner

It must be noted that the discussion to follow will not be a comprehensive analysis of fiduciary duties owed by the general partner, nor a discussion on the legal concepts of negligence.[1486] Such a discussion is beyond the scope of this paragraph. The intention of this paragraph is to highlight the salient feature of limited liability afforded by the limited partnership and the basic roles of the general partner and limited partner therein. According to Dzulynsky, partners owe a fiduciary responsibility to other partners, which includes, among other things, loyalty, good faith and avoidance of conflicts of interest.[1487] In the context of limited partnerships, this is often viewed as a duty of the general partner to the limited partners.[1488] As mentioned above, section 56 of the Partnership Act of 1996 states that a general partner in a limited partnership has all the rights and powers and is subject to all the restrictions and liabilities of a partner in an ordinary partnership, with certain specified exceptions. According to Dolden, Canadian courts have tended to look to the terms of the limited partnership agreement to determine the extent of the fiduciary duty owed by general partners.[1489] In practice, the partnership agreements typically attempt to address any contemplated activities that may be viewed as inconsistent with such responsibility.[1490] For example in practice, transactions where the general partner has a conflict of interest may be subject to a veto by an investor committee.[1491] However, any exceptions should be addressed with a high degree of specificity, as a blanket exemption from all fiduciary or like duties or like standards is unlikely to be accepted by a Canadian court.[1492]

In *337965 B.C. Ltd v Tackama Forest Products Ltd* the court dealt with the fiduciary obligations of general partners in entering into financing agreements for the limited partnership.[1493] The fiduciary

[1486]In this regard see chapter three. Also Canadian courts would recognise a gross negligence standard, however the distinction between 'ordinary' negligence and 'gross' negligence is less clear than in some other jurisdictions.
[1487]Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 28-33.
[1488]Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 28-33.
[1489]Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at page 27.
[1490]Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at page 27.
[1491]Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 28-33.
[1492]Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at page 27.
[1493]*337965 B.C. Ltd v Tackama Forest Products Ltd* 1992, 91 D.L.R. (4th) 129 (B.C.C.A.).

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duty of the general partner to the limited partners was expressly stated in the limited partnership agreement, namely:

> 'The General Partner and the Managing General Partner will act in a fiduciary capacity towards the Limited Partners and will exercise their powers and discharge their duties under this agreement honestly, in good faith and in the best interests of the Limited Partners.'[1494]

In this case, the limited partnership agreement provided the general partner with the express authority to negotiate with financial institutions on behalf of the limited partnership. The general partner negotiated a financing agreement, which was consistent with this authority; and as a result of the new financing agreement, the general partner derived a benefit, to the detriment to the limited partners.[1495] The limited partners brought an action against the general partner for breach of fiduciary duty and claimed that as the general partner had derived profit through its position as a general partner and a fiduciary of the limited partners, without the consent of the limited partners, it was required to disgorge these profits.[1496] In *337965 B.C. Ltd v Tackama Forest Products Ltd,* the court held that a fiduciary duty arose under both the Partnership Act of 1996 and the terms of the limited partnership agreement, however it held that the nature and extent of the fiduciary duty 'must be found within the four corners of the limited partnership agreement, properly construed'.[1497] The court held that no breach occurred because the acts of the general partner were expressly authorised by the limited partnership agreement and therefore no consent was required.[1498] Nevertheless, the general partners and limited partners to a limited partnership generally have significant flexibility in structuring and documenting their commercial arrangements, despite statutes in a number of Canadian provinces having provisions that prohibits the general partner from taking certain actions without the consent of all limited partners.[1499] For example, in Ontario these prohibitions include prohibitions against any act that makes it impossible to carry on the ordinary business of the limited partnership and against consenting to a judgment against the limited partnership.[1500] In practice, these prohibitions are often ignored, or the limited partnership agreement will address such prohibitions by providing for powers of attorneys in favour of the general partner or requiring approval of only a majority limited partner in such circumstances.[1501]

[1494] *337965 B.C. Ltd v Tackama Forest Products Ltd* 1992, 91 D.L.R. (4th) 129 (B.C.C.A.).
[1495] *337965 B.C. Ltd v Tackama Forest Products Ltd* 1992, 91 D.L.R. (4th) 129 (B.C.C.A.).
[1496] *337965 B.C. Ltd v Tackama Forest Products Ltd* 1992, 91 D.L.R. (4th) 129 (B.C.C.A.).
[1497] *337965 B.C. Ltd v Tackama Forest Products Ltd* 1992, 91 D.L.R. (4th) 129 (B.C.C.A.).
[1498] *337965 B.C. Ltd v Tackama Forest Products Ltd* 1992, 91 D.L.R. (4th) 129 (B.C.C.A.).
[1499] Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 28-33.
[1500] Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 28-33.
[1501] Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 28-33.

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Taxation

In terms of the Canadian Income Tax Act,[1502] a limited partnership is not itself taxable. A limited partnership is generally treated as fiscally transparent for most Canadian income tax purposes such that its income, gains and losses flow through to the partners, retaining their original characterisation.[1503] As limited partnerships are not themselves taxable, there are no exemptions applicable to them.[1504] However, each partner, for example, a pension fund is generally entitled to claim any available tax-exempt or tax-deferred status under the Canadian Income Tax Act.[1505] Nevertheless, the Canadian tax laws that regulate limited partnerships are complex and it is beyond the scope of this thesis to comprehensively detail all material aspects of such laws. However, paragraph 2.1.(b) of chapter four will highlight the key legislated tax concessions that are available to investors and fund managers in terms of the numerous Canadian private equity tax incentive schemes that have been introduced by Canadian policymakers. For example, in Canada numerous tax incentive schemes have been introduced, but they are aimed primarily at small businesses or individual investors who are Canadian taxpayers.[1506]

Chapter four will highlight, for instance, that Canadian-controlled private corporations are entitled to a lower rate of tax deduction on operating income up to a specific threshold; they are also entitled to enhanced investment tax credits for qualified expenditures on scientific research and experimental development; as well as the deferral of an employee's taxable benefit arising from the exercise of share options.[1507] In addition, shareholders of Canadian-controlled private corporations are entitled to a capital gains exemption on a disposition of qualified small business corporation shares.[1508] A Canadian-controlled private corporation is a Canadian corporation that is not listed on a stock exchange and that is not controlled, directly or indirectly, by one or more non-residents of Canada.[1509]

[1502]R.S.C., 1985, (5th Suppl).

[1503]See Carroll, C. and Kay, S. (2011), 'Investment Funds: Jurisdictional Comparisons', First Edition, Sweet and Maxwell Publishers, at pages 49-60. See also Cornelius, P. (2011), 'International Investments in Private Equity: Asset Allocation, Markets, and Industry Structure', 1st edition, Elsevier Publishing, at pages 44-48.

[1504]See Carroll, C. and Kay, S. (2011), 'Investment Funds: Jurisdictional Comparisons', First Edition, Sweet and Maxwell Publishers, at pages 49-60. See also Cornelius, P. (2011), 'International Investments in Private Equity: Asset Allocation, Markets, and Industry Structure', 1st edition, Elsevier Publishing, at pages 44-48.

[1505]R.S.C., 1985, (5th Suppl).

[1506]Cumming, D.J. (2007), 'Government policy towards entrepreneurial finance: Innovation investment funds', Journal of Business Venturing, 22(2), 193-235.

[1507]Cumming, D.J. (2011), 'Public policy and the creation of active venture capital markets', Venture Capital: An International Journal of Entrepreneurial Finance, 13:1, at pages 75-94.

[1508]Cumming, D.J. (2011), 'Public policy and the creation of active venture capital markets', Venture Capital: An International Journal of Entrepreneurial Finance, 13:1, at pages 75-94.

[1509]Brander, J.A., Du, Q. and Hellmann, T.F. (2010b), 'The Effects of Government-Sponsored Venture Capital: International Evidence', NBER Working Paper No. 16521, November 2010. Available at www.nber.org/papers/w16521.pdf, accessed in August 2012.

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Furthermore, the Canadian federal government, as well as specific Canadian provincial governments, provides tax credits to individuals who are Canadian residents in specific provinces and who have invested in what is called a labour-sponsored venture capital corporation ('LSVCC').[1510]

Nevertheless, the limited partnership in Canada, similar to the limited partnerships in the jurisdictions discussed previously in this chapter, remain the predominant legal vehicle for private equity funds because of the combination of limited liability protection; fiscal transparency; and the contractual flexibility in negotiating the partnership agreement. It is evident from the above discussion that the limited partnership structure is not without risks. In order to establish and maintain the protection of limited liability the general and limited partners must fully understand and comply with the provisions of the various Canadian provincial partnership legislation, such as the British Columbia Partnership Act of 1996.[1511] More importantly, the limited partnership agreement should be well drafted and clearly set out the rights and obligations of the general partners and limited partners, because it must at all times ensure that the conduct of the partners is consistent with the provisions of the relevant legislation and avoid disputes among the partners themselves.[1512]

3.6 Conclusion

In concluding this section of the chapter, it is submitted that when considering the commencement of a private equity fund, one needs to consider which vehicle will be best suited to the circumstances. The success of any business may depend upon choosing the correct form of an organisation or business structure. Factors to be taken into account invariably include the number of participants in the business, how the business is to be operated from a management and control point of view, statutory formalities to be complied with, achieving limited liability for participants, the requirement of perpetual succession and, importantly, income tax considerations. Both the partnership and trust lack legal personality. However, both vehicles provide flexibility in respect of income and capital allocation and retention, but still provide a degree of limitation in respect of individual liability.

[1510] Johan, S., Schweizer, D. and Zhan, F. (2014), 'The Changing Latitude: Labor-Sponsored Venture Capital Corporations in Canada', Corporate Governance: An International Review, 22(2), pages 145-161. These are some of the incentives schemes that will be discussed in chapter four.

[1511] As mentioned earlier, Canadian provinces and territories have their own partnership legislation, however similar to the Delaware example, which was discussed in paragraph 3.2 of this chapter, the British Columbia Partnership Act of 1996 was analysed in this paragraph for ease of reference. The reason for this is because British Columbia have a well developed common-law regime governing limited partnerships, which is generally considered the more sophisticated of the Canadian provinces and territories. Furthermore, the provisions contained in the British Columbia Partnership Act of 1996 are much the same as the equivalent legislation in most of the other provinces. In addition, it is beyond the scope of this discussion to analyse all the relevant legislation pertaining to limited partnerships in of all the other provinces and territories of Canada.

[1512] See Dolden, E.A. (1996), 'Partnerships, Limited Partnerships and Joint Ventures: Managing the Risks', Dolden Wallace Folick LLP, June 1996, at page 29.

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Furthermore, when analysing the various legal forms used to structure private equity funds in the UK, Canada, Australia and the US, it is evident that predominantly the same considerations apply as mentioned above. The purpose of the discussion of the various organisational forms used in these foreign jurisdictions is to highlight that despite these jurisdictions having developed sophisticated levels of development this does not imply that, for example, the regulatory system of the US is more efficient than that of South Africa. On the contrary, it is evident from the discussion that the US system is much more complex and cumbersome than that of South Africa and so, at times, unduly complicates the structuring of private equity funds in the US. However, what is clearly evident is that these foreign jurisdictions had significantly contributed towards the development of their respective private equity markets via consistent regulatory reforms. In addition, specific regulatory regimes exist in the US, Canada, Australia and UK which define private equity investment vehicles on a more specific basis, both of which are lacking in South Africa.

In addition, it is evident that the limited partnership is the predominant legal form in the foreign jurisdictions discussed above. There are three primary reasons for this, which have been highlighted throughout the preceding paragraphs of this chapter. Firstly, the limited partnership is fiscally transparent, which means that profits and losses in a limited partnership flow through the fund to the partners, all of whom are taxed on their personal income tax returns. The difference is that the limited partners get to share in the profits and losses, without having to participate in the private equity fund. Secondly, a limited partner's liability for the partnership's debt is limited to the amount of money that such a partner has contributed to the partnership. Thirdly, the limited partnership affords contractual flexibility amongst the general partners and limited partners. The flexibility of the limited partnership allows the participants to enter into express contractual terms that align the incentives of the private equity firm with those of outside investors. A limited partnership is constituted by express contract or by implication from the conduct of the partners; however an express agreement between the partners would obviously be practically more desirable. There are also disadvantages to using the limited partnership, such as the general partners carrying the burden of all the fund's debts and obligations. Also, the general partner has the ability to make decisions on behalf of the private equity fund, and those decisions become the responsibility of all the general partners.

4. Regulatory and Licensing Requirements of a Private Equity Firm

The discussion to follow will highlight the principal regulations and regulatory bodies that would have authority over a private equity fund and its manager in South Africa, US, UK, Australia and Canada. Paragraph four will analyse the key regulatory and licensing requirements, but also the key trends and developments in the relevant areas, highlighting the most significant issues which are current and emerging, both in South Africa and the foreign jurisdictions mentioned above. It is important to note at the outset that this paragraph is not aimed at providing a comparison with South African

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licensing requirements with those in foreign jurisdictions such the US, UK, Australia, and Canada. It is aimed at encouraging best practices that will hopefully lead to more efficient fund structuring in South Africa.[1513]

4.1 South African Regulatory and Licensing Requirements

In South Africa, the Financial Services Board monitors, regulates and supervises the financial services industry through the Financial Advisory and Intermediary Services Act 37 of 2002.[1514] In terms of the provisions of the Financial Advisory and Intermediary Services Act 37 of 2002, the General Code of Conduct for Authorised Financial Service Providers and Representatives was established, making it mandatory for a range of disclosures to be made to clients, when an advisory service is provided.[1515] The General Code of Conduct regulates the provision of advisory and intermediary services by Financial Service Providers, setting out the process for engaging clients. In the General Code of Conduct for Authorised Financial Service Providers and Representatives the purpose of the Financial Advisory and Intermediary Services Act 37 of 2002 is stated as follows:[1516]

> 'The object of this Code is to ensure that clients to whom financial services are rendered subject to this Code will be able to make well informed decisions, that their financial needs regarding financial products are appropriately and suitably satisfied and that for those purposes, discretionary FSPs and their representatives are obliged to comply with the provisions of the Act.'

The regulation and licensing of fund managers in South Africa depends *inter alia* on the type of investors they intend securing, the nature of the services they provide, as well as the type of investment fund structure they intend managing. Nevertheless, the provision of fund management services in South Africa, is largely subject to the provisions of the Financial Advisory and Intermediary Services Act 37 of 2002. Furthermore, private equity firms that intend to secure pension funds as investors must meet the additional requirements set out in the Pension Funds Act 24 of 1956 if their private equity fund(s) are to qualify as 'private equity funds'. The investment regulations in the Pension Funds Act 24 of 1956 permit pension funds to invest in private equity funds and

[1513]Chapter four is a comparative analysis of the extent to which the law impacts the private equity market. The applicable regulatory developments and legislation of the US, UK, Canada and Australia are analysed and compared to the South African position in order to determine whether the South African law can learn anything from these jurisdictions. Chapter four will consider and analyse two key impediments; namely tax legislation and exit alternatives; and show how legislation could effectively address the former and how the lack of exit routes is an impediment to the growth of the South African private equity industry.

[1514]See also paragraph 3 of chapter 5 which provides a broad overview of the current financial services regulatory framework aimed at contextualizing the considerations being proposed in chapter 5.

[1515]Under section 15 of the Financial Advisory and Intermediary Services Act 37 of 2002, the Registrar of Financial Services Providers, published a general code of conduct for authorised financial services providers, and their representatives.

[1516]Part I, Introductory Provisions, of the General code of conduct for authorised financial services providers and representatives, 2003.

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stipulate requirements in order for a private equity fund to qualify for investment by a pension fund.[1517]

It is also important to note as part of this introduction that if a fund manager manages a collective investment scheme, the provision of that service is exempted from regulation in terms of the Financial Advisory and Intermediary Services Act 37 of 2002, as it is subject to regulation in terms of the Collective Investment Schemes Control Act 45 of 2002. However, a private equity fund structured as either a partnership or trust could in theory satisfy all of the requirements of a collective investment scheme and be included to be regulated as such in terms of the Collective Investment Schemes Control Act 45 of 2002 if 'members of the public' are invited and then permitted to invest.[1518] It would be prudent not to trigger the application of the Collective Investment Schemes Control Act 45 of 2002, by inviting or permitting members of the public to invest in the private equity fund because there is no licensing scheme in place in South Africa to regulate private equity funds in terms of the Collective Investment Schemes Control Act 45 of 2002.[1519] In all likelihood the private equity fund would be regarded as unlawful, should the application of the Collective Investment Schemes Control Act 45 of 2002 be triggered.

4.1.1 Financial Advisory and Intermediary Services Act 37 of 2002

The Financial Advisory and Intermediary Services Act 37 of 2002 ('FAIS'), regulates the provision of advice by financial services providers ('FSPs') in South Africa. A person may not act or offer to act as a financial services provider unless that person is authorised by the Registrar of Financial Services Providers to do so. Any person,[1520] may submit an application for authorisation as a financial services provider in South Africa.[1521] In terms of section 1(1) of FAIS a 'financial services provider' ('FSP') is defined as follows:

[1517]'March 2012 Regulations' means the regulations dated 15 March 2012 entitled 'Pensions Fund Act, 1956: Amended Regulation 28 of the Regulations made under Section 36 of the Act: Conditions for Investment in Private Equity Funds Approval in terms of Section 5(2)(e) of the Act' (GN 1 of 15 March 2012).
[1518]A 'collective investment scheme' is defined in part I of the Collective Investment Schemes Control Act 45 of 2002: 'a scheme, in whatever form, including an open-ended investment company, in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio, ...'.
[1519]The Collective Investment Schemes Control Act 45 of 2002 ('CISCA'), came into operation on 3rd March 2003. In summary Collective Investment Schemes ('CIS') are broadly regulated as follows:(1) managers of CISs must be registered in terms of CISCA;(2) managers of CISs must comply with the fit and proper requirements in terms of Board Notice 911 of 2010, issued in terms of CISCA; (3) managers of CISs must comply with capital requirements and provide seed capital for each portfolio they administers (except in respect of exchange traded portfolios listed on an exchange); (4) portfolios must comply with prudential investment guidelines; (5) the prior approval of the Registrar is required for each new portfolio; (6) managers must comply with quarterly reporting requirements; and (7) investors must receive annual reports containing prescribed information.
[1520]Whether domiciled in or outside South Africa.
[1521]See Van Wyk, K. (2011), Regulations and Ethics of South African Financial Markets', The South African Institute of Financial Markets, September 20111, Chapter 4, at pages 66-102.

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> 'means any person, other than a representative, who as a regular feature of the business of such person -
> (a) furnishes advice; or
> (b) furnishes advice and renders any intermediary service; or
> (c) renders an intermediary service.'

The term 'financial services' has a specific meaning in terms of section 1 of FAIS and is defined as:

> '… any service contemplated in paragraph (a), (b) or (c) of the definition of 'financial services provider', including any category of such services.'

In terms of section 1(1) of FAIS 'advice' is defined as follows:

> 'means, subject to subsection (3)(a), any recommendation, guidance or proposal of a financial nature furnished, by any means or medium, to any client or group of clients –
> (a) in respect of the purchase of any financial product; or
> (b) in respect of the investment in any financial product; or
> (c) on the conclusion of any other transaction, including a loan or cession, aimed at the incurring of any liability or the acquisition of any right or benefit in respect of any financial product; or
> (d) on the variation of any term or condition applying to a financial product , on the replacement of any such product, or on the termination of any purchase of or investment in any such product, and irrespective of whether or not such advice –
> (i) is furnished in the course of or incidental to financial planning in connection with the affairs of the client; or
> (ii) results in any such purchase, investment, transaction, variation, replacement or termination, as the case may be, being effected;

In terms of the above definition, the 'advice' must relate to a financial product.[1522] A 'financial product', as defined in terms of FAIS, means, among others: securities and instruments (such as shares in a company, debentures and securitised debt; any money market instrument, any warrant, certificates and other instruments acknowledging, conferring or creating rights to subscribe to, acquire, dispose of, or convert the securities and instruments); participatory interest in one or more collective investment scheme; a long-term and short-term insurance contract; benefits by a pension fund; foreign currency denominated investment instrument (including a foreign currency deposit) and any

[1522] See also section 8(1) of the General Code of Conduct for Authorised Financial Services Providers and Representatives of 2003, which states that one of the duties of an FSP or their representatives, is to identify financial products that will be appropriate to the client's risk profile and financial needs, subject to the limitations imposed on the FSP or any contractual arrangements. The limitations are in relation to the licence categories held by the FSP and contractual arrangements refer to those arrangements with product suppliers.

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other products similar in nature to the financial products described in this paragraph.[1523] However, the term 'advice' under FAIS expressly excludes factual advice given during the procedure for entering into a transaction in respect of any financial product, in relation to the description of a financial product, in answer to routine administrative queries, in the form of objective information about a particular financial product or by the display or distribution of promotional material.[1524] It also excludes an analysis or report on a financial product that does not contain any express or implied recommendation, guidance or proposal that any particular transaction in respect of the relevant product is appropriate to the particular investment objectives, financial situation or needs of a client.[1525]

In terms of section 1(1) of FAIS an 'intermediary service' is defined as follows:

> 'means, subject to subsection (3)(b), any act other than the furnishing of advice, performed by a person for or on behalf of a client or product supplier –
> (a) the result of which is that a client may enter into, offers to enter into or enters into any transaction in respect of a financial product with a product supplier; or
> (b) with a view to –
> (i) buying, selling or otherwise dealing in (whether on a discretionary or non-discretionary basis), managing, administering, keeping in safe custody, maintaining or servicing a financial product purchased by a client from a product supplier or in which the client has invested;
> (ii) collecting or accounting for premiums or other moneys payable by the client to a product supplier in respect of a financial product; or
> (iii) receiving, submitting or processing the claims of a client against a product supplier.'

The interpretation of the definition of 'intermediary service' under FAIS was dealt with by the Supreme Court of Appeal in *Tristar Investments v The Chemical Industries National Provident Fund*.[1526] The Chemical Industries National Provident Fund (the Respondent) entered into an agreement with TriStar Investments (Pty) Ltd (the Appellant), in terms of which Tristar agreed to provide certain services to the Chemical Industries National Provident Fund (the 'Agreement'). Tristar was an authorised FSP, licensed under FAIS to provide advice, but not intermediary services. The Chemical Industries National Provident Fund contended that it was not bound by the Agreement

[1523]In terms of Part 1 Introductory Provisions as per section 1 of FAIS.
[1524]Modise, L., Horak, W. and Van Zuylen, C. (2014), 'Transactions: South Africa', in Private Equity in 29 Jurisdictions Worldwide', contributing editors Cogut, C. and Curbow, W., published by Getting the Deal Through, at pages, at pages 276.
[1525]Modise, L., Horak, W. and Van Zuylen, C. (2014), 'Transactions: South Africa', in Private Equity in 29 Jurisdictions Worldwide', contributing editors Cogut, C. and Curbow, W., published by Getting the Deal Through, at pages, at pages 276.
[1526]*Tristar Investments v The Chemical Industries National Provident Fund* 2013 ZASCA, (59) (Case No. 455/12).

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due to *inter alia* its contention that the Agreement was void because it was unlawful. The unlawfulness, in the present situation, was that Tristar was rendering an intermediary service for which it was not licensed, which was in contravention of section 7 of FAIS. Section 7 of FAIS prohibits a person from acting or offering to act as an FSP unless that person has been issued with a licence to do so. As mentioned above, an FSP is defined in FAIS as a person who, as a regular feature of his or her business, furnishes advice or renders any intermediary service or both. Tristar undertook, *inter alia*, to monitor and evaluate the performance of investments and asset managers, correct any underperformance, and to take appropriate corrective action. In this regard, Nugent JA in *Tristar Investments v The Chemical Industries National Provident Fund*,[1527] stated:

> 'The agreement contemplated that one or more independent asset managers would be appointed to effect the various investments approved by the Fund. Amongst the services TriStar was to provide, under the heading 'Investment policy implementation', were to 'draft detailed asset manager mandates for [the Fund's] domestic and international asset managers', and to 'implement the asset allocation model, investment strategy and asset manager mandates', and to 'negotiate any contractual issues with the current and any new asset managers on behalf of [the Fund], and to 'manage the transition from [the Fund's] current domestic and international portfolios to be created as a result of this process'. I need not set out in detail the various services to be provided under the heading 'Ongoing monitoring and management'. It is sufficient to say that it undertook, amongst other things, to monitor and evaluate the performance of the investments, and the performance of the asset managers, and, in some cases to 'correct any underperformance', and in other cases to 'take appropriate corrective action'. Clearly the 'corrective action' it was to undertake was no more than to ensure that the asset managers adhered to their mandates.'[1528]

The court held that none of the services in terms of the Agreement constituted intermediary services in the ordinary meaning of the definition, and neither did the court see any reason as to why the legislature would have thought it necessary for services of that kind to be regulated. Therefore, Tristar was not required to be licensed to provide the services in terms of the Agreement, and the objection raised by the Chemical Industries National Provident Fund was dismissed. Nugent JA held as follows:

> '[13] Sub-clause (a) of the definition of an intermediary service, properly construed, contemplates acts that directly result in the consequences referred to. To construe it as including any act that indirectly has that result would lead to absurdities. It contemplates a person who stands with a

[1527] *Tristar Investments v The Chemical Industries National Provident Fund* 2013 ZASCA, (59) Case No:455/12.
[1528] *Tristar Investments v The Chemical Industries National Provident Fund* 2013 ZASCA, (59) Case No:455/12 at paragraph 12.

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client (or clients) on the one side, and a supplier of financial products on the other side, acting as the 'go-between' to effect the relevant transactions. Quintessentially, that person is the asset manager, who is mandated to act on behalf of the Fund. As for sub-clause (b), it contemplates a person who manages or administers the relevant financial products.[14] None of the services TriStar undertook to provide falls foul of those provisions. Initially they were to compile and convey the appropriate mandates and instructions to the asset managers, and thereafter to take steps to ensure compliance with their mandates. It was not to bring about the relevant transactions – those would be brought about by the asset managers – nor was it to manage or administer the financial products. So far as it was to manage or administer anything at all, it was to manage and administer no more than the mandates of the asset managers.[15] In my view none of those constitutes 'intermediary services' on the ordinary meaning of the language of the definition. I can also see no reason – and none could be suggested – why the legislature would have thought it necessary for services of that kind to be regulated. In those circumstances TriStar was not required to be licensed to provide them, and the objection raised by the Fund ought to have been dismissed.'[1529]

The importance of this judgment is that one does not require a licence to provide intermediary services, if the services in question do not constitute intermediary services as under FAIS. The Supreme Court of Appeal judgement in *Tristar Investments v The Chemical Industries National Provident Fund* represents an important precedent especially because it held that it cannot be assumed that all services in respect of financial products which do not constitute 'advice' would constitute 'intermediary services', but rather it must be specifically considered whether the services in fact constitute 'intermediary services'.[1530] The restrictive interpretation adopted by the court in interpreting the language used in the definition of 'intermediary service' under FAIS has to be viewed in a positive light. Particularly, as the definition is capable of a broad interpretation. Furthermore, the judgment highlights the principle that intermediary services must be related to a financial product and that the mere monitoring or management of a fund manager will not constitute an intermediary service in terms of FAIS. The same principles would apply to an individual client where an FSP or representative performs a similar function with regard to an asset manager, even though the client in this case was a provident fund.

Nevertheless, it is evident that the term 'financial services' in terms of section 1(1) of FAIS refers to the provision of 'advice' and 'intermediary services'. The definitions mentioned above are some of the definitions contained in FAIS and highlight which specific services are regulated under FAIS and it also makes it very clear which financial products are subject to the provisions of FAIS. Nevertheless, FAIS provides for specific services that may be provided by a licensed FSP, namely

[1529] *Tristar Investments v The Chemical Industries National Provident Fund* 2013 ZASCA, (59) Case No:455/12 at paragraphs 13-15.
[1530] *Tristar Investments v The Chemical Industries National Provident Fund* 2013 ZASCA, (59) Case No:455/12.

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advice only; advice and intermediary services; or intermediary services only. FAIS sets the minimum standards for FSPs and their representatives if they wish to render advisory and intermediary services to the public and therefore it is of the utmost importance that providers understand the basic fundamentals of FAIS compliance.[1531] In addition, the Registrar of Financial Services Providers authorises and supervises various categories of FSPs:[1532]

- Category I: Financial advisers and intermediaries who may not use discretion in the rendering of financial services.
- Category II: Intermediary services in terms of a mandate granting to the FSP discretion regarding the choice of financial products.
- Category IIA: Hedge fund managers.
- Category III: Investment administrators specialising mainly in bulking collective investments on behalf of clients (linked investment services providers).
- Category IV: Assistance business administrators (funeral brokers).

A fund manager may provide advice to its clients.[1533] However, typically a fund manager will provide intermediary services.[1534] Nevertheless, in practical terms, before the fund manager can provide such intermediary services, the fund manager must first be licensed in terms of one of the above mentioned categories.[1535] As from December 2012,[1536] all FSPs providing financial services to private equity funds are required to hold a Category II FSP licence.[1537] FAIS prohibits any person from acting as an FSP unless such a person has been properly licensed.[1538] An authorised FSP may

[1531]Van Zyl, F.H. (2004), 'The Financial Advisory and Intermediary Services Manual', Juta and Company, at 1-11.

[1532]The term 'financial services provider' is wide and the regulated activities diverse, ranging from relatively simple activities, such as selling funeral policies to very complex activities, such as buying a derivative instrument to hedge a portfolio's exposure. Therefore, policymakers introduced requirements appropriate to each category.

[1533]In this general sense.

[1534]As set out in terms of a Category II FSP licence.

[1535]Section 3(1) of the General Code of Conduct for Authorised Financial Services Providers and Representatives of 2003, describes the financial advisory and intermediary service process with several of the steps requiring the presentation of or completion of appropriate documentation. For example, the remuneration to be paid for the financial service have to be established at the initial stage of the professional relationship between the client and the FSP or representative.

[1536]Board Notice 208 of 2012, 13th December 2012, Financial Advisory and Intermediary Services Act 37 of 2002, Exemption of Certain Persons Conducting Financial Services Related Business with Private Equity Funds, No. 35997.

[1537]Category II FSPs must at all times comply with the following requirements, namely the assets (excluding goodwill and other intangible assets and investments in related parties) must exceed liabilities (excluding loans validly subordinated in favour of all other creditors); the FSP must maintain sufficient current assets to cover current liabilities must be maintained; and the FSP must maintain liquid assets equal to 8/52 weeks of annual expenditure must at all times be maintained.

[1538]Prior to the effect of amended Regulation 28 as read with the March 2012 Regulations, SAVCA met with the FSB to seek clarification as to the application of FAIS to private equity funds. The outcomes from this meeting were that SAVCA members should apply for a Category 1 licence for the investment advisor to the private equity fund, provided that the investment advisor does not provide discretionary financial services. If the private equity fund is managed by a discretionary fund manager, then the fund manager will require a Category II licence. In addition, FAIS requires that the Registrar draft and publish codes of conduct for

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also not conduct financial services related business with a person rendering financial services if such person has not also been properly licensed.[1539]

FAIS covers a comprehensive regulatory framework applying to FSPs and it is beyond the scope of this discussion to cover all the related aspects contained in FAIS. For example, some of the important aspects covered in FAIS are:[1540]

- Only fit and proper persons, namely persons who have not been found guilty of dishonesty in the past and who are properly qualified with the requisite experience, will be licensed to conduct business as an FSP.
- FSP or its representative must avoid and where this is not possible, mitigate any conflict of interest between an FSP or representative and the client.[1541]
- FSP, other than a representative, must adopt, maintain and implement a conflict of interest management policy that complies with the provisions of the Act.[1542]
- FSP must be solvent and, in the case of FSPs holding assets or receiving money, must in addition have sufficient current assets to meet current liabilities and maintain a prescribed number of liquid assets, depending on the category of FSP.
- FSP must hold guarantees and fidelity guarantee insurance and professional indemnity insurance depending on the category of FSP and whether it receives or holds clients' cash or financial products.
- FSP must comply with the operational requirements such as having a fixed address and telephone, a bank account, storage and filing facilities and appropriate anti money-laundering control systems.
- FSP must have proper accounting records and be audited annually.
- FSP must, in addition, submit a report by the auditor certifying the amount of cash and market value of assets held on behalf of clients and whether such cash and assets are held separately from its own cash and assets.
- FSP must comply with the General Code of Conduct in addition to the special Code of Conduct applicable to the industry concerned.

However, the determination of fit and proper requirements under FAIS (mentioned above) is an

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authorised FSPs, which upon publication become binding on all FSPs and their representatives to which such codes apply.

[1539]In terms of section 7(1) and (3) of FAIS. In order to protect consumers against inappropriate financial advice, FAIS requires an FSP to register with the Financial Services Board ('FSB'), which issues a licence only when predetermined minimum qualifications are met.

[1540]Van Wyk, K. (2011), Regulations and Ethics of South African Financial Markets', The South African Institute of Financial Markets, September 20111, Chapter 1, at pages 16-17.

[1541]Sec 3(1)(b) and (c), General Code of Conduct as amended by BN 58 of 2010 published on 19 April 2010.

[1542]Sec 3A(2)(a) of General Code of Conduct as amended by BN 58 of 2010 published on 19 April 2010 .

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important aspect to the discussion at hand, and will next be considered in greater detail.

Fit and Proper Requirements

The regulatory requirements in South Africa affecting the private equity fund management industry has had an increase in focus by the regulator (FSB), particularly with regard to the competence of individuals providing financial services.[1543] In order to accommodate the private equity industry within the fit and proper requirements, the FSB acknowledged that what was needed from the private equity industry was information on the appropriate experience and qualifications that should be set for private industry professionals in order to fulfill the fit and proper requirements.[1544] For example, what is the benchmark for the private equity industry? What would investors require from a private equity fund manager in order to raise a fund? Nonetheless, there is currently no specific category of FSP licence tailored for private equity managers in South Africa.[1545] In terms of section 8 of FAIS, the Registrar must determine the requirements with which FSPs, key individuals and representatives of the provider must comply. These requirements are termed the Determination of Fit and Proper Requirements for FSPs and their representatives. In 2006, the Advisory Committee of Financial Services Providers identified the need to review the fit and proper requirements set out in FAIS.[1546] The fit and proper requirements were updated in 2008 in terms of Board Notice 106 of 2008 which came into effect on the 31st December 2008. Subsequently, several amendments have been effected. The fit and proper requirements contain the following sections:[1547]

[1543]At the outset of this discussion under paragraph 4.1.1 of this chapter relating to ‘fit and proper requirements’, it is noted that it was decided not to include a discussion on the South African Fidentia case study, but simply to make reference thereto. The reasons, *inter alia*, are as follows: (i) the Fidentia case was a matter of simple fraud that in a nutshell fell squarely outside the scope of this thesis; (ii) the media references to a Fidentia ‘private equity portfolio’ were misleading because such a supposed portfolio was a collection of shares held in companies which were not registered in investors' names or in the name of a nominee company. The shares held in companies in the supposed ‘private equity portfolio’ were either held in the name of Fidentia Asset Management or the names of key individuals associated with Fidentia Asset Management; (iii) private equity consists of investments in unlisted investee companies, with an investment horizon of between five and seven years after which the private equity manager will ‘exit’ the underlying investee company. This strategy was missing from the Fidentia case study; (iv) at the time of the Fidentia scandal, the prevailing South African regulations restricted the maximum amount to 5% of the total fund size that pension funds could allocate to private equity. The Financial Services Board (FSB) in its inspection report stated that R695 million of the R1,6 billion consolidated client assets under management of Fidentia Asset Management was in private equity which was in excess of the 5% limit; (v) Fidentia Asset Management did not use acceptable accounting procedures; (vi) Fidentia Asset Management operated outside the South African Regulatory and Licensing Requirements; and (vii) the actual pension funds’ mandates were not to invest in private equity. However, it could be argued that should there have been adequate regulatory and licensing requirements in place at the time, the negative impact of the Fidentia case would in all likelihood have been minimised in the least.

[1544]‘SAVCA’s approaches to the FSB on FAIS Exemptions’, 17th August 2009.

[1545]The FSB is seeking to introduce a category of FSP licence specifically for the private equity industry and the prelimary draft of the Code of Conduct for Private Equity Managers is largely based on several of the European Union’s Alternative Investment Fund Managers Directive.

[1546]Board Notice 91 of 2006, Financial Advisory and Intermediary Services Act 37 of 2002, Determination of Fit and Proper Requirements for Financial Services Providers, 2006, No. 29131.

[1547]Available at www.fsb.co.za/Departments/fais/requirements/Pages/requirements.aspx, accessed at August 2016.

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- Honesty and Integrity requirements that are applicable to all FSPs, key individuals, representatives and compliance officers.
- Competency requirements that consist of experience and qualification requirements that are applicable to all FSPs, key individuals and representatives.
- Operational ability requirements that are applicable to all FSPs, key individuals and representatives.
- Solvency requirements that are applicable to the FSP.

Section 6A(1) to (4) of FAIS, relating to fit and proper requirements, reads as follows:

‘(1) The registrar, for purposes of this Act, by notice in the Gazette

(a) must –

(i) classify financial services providers into different categories;

(ii) determine fit and proper requirements for each category of providers; and

(iii) in each category of providers determine fit and proper requirements for –

(aa) key individuals of providers;

(bb) representatives of providers;

(cc) key individuals of representatives of providers; and

(dd) compliance officers; and

(b) may determine fit and proper requirements for providers, key individuals, representatives, key individuals of representatives and compliance officers in general.

(2) Fit and proper requirements may include, but are not limited to, appropriate standards relating to –

(a) personal character qualities of honesty and integrity;

(b) competence, including –

(i) experience;

(ii) qualifications; and

(iii) knowledge tested through examinations determined by the registrar;

(c) operational ability;

(d) financial soundness; and

(e) continuous professional development.

(3) Different fit and proper requirements may be determined for providers, representatives and compliance officers that are natural persons and for those that are partnerships, trusts or corporate or unincorporated bodies.

(4) The registrar may, by notice in the *Gazette*, amend the fit and proper requirements from time to time, and a provider, key individual, representative, key individual of a representative and compliance officer must comply therewith such period as determined by the registrar.’

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Section 8 of FAIS is applicable to FSPs and key individuals with regard to the authorisation of FSPs, who are responsible for managing or overseeing the activities of an entity rendering any financial service. Section 8(1) of FAIS reads as follows:

> 'An application for an authorisation referred to in section 7(1), including an application by an applicant not domiciled in the Republic, must be submitted to the registrar in the form and manner determined by the registrar by notice on the official web site, and be accompanied by information to satisfy the registrar that the applicant complies with the fit and proper requirements determined for financial services providers or categories of providers, determined by the registrar by notice in the *Gazette*, in respect of –
> (a) personal character qualities of honesty and integrity;
> (b) competence;
> (bA) operational ability; and
> (c) financial soundness.'

According to section 8 of FAIS, authorisation of financial service providers or categories of providers, is subject to the satisfaction of the Registrar of FSPs that the applicant complies with the fit and proper requirements.[1548] In addition, such fit and proper standards apply to individuals of the FSP and the FSPs themselves. Section 8(1A) of FAIS reads as follows:

> 'If the applicant is a partnership, trust or corporate or unincorporated body, the requirements in paragraphs (a) and (b) of subsection (1) do not apply to the applicant, but in such a case the application must be accompanied by additional information to satisfy the registrar that every person who acts as a key individual of the applicant complies with the fit and proper requirements for key individuals in the category of financial services providers applied for, in respect of –
> (a) personal character qualities of honesty and integrity;
> (b) competence; and
> (c) operational ability,
> (d) to the extent required in order for such key individual to fulfil the responsibilities imposed by this Act.'

[1548]In December 2015, the Registrar, in a Memorandum for Proposed Amendments to Fit and Proper Requirements for Financial Service Providers and Representatives, 2015 ('the Memorandum'), announced the intention to make amendments to the Fit and Proper requirements. The proposed amendments will be effected by repealing the Notice on Determination of Qualifying Criteria and Qualifications for Financial Service Providers Number 1 of 2008; and determining new Fit and Proper requirements for FSP, Key Individuals and Representatives. These changes have been proposed to align the Fit and Proper Requirements with the competency framework applicable to FSPs, their Key Individuals and Representatives. Available a twww.fsb.co.za/departments/fais/communication/documents/explanatory% 20memorandum%20for%20proposed%20amendments%20to%20fit%20and%20proper%20requirements%20for%20fsps%20and%20representatives,%202015.pdf, accessed in December 2016.

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Representatives, who are employed by authorised FSPs and render a financial service for and on behalf of such FSP, must comply with section 13 of FAIS which sets out the qualifications of representatives and the duties of FSPs.[1549] Section 13(1) to (2) of FAIS reads as follows:

> '(1) A person may not –
>
> (a) carry on business by rendering financial services to clients for or on behalf of any person who –
>
> (i) is not authorised as a financial services provider; and
>
> (ii) is not exempted from the application of this Act relating to the rendering of a financial service;
>
> (b) act as a representative of an authorised financial services provider, unless such person –
>
> (i) prior to rendering a financial service, provides confirmation, certified by the provider, to clients
>
> (aa) that a service contract or other mandate, to represent the provider, exists; and
>
> (bb) that the provider accepts responsibility for those activities of the representative performed within the scope of, or in the course of implementing, any such contract or mandate; and
>
> (iA) meets the fit and proper requirements; and
>
> (ii) if debarred as contemplated in section 14, complies with the requirements determined by the registrar by notice in the *Gazette*, for the reappointment of a debarred person as a representative; or
>
> (c) render financial services or contract in respect of financial services other than in the name of the financial services provider of which such person is a representative.
>
> (2) An authorised financial services provider must –
>
> (a) at all times be satisfied that the provider's representatives, and the key individuals of such representatives, are, when rendering a financial service on behalf of the provider, competent to act, and comply with –
>
> (i) the fit and proper requirements; and
>
> (ii) any other requirements contemplated in subsection (1)(b)(ii);
>
> (b) take such steps as may be reasonable in the circumstances to ensure that representatives comply with any applicable code of conduct as well as with other applicable laws on conduct of business .'

In addition, FAIS imposes accounting and audit requirement duties on FSPs, such as FSPs having to submit financial statements and compliance reports annually to the FSB. This is to enable the FSB

[1549]Section 13 of FAIS. Under Chapter III: Representatives of Authorised Financial Services Providers, Qualifications of representatives and duties of authorised financial services providers.

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to determine whether the FSP complies with the solvency requirements of the determination of fit and proper requirements set out above. For example, section 19(2) of FAIS reads as follows:

> '(a) An authorised financial services provider must cause the statements referred to in subsection (1)(b) to be audited and reported on in accordance with auditing pronouncements as defined in section 1 of the Auditing Professions Act, 2005 (Act No. 26 of 2005) by an external auditor approved by the registrar.
>
> (b) the financial statements must -
>
> (i) fairly represent the state of affairs of the provider's business;
>
> (ii) refer to any material matter which has affected or is likely to affect the financial affairs of the provider; and
>
> (iii) be submitted by the authorised financial services provider to the registrar not later than four months after the end of the provider's financial year or such longer period as may be allowed by the registrar.'

A further consideration relates to continuous professional development. Board Notice 106 of 2008 under FAIS increased the minimum level of competence required by FSPs, key individuals and representatives. Prior thereto, FSPs, key individuals and representatives required a minimum level of competence and was examined on a once off basis and not on a continuous basis.[1550] However, in terms of Board Notice 106 of 2008, an FSP, a key individual and/or representative must meet the continuous professional development requirements. They must obtain a number of prescribed credits over a three year period, via for example formal studies, workshops, conferences and seminars, which have to be approved by the FSB. The regulatory examinations have been introduced in terms of Board Notice 106 of 2008.[1551] In addition, the qualification requirements vary according to the category in which the FSP falls.[1552]

[1550] All sole proprietors and key individuals must meet the qualification requirements when they apply to the Registrar for authorisation as an authorised FSP or approval as a key individual.

[1551] These examinations consist of two levels. The purpose of the examination requirement is to ensure that any person who acts as a key individual or representative is able to provide the relevant and necessary information to consumers. Level 1 is a legislative examination addressing the legal obligations that are imposed on a sole proprietor, key individual and representative. This includes FAIS, Code of Conduct and Anti-Money laundering requirements. Level 2 addresses product specific knowledge.

[1552] Category I refers to all other persons other than persons referred to in Categories II, IIA, III and IV. Category II refers to persons who are authorised as discretionary FSPs whereas persons who are authorised as hedge fund FSPs fall under Category IIA. Category III refers to persons who are authorised as administrative FSPs and persons who require licences as Assistance Business FSP falls under Category IV. The entry level qualification for an FSP (who is a sole proprietor) and key individuals in respect of Category I and IV is Matric and a fully recognised qualification as determined by the Registrar by notice in the Gazette. However, a representative of the same category can be appointed even if they meet entry level requirements, provided that they work under supervision of an authorised FSP being a natural person or a representative or key individual of the provider who meets the relevant requirements set out in Board Notice 104 of 2008, until meeting the qualification requirements. An FSP (who is a sole proprietor) and key individual must meet the entry level requirement of a Bachelors degree or equivalent qualification from the recognised qualification list for Categories II, IIA and III.

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Nevertheless, it is evident from the discussion thus far that South African policymakers have attempted to set a minimum standard that would be imposed on FSPs. It is submitted that these minimum entry requirements, such as the determination of fit and proper requirements are necessary in developing the local financial services market because it encourages the adherence to acceptable ethical standards.

In *Financial Services Board v Barthram and Another*,[1553] the Supreme Court of Appeal delivered a judgment highlighting that representatives of FSPs must be honest and people of integrity or face being disbarred from ever working in the financial services industry. The case related to Mr PGE Barthram who was employed by Discovery Life Limited to market and sell its products and policies, and to provide advice and intermediary services in relation to the products and policies provided by Discovery. Discovery conducts its business as an FSP under FAIS, and therefore is required to uphold the qualities of honesty and integrity. Barthram purported to resign from Discovery and commenced employment a day later with Old Mutual Life Insurance Limited. As a result, Discovery's chief compliance officer notified Barthram that Discovery had taken a decision to notify the Registrar of Financial Services Providers that Barthram had failed to comply with the fit and proper requirements under FAIS for the continued appointment as a Representative for Discovery. Section 14(3) of FAIS provides that an authorised FSP must within a period of fifteen days after the removal of the name of a Representative from the register as contemplated in section 14(1) of FAIS, inform the Registrar in writing thereof and provide the Registrar with the reasons for the debarment in such format as the Registrar may require. The Registrar may then make known any such debarment and the reasons therefore by notice in the Gazette or by means of any other appropriate public media.[1554]

Following the notice to Barthram, Discovery withdrew Barthram's authority to act on its behalf and removed his name from the register of Representatives. In Discovery's notice, it highlighted the reasons for the removal as 'honesty and integrity'. On receipt of the notice from Discovery, the Registrar of Financial Services Providers listed Barthram on its website as a debarred Representative, stating that Barthram 'does not comply with personal character qualities of honesty and integrity'. The action by the Registrar of Financial Services Providers disbarred Barthram from working in the industry as a whole. Section 14(1) of FAIS makes provision for the debarment of financial services representatives and requires that an authorised FSP must ensure that any Representative who no longer complies with the 'fit and proper' requirements referred to in section 13(2)(*a*) read with section 8(1), or has contravened or failed to comply with any provision of FAIS in a material manner, is prohibited by such provider by the withdrawal of any authority to act on behalf

[1553] *Financial Services Board v Barthram and Another* 2015, 96, SCA (Case No. 20207/2014).

[1554] Section 14(2) of FAIS states that 'for the purposes of the imposition of a prohibition contemplated in subsection (1), the authorised financial services provider must have regard to information regarding the conduct of the representative as provided by the registrar, the Ombud or any other interested person.'

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of the FSP, and that the Representative's name is removed from its register referred to in section 13(3) of FAIS.

Barthram filed an application in the North Gauteng High Court, Pretoria to review and set aside his debarment, and although Discovery opposed the review application, the Registrar did not. The High Court decided in favour of Barthram and held Discovery and the Registrar had failed to recognise the distinction between debarment by FSPs and debarment by the Registrar. The High Court held that the debarment by a FSP effectively means that the Representative can no longer represent that particular FSP, whereas debarment by the Registrar precludes the Representative from rendering financial services on behalf of any FSP. The High Court judgment meant that Barthram should have only been debarred from representing Discovery, and not the entire financial services industry. One of the consequences of the High Court judgment was that Representatives who had been previously disbarred from the entire industry because they had been disbarred by one FSP could approach the Registrar and demand reinstatement to the Registrar of Representatives so that they can work for other FSPs. This led the Registrar to appeal the decision of the High Court. The Registrar argued that the High Court had erred in its finding that the effect of a debarment of Barthram by Discovery was that he was only precluded from rendering financial services to the public on behalf of Discovery. In *Financial Services Board v Barthram and Another*,[1555] Ponnan JA stated:

> 'The court below appears to have misinterpreted the legal effect of a debarment in terms of s 14(1) in holding that it precludes the representative from acting as such only in respect of the debarring FSP. The absurdity of such an approach is patent. The debarment of the representative by an FSP is evidence that it no longer regard the representative as having either the fitness and propriety or competency requirements. A representative who does not meet those requirements lacks the character qualities of honesty and integrity or lacks competence and thereby poses a risk to the investing public generally. Such a person ought not to be unleashed on an unsuspecting public and it must therefore follow that any representative debarred in terms of s 14(1), must perforce be debarred on an industry-wide basis from rendering financial services to the investing public.'[1556]

The Registrar succeeded in its appeal and the case highlights the fact that failure by a Representative to uphold the standards of integrity and honesty will result in a Representative not only being debarred by his employer but by the Registrar on an industry wide basis.

[1555] *Financial Services Board v Barthram and Another* 2015, 96, SCA, Case No. 20207/2014.
[1556] *Financial Services Board v Barthram and Another* 2015, 96, SCA, Case No. 20207/2014 at paragraph 16.

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In *Pienaar v Registrar of Financial Services and Another*,[1557] the court judgment led to the reinstatement of a representative who had been debarred. In this case a distinction had been made between the two types of debarments, one where the FSP initiates the debarment in terms of Section 14(1) of FAIS as stated above; and another in terms of section 14A of FAIS, which applies when the FSB effects the debarment. Section 14A(1) to (3) of FAIS reads as follows:

> '(1) The registrar may, subject to subsection (2), at any time debar a person, including a representative, for a specified period from rendering financial services if satisfied on the basis of available facts and information that the person –
>
> (a) does not meet, or no longer meets, the requirements contemplated in section 8(1)(a); or
>
> (b) has contravened or failed to comply with any provision of this Act.
>
> (2) The provisions of section 9(2) regarding a decision to suspend a licence, apply with the necessary changes to the debarment of a person contemplated in subsection (1).
>
> (3) An authorised financial services provider must within a period of five days after being informed by the registrar of the debarment of a representative or key individual, remove the names of that representative and key individuals from the register as contemplated in section 13 (3).
>
> (4) The registrar may make known any such debarment and the reasons therefor, or the lifting thereof, by notice on the official web site or by means of any other appropriate public media.'

In *Pienaar v Registrar of Financial Services and Another,*[1558] the FSP initiated the debarment in terms of Section 14(1) of FAIS. In the case, the FSB indicated that its duty was to regulate the FSP who, in turn, was obliged to ensure that its Representatives complied with the requirements of FAIS. In *Pienaar v Registrar of Financial Services and Another,*[1559] the FSB stated that it:

> ' ... is not required to evaluate or adjudicate on the reasonableness, validity or otherwise of the reasons for the debarment.'[1560]

However, that it had an obligation to:

> '…ensure that a financial services provider acts in accordance with the provisions of the Act. As such, the Registrar may engage a financial services provider to determine whether a debarment was effected in accordance with the requirements of section 14(1) of the FAIS Act.' [1561]

[1557] *Pienaar v Registrar of Financial Services and Another*, 2013, 37 ZAECPEHC, (Case No. 629/2013).
[1558] *Pienaar v Registrar of Financial Services and Another*, 2013, 37 ZAECPEHC, (Case No. 629/2013).
[1559] *Pienaar v Registrar of Financial Services and Another*, 2013, 37 ZAECPEHC, (Case No. 629/2013).
[1560] *Pienaar v Registrar of Financial Services and Another*, 2013, 37 ZAECPEHC, (Case No. 629/2013).
[1561] *Pienaar v Registrar of Financial Services and Another*, 2013, 37 ZAECPEHC, (Case No. 629/2013).

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Therefore, the request for debarment must relate to the fit and proper status of the Representative, and not another reason. These reasons mentioned above also guide the Registrar's decision whether or not to grant the request and place the representative on the register of debarred representatives. In *Pienaar v Registrar of Financial Services and Another*,[1562] the court found that the supporting documentation, submitted with the debarment request, was insufficient evidence for the reason given for the debarment. In this case the debarment process was used to attain a different outcome to what was intended in terms of FAIS. In addition, Mageza AJ in *Pienaar v Registrar of Financial Services and Another*[1563] referred to a requirement in the Promotion of Administrative Justice Act 3 of 2000 that an individual is entitled to just and reasonable procedure. Mageza AJ stated as follows:

> 'Section 3(1) of the Promotion of Administrative Justice Act (the Act) requires administrative action which materially adversely affects the rights or legitimate expectations of any person to be procedurally fair. A compliance officer in the position of second respondent must provide any such person in terms of section 3(2)(b) of the Act adequate notice of the nature and purpose of the administrative action; reasonable opportunity to make representations; notice of any right of review and right to request reasons for the administrative action. In terms of section 6 of the Act a court may review action taken by an administrator who was biased and/or where such action was procedurally unfair. In receiving the information and carrying out the public function of recording the details of the debarment and publishing a notice in the Government Gazzette for public information the first respondent concurrently carries out a public function and must act consonant with procedural fairness.'[1564]

Furthermore, Mageza AJ stated that:

> 'Section 14(1) does not authorise unlawful acts either in respect of the conduct of the financial services provider or the first respondent (the FSB).'[1565]

Therefore, once a debarment is completed, the FSB is not empowered to undo it and this can only be nullified by the court such as in *Pienaar v Registrar of Financial Services and Another*.[1566] This would of course have serious financial implications for someone who had been debarred unfairly, and is not allowed to operate in the industry for the period prescribed under the debarment conditions. Mageza AJ was critical of the FSB as the court held that the FSB did not follow its own

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[1562] *Pienaar v Registrar of Financial Services and Another*, 2013, 37 ZAECPEHC, (Case No. 629/2013).
[1563] *Pienaar v Registrar of Financial Services and Another*, 2013, 37 ZAECPEHC, (Case No. 629/2013).
[1564] *Pienaar v Registrar of Financial Services and Another*, 2013, 37 ZAECPEHC, (Case No. 629/2013). at paragraph 25.
[1565] *Pienaar v Registrar of Financial Services and Another*, 2013, 37 ZAECPEHC, (Case No. 629/2013), at paragraph 24.
[1566] *Pienaar v Registrar of Financial Services and Another*, 2013, 37 ZAECPEHC, (Case No. 629/2013).

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due process. If it had, it would in all likelihood have not debarred the Representative. Mageza AJ stated as follows:

> 'First respondent failed to act lawfully by debarring applicant without determinable reason and exacerbated the situation by undertaking what I view as an inexplicable excursion to search for reasons post effecting the debarment. Its own letter dated 5 November 2012 acknowledged the letter requesting the debarment and with an alarming innocence and lack of consciousness of its duties, assured her that it had recorded the debarment of applicant and had entered this in its central representative register 'as per your notification in the letter referred to above'. In this Court first respondent advanced differing alternative premises in justifying its conduct. First it denies that it has a role to play in the process of a debarment by a requester and states that 'any aggrieved individual must address such grievance with the financial services provider.' That, 'the Registrar is not required to evaluate or adjudicate on the reasonableness, validity or otherwise of the reasons for debarment' but nonetheless it acknowledges that it has a duty to ensure the financial service provider acts within the terms of the FAIS Act and the law. The first respondent then makes the startling averment that Ms van Rooyen furnished it with reasons and, 'The reasons for the debarment were set out in a form used by the Registrar's office for this purpose' and, 'Attached to the form was a notice of motion (without any founding affidavit) in Case No 19761/2012 of the Western Cape High Court, in which van Rooyen figured as applicant and sought interdictory relief against Applicant (First Respondent in that matter) not to interfere in the affairs of Second Respondent.[17] I do not agree with this assertion made in first respondent's papers. In the first place, the prescribed form referred to by first respondent and annexed is no more than a sterile and bland document requiring only the personal details of the compliance officer and representative sought to be debarred. All that Ms van Rooyen had done in addition was to simply tick the 'Honesty and Integrity' box or column but failed to attach any report of a duly convened hearing or forensic investigative report from which the first respondent could have seen detail resembling reasons. There were none. The fact such a material assertion, is made by an officer charged with the responsibility to independently navigate the obligations set out in the FAIS Act and enforce compliance therewith, is disturbing.'[1567]

The irony of this case was that had the Regulator applied its mind properly and followed due process, it would have arrived at the same conclusion as the High Court, because the person requesting the debarment may well have found herself in trouble, based on the principles of honesty and integrity. In essence, once an employer determines that the Representative is not fit and proper the Representative may be barred from ever providing financial services to the investing public in South Africa. However any disbarment must be preceded by due process. Overall, the case enhances

[1567] *Pienaar v Registrar of Financial Services and Another*, 2013, 37 ZAECPEHC, (Case No. 629/2013), at paragraphs 16-17.

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protection for the investing public and clarifies the implications of disbarment of a Representative by his employer.

In *Hollenbach v Registrar of Financial Services and Another*,[1568] the Appeal Board had to consider, in a nutshell, the nature and effect of an invalid debarment by an FSP of a representative. The Appeal Board in the *Hollenbach*[1569] case stated that this question was answered by the authoritative judgment in *Bathram*[1570] discussed above. The Appeal Board in *Hollenbach* stated:

> 'The question was answered in Bathram (supra) at [15]:
>
> > "A debarment of a representative is terms of s 14(1) is complete when the FSP has withdrawn the representative's authority to act on its behalf and has removed such person's name from its own register in terms of s 13(3). Moreover, the Registrar only gets to learn of a repesenative's debarment, after the event, on being informed of such by the FSP in terms of s 14(3). Upon removal of the representative's name from the FSPs register, the FSB's central register is correspondingly updated."
>
> The court added at [16] that –
>
> > "it must therefore follow that any representative debarred in terms of s 14(1), must perforce be debarred on an industry-wide basis from rendering financial sercices to the investing public."
>
> This means that the decision to debar is that of the FSP and not the Registrar. Once that has taken place s 14(3) of the Act kicks in, requiring the Registrar to update the central register:
>
> > "(a) The authorised financial services provider must within a period of 15 days after the removal of the names of a representative and key individuals from the register as contemplated in subsection (1), inform the registrar in writing thereof and provide the registrar with the reasons for the debarment in such format as the registrar may require. (b) The registrar may make known any such debarment and the reasons therefor by notice on the official web site or by means of any other appropriate public media." '[1571]

[1568] *Hollenbach v Registrar of Financial Services and Another*, 2016, Appeal Board of the Financial Services Board, (Case No. A9/2016), at paragraphs 11-15.
[1569] *Hollenbach v Registrar of Financial Services and Another*, 2016, Appeal Board of the Financial Services Board, (Case No. A9/2016), at paragraphs 11-15.
[1570] *Financial Services Board v Barthram and Another* 2015, 96, SCA (Case No. 20207/2014), at paragraphs 15-16.
[1571] *Hollenbach v Registrar of Financial Services and Another*, 2016, Appeal Board of the Financial Services Board, (Case No. A9/2016), at paragraphs 15-18.

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Therefore, the Appeal Board in *Hollenbach v Registrar of Financial Services and Another,*[1572] dismissed the Appellant's appeal on the grounds that the two jurisdictional facts required to update the register have been satisfied. Firstly, that the FSP must inform the Registrar of the debarment; and secondly that the FSP must provide the Registrar with reasons for the debarment.[1573] The Appeal Board in *Hollenbach* stated:

> 'It is not disputed that these jurisdictional requirements were satisfied.'[1574]

According to Slabbert, the requirement for being considered a 'fit and proper' person is neither defined nor described in legislation, and given the lack of definition, it has to be interpreted in a subjective manner.[1575] Slabbert argues that:[1576]

> ' ... what exactly a 'fit and proper' person is not defined or described in legislation or regulations. It is commonly accepted that in order to be 'fit and proper' a person must show integrity, reliability and honesty, as these are the characteristics which could affect the relationship ... Although the burden of proof is on the applicant to prove that he or she is a 'fit and proper' person to enter the ... profession, the decision remains essentially a discretionary value-judgement on the part of seniors.'[1577]

[1572]*Hollenbach v Registrar of Financial Services and Another*, 2016, Appeal Board of the Financial Services Board, (Case No. A9/2016), at paragraph 18.

[1573]*Hollenbach v Registrar of Financial Services and Another*, 2016, Appeal Board of the Financial Services Board, (Case No. A9/2016), at paragraph 18.

[1574]*Hollenbach v Registrar of Financial Services and Another*, 2016, Appeal Board of the Financial Services Board, (Case No. A9/2016), at paragraph 18.

[1575]Slabbert, M. (2011), 'The Requirement of Being a 'Fit and Proper' Person for the Legal Profession', PELJ, 14(4) at 209. Slabbert's article largely related to the 'fit and proper' requirements with regard to the legal profession, including reference to case law. Despite the discussion at hand being with regard to the financial services industry, the principles relating to the conduct and character of legal and investment professionals in terms of 'fit and property' are largely similar.

[1576]Slabbert, M. (2011), 'The Requirement of Being a 'Fit and Proper' Person for the Legal Profession', PELJ, 14(4), at 212.

[1577]See Slabbert, M. (2011), 'The Requirement of Being a 'Fit and Proper' Person for the Legal Profession', PELJ, 14(4), at pages 212-213. Slabbert argues that such discretionary value judgments have been politically influenced in South Africa in the past. For example, Mahatma Gandhi's application to be admitted as an advocate of the High Court of Natal was opposed by the Law Society of Natal because he was a person of Indian origin and as such not a 'fit and proper' person to practise law. See *In re Gandhi* 1894 NLR 263. Furthermore, in *Incorporated Law Society v Wookey* 1912 AD 623, Madeline Wookey's articles of clerkship were refused because she was a woman and women were seen to be improper for legal practice. Innes ACJ, Solomon J and J de Villiers JP upheld an appeal by the law society that the respondent should not be admitted as an attorney because she was a female. Innes ACJ addressed the question to counsel appearing for the respondent: 'How can a married woman appear for another and not for herself?' at 626. The full bench of the then Appellate Division relied on Roman Dutch law and its exclusion from legal practice of persons who could be termed 'unfit and improper' including, deaf, the blind, pagans, Jews, persons who denounced the Christian Trinity and women. Also during the years before South Africa became a democracy, various Law Societies brought applications to have lawyers involved in the struggle against apartheid removed from the roll of attorneys or advocates mainly on the basis that they were not 'fit and proper' persons because they violated the legislation of the country. See also *Society of Advocates of SA (Witwatersrand Division) v Fischer* 1966 (I) SA 133 (T); *Ex Parte Krause* 1905 TS 221; *Incorporated Law Society, Transvaal v Mandela* 1954 (3) SA 102

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Furthermore:

> 'The test to determine whether or not an applicant is indeed 'fit and proper' … is not perfect, nor is it any guarantee … would act morally and ethically in future, yet it is a means of screening … and it must be enhanced by further training through seminars or workshops on ethical behaviour or morality within the … profession. The 'fit and proper' test could be seen in the same light as the 'I do' that marriage partners exchange during a wedding ceremony. By saying 'I do' the partners accept the responsibility to try to make a success of the marriage. They know that circumstances and personalities might change in future, yet a commitment is made. If the 'fit and proper' person test is to remain the moral scrutiny of prospective lawyers, its consequences and meaning should be communicated to each and every candidate so that all of them know exactly what moral conduct is expected of them not only shortly after admission but also well into the future. This knowledge should be followed up by extra training in ethics. To remind them of their respective Codes of Conduct or Ethical Rules is not enough to guarantee acceptable behaviour.'[1578]

Slabbert quotes the President of the Supreme Court of Appeal, Harms J in *Malan and another v The Law Society, Northern Provinces*,[1579] when he stated:[1580]

> 'The exercise of this discretion is not bound by rules and precedents consequently have a limited value. All they do is to indicate how other courts have exercised their discretion in the circumstances of a particular case. Facts are never identical, and the exercise of a discretion need not be the same in similar cases. If a court were bound to follow a precedent in the exercise of its discretion it would mean that the court has no real discretion.'[1581]

It is submitted that the financial services industry in South Africa has put in place measures to ensure that FSPs employ individuals who are sufficiently qualified to perform their duties. The fit and proper requirements discussed above not only encourage the employment of fit and proper individuals but also improve public confidence in the employees and the quality of services that are being offered, particular with regard to private equity firms. Prior to the effect of amended Regulation 28 as read with the March 2012 Regulations discussed earlier,[1582] the South African Venture Capital Association

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(T); *Matthews v Cape Law Society* 1956 (1) SA 807 (C); *Incorporated Law Society, Natal v Hassim* 1976 (4) SA 332; *Ex Parte Moseneke* 1979 (4) SA 884 (T); *Natal Law Society v Maqubela* 1986 (3) SA 849 (N).

[1578] Slabbert, M (2011), 'Requirement of Being a 'Fit and Proper' Person for the Legal Profession', PELJ, 14(4) at 225-226.

[1579] *Malan and another v The Law Society, Northern Provinces* 2009, 1 All SA 133 (SCA).

[1580] Slabbert, M. (2011), 'The Requirement of Being a 'Fit and Proper' Person for the Legal Profession', PELJ, 14(4) at 212.

[1581] See also *Naylor and another v Jansen* 2007 (1) SA 16 (SCA), at paragraph 21.

[1582] 'March 2012 Regulations', the regulation dated 15 March 2012 entitled 'Pensions Fund Act, 1956: Amended

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('SAVCA') met with the FSB on 13th August 2009 to seek clarification as to the application of FAIS to private equity funds, as well as to apply for an exemption for private equity advisors from compliance with the provisions of FAIS and its subordinate legislation.[1583] The outcomes from this meeting were that SAVCA members should apply for a Category 1[1584] licence for the investment advisor to the fund, provided that the investment advisor does not provide discretionary financial services. If the fund is managed by a discretionary fund manager, then the fund manager will require a Category II licence.[1585] The FSB at the meeting also acknowledged that the fit and proper requirements were inappropriate for the private equity industry.[1586] In order to accommodate the private equity industry within the fit and proper requirements, the FSB stated that what was needed from the private equity industry was information on the appropriate experience and qualifications that should be set for private equity industry professionals in order to fulfill the fit and proper requirements. For example, what is the benchmark for the private equity industry? What would investors require from a private equity fund manager in order to raise a fund? In the meeting the FSB confirmed that key individuals rendering financial services and representatives are required to write a regulatory exam and a product–knowledge exam.[1587] The FSB acknowledged that the product-knowledge exam for 'securities and financial instruments' was not appropriate for private equity professionals and indicated a willingness to set a specific product-knowledge exam for private equity professionals (which would be done in conjunction with SAVCA).[1588] The FSB stated that the regulatory exam should be less burdensome if the private equity professionals are only required to have knowledge on a limited code of conduct and not the general code of conduct.[1589] The outcomes from this meeting laid the foundation for the March 2012 Regulations.

Currently, FAIS requires that the Registrar draft and publish codes of conduct for authorised FSPs, which upon publication become binding on all FSPs and their representatives to which such codes apply.[1590] Section 16(1) of FAIS further provides that a code of conduct must be drafted so that an authorised FSP and its representatives are obliged by the provisions of the code to *inter alia* (a) act honestly and fairly, and with due skill, care and diligence, in the interests of the clients and the integrity of the financial services industry; (b) act with circumspection and treat clients fairly in a situation of conflicting interests; and (c) comply with all applicable statutory and common law requirements applicable to the conduct of the business. If there is any contravention of FAIS by a

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Regulation 28 of the Regulations under Section 36 of the Act: Conditions for Investment in Private Equity Funds Approval in terms of Section 5(2)(e) of the Act' (Government Notice 1 of 15 March 2012).
[1583]'SAVCA's approaches to the FSB on FAIS Exemptions', 17th August 2009. Available at http://www.savca.co.za/news/item.aspx?id=170, accessed in June 2013.
[1584]See requirements for a category I FSP in terms of the FAIS Act.
[1585]See requirements for a category II FSP in terms of the FAIS Act.
[1586]'SAVCA's approaches to the FSB on FAIS Exemptions', 17th August 2009.
[1587]'SAVCA's approaches to the FSB on FAIS Exemptions', 17th August 2009.
[1588]'SAVCA's approaches to the FSB on FAIS Exemptions', 17th August 2009.
[1589]General Code of Conduct for Authorised FSPs and Representatives in terms of Board Notice 80 of August 2003.
[1590]Section 15 of the Financial Advisory and Intermediary Services Act, 37 of 2002.

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private equity fund manager the Registrar has the power to suspend or withdraw the fund manager's licence which would result in pension funds being precluded from investing in the private equity fund(s) managed by such a fund manager.[1591]

Section 2 of the General Code of Conduct for Authorised FSPs and Representatives of 2003, provides that:[1592]

> '...a provider must at all times render financial services honestly, fairly, with due skill, care and diligence and in the interests of clients and the integrity of the financial services industry.'

In terms of section 3(b) a provider and a representative of the provider must avoid and where this is not possible mitigate any conflict of interest between the provider and a client or the representative and a client. In terms of section 1 of the General Code a conflict of interest is defined as:[1593]

> 'any situation in which a provider or representative has an actual or potential interest that may, in rendering a financial service to a client (a) influence the objective performance of his, her or its obligation to that client; or (b) prevent a provider or representative from rendering an unbiased and fair financial service to that client, or from acting in the interests of that client, including but not limited to (i) a financial interest; (ii) an ownership interest; (iii) any relationship with a third party.'[1594]

Section 3(b) places a positive obligation on every FSP to avoid a conflict of interest and where such conflict cannot be avoided, to mitigate against such conflicts. For example, a conflict of interest could occur by way of an economic benefit received by the fund manager from a transaction entered into by the private equity fund. The private equity fund's constitutional documents should contain well drafted provisions aimed at mitigating such conflict of interest risks. For example, the constitutional documents should spell out a well communicated conflict of interest policy that sets out what constitutes a conflict of interest; a disclosure procedure; a conflict of interest assessment and mitigation process to be followed before approving a transaction; and a procedure for the communication of the outcome of such process to all stakeholders of the private equity fund. The General Code places a very important obligation on an FSP in that it has to ensure that the constitutional documents (namely a trust deed or partnership agreement in the case of a *bewind* trust or *en commandite* partnership respectively) of the private equity fund, guards against conflicts

[1591] Section 9 of the Financial Advisory and Intermediary Services Act, 37 of 2002.
[1592] Board Notice 80 of August 2003.
[1593] General Code of Conduct for Authorised FSPs and Representatives of 2003.
[1594] Board Notice 80 of August 2003.

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as opposed to being a vehicle through which such conflict may arise. This is specifically emphasized under regulation 4 of the March 2012 Regulations:[1595]

> 'The responsible person, manager, administrator, or advisor of a private equity fund must disclose to the fund any possible conflict of interest that may arise or any direct or indirect benefit it may obtain or may have obtained as a consequence of any transaction concluded by the private equity fund or in the acquisition or disposal of assets in the execution of the business of the private equity fund.'

Thus, should a private equity fund firm be in contravention of any of the provisions of FAIS, its licence could be suspended or withdrawn by the Registrar, which would render the private equity fund ineligible to receive contributions from investors. Section 9(1)(c) of FAIS confers on the Registrar the power to suspend or withdraw the licence of an FSP in instances where the FSP has failed to comply with any other provisions of the Act. As the definition of 'this Act' includes in its meaning any code of conduct, it appears that the Registrar has the power to suspend the licence of an FSP where there is non-compliance with any provision of the General Code. In addition, section 9(2)(d) of FAIS provides that where the licence of an FSP is suspended or withdrawn, the Registrar must make known the reasons for such suspension or withdrawal and any terms attached thereto by way of notice in the Government Gazette and may make known such information by means of any other appropriate public media.

4.1.2 Pension Funds Act 24 of 1956

The limitations imposed in the Pension Funds Act 24 of 1956 and the regulations issued pursuant thereto are the only regulatory prohibitions that prevents a pension fund organisation[1596] from participating as an investor in a private equity fund structured as either a *bewind* trust, *en commandite* partnership or company. In terms of regulation 3(1) of the March 2012 Regulations,[1597] pension funds may invest in private equity funds on condition that any person rendering a financial service, whether discretionary or otherwise, to that private equity fund, is a discretionary FSP[1598] or a representative of such an FSP.[1599] A FSP has been defined under section 1(1) of FAIS.[1600] Amended Regulation 28 of the Pension Fund Act 24 of 1956 defines a private equity fund as follows:

[1595]'March 2012 Regulations' means the regulations dated 15 March 2012 entitled 'Pensions Fund Act, 1956: Amended Regulation 28 of the Regulations made under Section 36 of the Act: Conditions for Investment in Private Equity Funds Approval in terms of Section 5(2)(e) of the Act' (Government Notice 1 of 15 March 2012).
[1596]As defined under the Pension Funds Act 24 of 1956.
[1597]'March 2012 Regulations' means the regulations dated 15 March 2012 entitled 'Pensions Fund Act, 1956: Amended Regulation 28 of the Regulations made under Section 36 of the Act: Conditions for Investment in Private Equity Funds Approval in terms of Section 5(2)(e) of the Act' (Government Notice 1 of 15 March 2012).
[1598]Category II Licence holder as discussed above.
[1599]Regulation 28 means the Pensions Fund Act, 1956: Amendment of Regulation 28 of the Regulations made under Section 36 of the Act (Government Notice 183 of 4 March 2011: took effect on 1 July 2011).
[1600]See paragraph 4.1.1 of chapter two.

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> 'Private Equity Fund' means a managed pool of capital that … (c) is managed by a person licensed as a discretionary Financial Services Provider as defined in the Code of Conduct for Administrative and Discretionary Financial Service Providers, 2003, or if a foreign private equity fund managed by a person licensed as a Category I Financial Services Provider that is authorised to render financial services on securities and instruments as defined in the Determination of Fit and Proper Requirements for Financial Services Providers, 2008…'

In addition, Regulation 28 to the Regulations sets out certain limitations relating to the types of assets in which a pension fund may invest and the percentage which a particular type of investment may bear to the total market value of the total assets of the pension fund.[1601] The applicability of any limitation and the scope of any limitation are determined by having regard to the particular constitution, circumstances and investment policy of the relevant pension fund. Accordingly, each pension fund, which is to become an investor in the trust, must satisfy itself as to the extent to which the pension fund is entitled to effect an investment in the trust. In terms of section 13B(1) of the Pension Funds Act,[1602] no person shall administer on behalf of a pension fund the investments of such a pension fund, or the disposition of benefits provided for in the rules of the fund, unless the registrar has in a particular case or in general granted approval and the person complies with such conditions as the registrar may from time to time determine in the particular case or in general. During 2011 the amendment of Regulation 28 of the regulations made under section 36 of the Pension Funds Act was introduced. The preamble to the latter amendment states:

> 'A fund has a fiduciary duty to act in the best interest of its members whose benefits depend on the responsible management of fund assets. This duty supports the adoption of a responsible investment approach to deploying capital into markets that will earn adequate risk adjusted returns suitable for the fund's specific member profile, liquidity needs and liabilities. Prudent investing should give appropriate consideration to any factor which may materially affect the sustainable long-term performance of a fund's assets, including factors of an environmental, social and governance character. This concept applies across all assets and categories of assets and should promote the interests of a fund in a stable and transparent environment.'

However, prior to the amendment there was no reference to private equity in Regulation 28. Pension funds in South Africa that included private equity in their portfolios had to include it under the 'old' Regulation 28 guidelines for either 'other assets', which allowed a 2.5 percent allocation, or 'unlisted equity', which allowed a 5 percent allocation. However, many pension fund trustees were not

[1601]The prudential investment limits for pension funds registered under the Pension Funds Act 24 of 1956 permits pension funds to invest up to 10 percent of their assets in private equity funds, with a limit of 2.5 percent per private equity fund and 5 percent per fund-of-funds.
[1602]Pension Fund Act 24 of 1956.

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prepared to allocate any funds to private equity because the legislation was not clear on its categorisation and made no specific reference to private equity at all. However, the amendments to Regulation 28 now allow pension fund allocations to private equity. An allocation of up to 10 percent may go to private equity.[1603]

As stated at the beginning of this chapter, the private equity industry in South Africa does not have a specifically designated regulator or its own industry-specific legislation. There is no requirement that a private equity fund be registered with a government agency, other than the amended Regulation 28 requiring that the private equity fund manager of a private equity fund be licensed as a discretionary FSP under FAIS. The March 2012 Regulations merely state in regulation 2(2) that a 'fund may only invest in a private equity fund which is a member of a private equity fund industry body recognised by the Registrar', referring to industry bodies such as ASISA[1604] and SAVCA. The March 2012 Regulations, largely contain the conditions for a private equity fund to qualify for investment by a pension fund. A further condition is regulation 5 of the March 2012 Regulations that requires that the private equity fund must submit to the pension fund, at least quarterly, the investment reports recording the private equity fund's performance, activities, the value of investments and any other information to enable the pension fund to fulfill its reporting requirements.

Regulation 9 requires the financial statements of the private equity fund to be audited annually and made available to the pension fund within 120 days after the end of the private equity fund's financial year end. It further requires that a pension fund may only invest in a private equity fund that has clear policies and procedures for determining the fair value of the assets of the private equity fund, which valuation must be independently verified at least annually be a third party and must be in line with the International Private Equity Valuation Guidelines.[1605] Regulation 6 requires that the pension fund must ensure that the assets of the private equity fund are verified by the auditors through a scrip count at intervals not exceeding 6 months. Regulation 2 of the March 2012 Regulations has established the permissibility of private equity funds structured as *en commandite* partnerships, *bewind* trusts and companies. Since the above mentioned regulations came into effect, it would be logical to expect an increase in related contractual terms for new private equity funds in which pension funds are looking to invest (or are currently invested in). These pension funds would be seeking assurances via express contractual terms from the private equity fund and the fund

[1603]The amendment of Regulation 28 of the regulations made under section 36 of the Pension Fund Act 24 of 1956 goes as far as defining a private equity fund.
[1604]Association for Savings and Investment South Africa.
[1605]A revised version of the International Private Equity and Venture Capital Valuation Guidelines ('IPEV Guidelines') was issued on 17 December 2012. The revised Guidelines are intended to be applicable across all private equity funds and to all financial instruments commonly held by private equity funds. The new Guidelines are effective for reporting periods post 1 January 2013. Available at www.privateequityvaluation.com/, accessed in June 2015.

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managers that they will be in compliance with the regulatory requirements prescribed by the Registrar.

Nevertheless, the introduction of the March 2012 Regulations has had two important implications. Firstly, the size of the permitted allocation into private equity would logically increase the possible pool of pension fund investors into private equity. However, the boards of trustees of pension funds must first consider the advantages and disadvantages of private equity. As mentioned in the introductory paragraph 1 of chapter one, private equity as an asset class has clear and demonstrable benefits, but also poses several dangers. Secondly, the fact that private equity has been specifically defined in terms of the March 2012 Regulations, implies that the boards of trustees of pension funds have to consider private equity as an asset class.

Pension fund trustees should assess the impact of the March 2012 Regulations and revise their pension fund asset allocations carefully. As mentioned above, the preamble to Regulation 28 declares that it recognises and promotes the responsibility of pension funds and boards of trustees to make sound retirement fund investments. It also better enables investments into private equity to support economic development. The March 2012 Regulations has at the least afforded private equity managers the opportunity to engage pension fund trustees with the possible investment into private equity.

4.1.3 Collective Investment Schemes Control Act 45 of 2002

An important regulatory consideration when forming a private equity fund in South Africa is the provisions of the Collective Investment Schemes Control Act 45 of 2002 ('CISCA'). CISCA regulates the establishment and administration of collective investment schemes in South Africa. As mentioned in paragraph 4.1 of this chapter, a private equity fund may have the characteristics of a collective investment scheme and may be subject to the laws governing such schemes. In terms of the CISCA a collective investment scheme is defined as follows:

> '...'collective investment scheme' means a scheme, in whatever form, including an open-ended investment company, in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio, and in terms of which (a) two or more investors contribute money or other assets to and hold a participatory interest in a portfolio of the scheme through shares, units or any other form of participatory interest; and (b) the investors share the risk and the benefit of investment in proportion to their participatory interest in a portfolio of a scheme or on any other basis determined in the deed, but not a collective investment scheme authorised by any other Act ...'[1606]

[1606]Part 1 under definitions of the Collective Investment Schemes Control Act 45 of 2002.

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CISCA regulates all collective investment schemes previously known as unit trusts in South Africa, where such investments are offered to members of the public. In theory private equity funds structured as an *en commandite* partnerships and *bewind* trusts could fulfill all of the requirements of a collective investment scheme and be subject to CISCA if 'members of the public' are invited and then are allowed to invest in such funds. The term 'members of the public' is defined to include:

> 'members of any section of the public, whether selected as clients, members, shareholders, employees or ex-employees of the person issuing an invitation to acquire a participatory interest in a portfolio; and a financial institution regulated by any law, but excludes persons confined to a restricted circle of individuals with a common interest who receive the invitation in circumstances which can properly be regarded as a domestic or private business venture between those persons and the person issuing the invitation.'[1607]

Currently there are no licensing schemes in place to regulate private equity funds under CISCA. Should the provisions of CISCA be invoked by inviting or permitting members of the public to invest in such a private equity fund, it could result in the fund being unlawful[1608] and persons involved in the administration of the fund being criminally liable.[1609] For this not to happen, the private equity fund should not be regarded as a collective investment scheme under CISCA based upon the exclusion wording appearing at the end of the definition of collective investment scheme in CISCA which states, '… but not a collective investment scheme authorised by any other Act …'.[1610]

There are two important exclusionary provisions in CISCA. The proviso to the above mentioned definition of members of the public contains the first important exclusion being:

> '… but excludes persons confined to a restricted circle of individuals with a common interest who receive the invitation in circumstances which can properly be regarded as a domestic or private business venture between those persons and the person issuing the invitation …'.[1611]

[1607]Part 1 under definitions of the Collective Investment Schemes Control Act 45 of 2002.
[1608]Section 5 of the Collective Investment Schemes Control Act 45 of 2002 states that 'No person may perform any act or enter into any agreement or transaction for the purpose of administering a collective investment scheme, unless such person (a) is registered as a manager by the registrar or is an authorised agent; or (b) is exempted from the provisions of this Act by the registrar by notice in the Gazette.'
[1609]Section 115(b) of the Collective Investment Schemes Control Act 45 of 2002 states that 'Any person who not being a manager or an authorised agent of a manager, performs an act amounting to administration...is guilty of an offence'.
[1610] 'Members of the public' is widely defined, which means that many private equity fund entities may qualify as a CIS. The Financial Services Board (FSB) have exempted private equity funds that are members of the South African Private Equity and Venture Capital Association from regulation under CISCA, provided that SAVCA members do not market their funds to members of the public. See March 2012 Regulations as discussed earlier.
[1611]Part 1 under definitions of the Collective Investment Schemes Control Act 45 of 2002.

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Given that private equity funds normally invite investor participants by means of a private placement memorandum it is arguable that private equity funds fall outside the jurisdiction of CISCA. Private equity funds are typically open to only a small number of investors who are invited on an individual 'bespoke' basis by means of a private placement memorandum to invest in the fund. The approach to the concept of 'member of the public' is consistent with the concept of 'the public', a term which has been extensively considered in many South African and foreign cases in the context of offers to the public.

It must be noted that the question as to what constitutes an offer to the public is 'one of the most vexing questions in this particular area of company law and is the source of most of the reported cases'.[1612] It is beyond the scope of this paragraph to discuss the extensive body of case law and authorities that have developed in terms of this phrase. Nevertheless, both Cassim *et al*[1613] and Delport[1614] provide a concise analysis of the phrase.[1615] At this point it is also important to note the distinction that the current discussion does not relate to the private equity fund that invests in the underlying investee company and the 'public' that invests in the underlying investee company. Rather, the issue at hand pertains more to the question of whether the offer to the public in the area of company law is the same as the law that regulates CISCA in the instance where the private equity fund is seeking investors.

According to Cassim *et al*, there was an anomaly in our law prior to the Companies Act 71 of 2008, with regard to what was meant by the term 'offer to the public'.[1616] This anomaly created complications as the test applied in deciding what was an offer of securities to the public by a shareholder in terms of section 142 of the Companies Act 61 of 1973 was different from the one that had to be applied when the company made an offer to the public of its own securities in terms of Chapter 6 of the Companies Act 61 of 1973.[1617] The Supreme Court of Appeal when faced with this in *Gold Fields Ltd v Harmony Gold Mining Company Ltd*[1618] tried to manage the anomaly away. Thus

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[1612]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', 2nd Edition, Juta and Company, Cape Town, at page 652. 'The issue is simply that, if an offer constitutes an offer to the public, it falls within the purview of the legislative provisions and thus becomes subject to a substantial body of restrictions and requirements, most notably the requirement to issue a prospectus.'

[1613]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', Second Edition, Juta and Company, Cape Town, at pages 652-657.

[1614]Delport, P.A. (2011), 'Offers and the Companies Act 71 of 2008', Journal of Contemporary Roman Dutch Law, 74(2) at pages 280-286.

[1615]Both Cassim *et al* and Delport make reference to *Gold Fields Ltd and another v Harmony Gold Mining Company Ltd and others* 2005 (3) All SA 114 (SCA).

[1616]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', Second Edition, Juta and Company, Cape Town, at page 653.

[1617]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', Second Edition, Juta and Company, Cape Town, at pages 652-657. See also Delport, P.A. (2011), 'Offers and the Companies Act 71 of 2008', Journal of Contemporary Roman Dutch Law, Volume 74, No. 2, at pages 280-286.

[1618]*Gold Fields Ltd and another v Harmony Gold Mining Company Ltd and others* 2005 (3) All SA 114 (SCA).

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the court ignored the special meaning of an offer to the public defined in chapter 6 of the Companies Act 61 of 1973, relying instead on cases dealing with the general meaning of the term. In *Gold Fields Ltd v Harmony Gold Mining Company Ltd,*[1619] Nugent JA stated as follows:

> 'I can add nothing useful to what has been said in earlier cases as to the meaning of 'public' (there is no suggestion that the word is used in section 145 in any special sense). In *S v V* 1977 (2) SA 134 (T) at 137 Franklin J (citing *S v Rossouw* and *Tatem Co v Inland Revenue Commissioners* to similar effect) said that: 'the ordinary meaning of the word 'public' is the community as a whole rather than the community as an organised body'. I think it is unhelpful, and potentially misleading, to attempt to determine by inference what is included in an 'offer to the public' by referring to the inclusions and exclusions in section 142 (the definition of an "offer to the public') and section 144 respectively, for those inclusions and exclusions might just as well have been inserted to avoid uncertainty. The better approach, in my view, is to ask whether the present offer can properly be said to have been made to the public as that term is ordinarily understood.'[1620]

The important question *inter alia* in *Gold Fields Ltd v Harmony Gold Mining Company Ltd*,[1621] was whether the offer should be held to be an offer to the public and therefore the intended offerees were afforded the protection of a prospectus. The court answered this question in *Gold Fields Ltd v Harmony Gold Mining Company Ltd*[1622] by stating the following:

> '... an offer that aims to acquire specific private property would not achieve its purpose if it was made to the public for no reason but that the property is in private hands. The offer in the present case is in that category. It is not made to the public but to shareholders in Gold Fields who are not, in that capacity, a mere section of the public at large.'[1623]

According to Delport, if an offer constitutes an offer to the public then it falls within the ambit of the provisions of the Companies Act 71 of 2008, subject to its numerous requirements and restrictions.[1624] Section 95(1)(h) of the Companies Act 71 of 2008, reads as follows:

> '(h) ' 'offer to the public' –
>
> (i) includes an offer of securities to be issued by a company to any section of the public, whether selected –

[1619] *Gold Fields Ltd and another v Harmony Gold Mining Company Ltd and others* 2005 (3) All SA 114 (SCA).
[1620] *Gold Fields Ltd and another v Harmony Gold Mining Company Ltd and others* 2005 (3) All SA 114 (SCA), at page 117.
[1621] *Gold Fields Ltd and another v Harmony Gold Mining Company Ltd and others* 2005 (3) All SA 114 (SCA).
[1622] *Gold Fields Ltd and another v Harmony Gold Mining Company Ltd and others* 2005 (3) All SA 114 (SCA).
[1623] *Gold Fields Ltd and another v Harmony Gold Mining Company Ltd and others* 2005 (3) All SA 114 (SCA), at page 510, paragraph 16.
[1624] Delport, P.A. (2011), 'Offers and the Companies Act 71 of 2008', Journal of Contemporary Roman Dutch Law, 74(2) at pages 280-286.

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(aa) as holders of that company's securities;

(bb) as clients of the person issuing the prospectus;

(cc) as the holders of any particular class of property; or

(dd) in any other manner; but

(ii) does not include –

(aa) an offer made in any of the circumstances contemplated in section 96; or

(bb) a secondary offer effected through an exchange;'

According to Cassim *et al*, the definition of an offer to the public must be applied literally as defined; and the term no longer has an ordinary meaning separate and distinct from the definition quoted above.[1625] The definition includes the ordinary meaning of the term, and this cannot be separated from the defined meaning as the court did in *Gold Fields Ltd v Harmony Gold Mining Company Ltd*.[1626] The adverse effect resulting from this literal interpretation of section 95(1)(h) is amplified by the amendment to the definition of the word 'offer' in terms of section 95(1)(g) of the Companies Act 71 of 2008. The extent of what is generally referred to as an offer to the public no longer includes an invitation to make an offer for securities in a company.[1627] Section 95(1)(g) of the Companies Act 71 of 2008, reads as follows:

' 'offer', in relation to securities, means an offer made in any way by any person with respect to the acquisition, for consideration, of any securities in a company.'

Coming back to the discussion at hand, private equity funds normally invite investor participants by means of a private placement memorandum and therefore it is arguable that private equity funds fall outside the jurisdiction of CISCA. A case that dealt with this issue was *Financial Services Board v Dynamic Wealth Ltd.*[1628] Dynamic Wealth argued that its investment scheme was not a collective investment scheme as defined in CISCA because its members were a restricted circle of individuals engaged in a domestic or private business venture and thus fell outside the definition of members of the public.[1629] In *Financial Services Board v Dynamic Wealth Ltd and others,*[1630] Wallis J summarily dismissed Dynamic Wealth's argument as follows:

'This claim was shown to be false when lists of the participants were provided to the inspectors. By way of example, a tennis association; a primary school and a school for the blind; a church;

[1625]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', Second Edition, Juta and Company, Cape Town, at pages 652-657.

[1626]*Gold Fields Ltd and another v Harmony Gold Mining Company Ltd and others* 2005 (3) All SA 114 (SCA), at page 117.

[1627]Delport, P.A. (2011), 'Offers and the Companies Act 71 of 2008', Journal of Contemporary Roman Dutch Law, 74(2), at pages 280-286.

[1628]*Financial Services Board v Dynamic Wealth Ltd and others* 2012 (1) All SA 135 (SCA).

[1629]*Financial Services Board v Dynamic Wealth Ltd and others* 2012 (1) All SA 135 (SCA).

[1630]*Financial Services Board v Dynamic Wealth Ltd and others* 2012 (1) All SA 135 (SCA).

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an optometrist and other businesses; several trusts, both family and charitable; some deceased estates and a number of individuals from various parts of the country and having little other than their investment in that portfolio in common. The answering affidavit said that membership was restricted to persons invited to join through Dynamic Wealth's network of independent financial advisers. However, this network was 470 strong and it recruited literally thousands of investors who invested hundreds of millions of Rand through these associations. There can be no doubt that investments were being solicited from members of the public.'[1631]

There is also the question as to whether or not private equity funds may contravene the Companies Act 71 of 2008. It is submitted that private equity funds are typically open to only a small number of investors who are invited on an individual 'bespoke' basis by means of a private placement memorandum to invest in the fund. The approach to the concept of 'member of the public' in terms of the Companies Act 71 of 2008, is consistent with the concept of 'the public', a term which has been extensively considered by South African case law in the context of offers to the public. However, private equity funds in South Africa are legally structured as either a *bewind* trust or *en commandite* partnership,[1632] therefore it is submitted that if the private equity fund is not a company, it cannot contravene the Companies Act 71 of 2008. The more direct question is whether the private equity fund would contravene CISCA.

Nevertheless, private equity funds formed in South Africa have to ensure that they are not unintentionally regulated by CISCA's broad provisions. The bottom line is that private equity firms, whether or not they are registered as Collective Investment Scheme ('CIS') managers under CISCA, are not allowed to solicit investments in private equity funds which are not registered under CISCA from members of the public in South Africa. Therefore, for CISCA not to be applicable, private equity firms/funds have to adhere to the exclusion in the definition of 'members of the public'. As mentioned above, 'members of the public' is widely defined, which means that many private equity fund entities may qualify as a CIS manager. Nevertheless, what may be necessary is a factual enquiry, having regard to all relevant facts. For instance, in *S v Rossouw*[1633] the court in considering the question, what constitutes an offer to the public, held that such a question can only be answered with reference to the circumstances of the particular case. For instance, these would include the true nature of the offer of the investment opportunity (that is, whether, as a matter of fact, the offer was capable of being accepted by any member of the public); the manner in which the offer of the investment opportunity was communicated, for example, whether it was advertised in the press or only addressed to certain specific recipients; and the number of offerees.[1634]

[1631] *Financial Services Board v Dynamic Wealth Ltd and others* 2012 (1) All SA 135 (SCA), at paragraph 23.
[1632] See paragraph four of chapter one at page 78.
[1633] *S v Rossouw* 1971 (3) All SA 135 (T).
[1634] *S v Rossouw* 1971 (3) All SA 135 (T).

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The proviso to the above mentioned definition of a 'collective investment scheme' in the CISCA contains the second important exclusion, namely that 'a collective investment scheme authorised by any other Act' will not be regarded as a collective investment scheme for the purposes of the CISCA.[1635] For example, one question that needs to be decided could be whether a private equity fund which complies with the Pension Fund Act 24 of 1956 regulations is a scheme 'authorised by any other Act'. It is submitted that the word 'authorised' as used in the latter definition can be contrasted with the use of the word 'regulated' as used in the definition of 'members of the public'. In the definition of 'members of the public', the reference is to 'a financial institution regulated by any law' which prima facie falls within the definition of 'members of the public'. However in the case of the definition of a 'collective investment scheme', it is not a requirement that the collective investment scheme concerned be regulated by any law and it is submitted that it is therefore sufficient if it is merely 'authorised by any other Act'. Furthermore, in terms of section 5(2)(e) of the Pension Funds Act 24 of 1956, the Registrar is specifically empowered to approve a person or a category of persons who can hold the money and assets of a pension fund.[1636] However, it could not be argued convincely, based on the wording of the March 2012 Regulations, that the Registrar automatically granted the relevant approval to private equity funds in terms of an Act, namely section 5(2)(e) of the Pension Funds Act 24 of 1956.

A private equity fund will have to comply with the conditions set out in the March 2012 Regulation, otherwise the private equity fund will not be able to enjoy the benefit of the collective investment scheme exclusion provision, in which case it will become subject to regulation in terms of CISCA (based on the assumption that 'members of the public' are invited or permitted to participate in the private equity fund).[1637] Nevertheless, the weakness of such an argument would be that it is restricted to investor participants that are pension funds regulated and authorised by the Pensions Fund Act 24 of 1956. For example, where investors are wealthy individuals, it could not be argued convincingly that a private equity fund falls within the collective investment scheme exclusion provision.

4.1.4 Conclusion

In concluding this paragraph 4.1 it is evident that South Africa's financial services sector is backed by a sound regulatory and legal framework. The non-banking sector is overseen by the Financial Services Board (FSB), which is an independent body responsible for the regulation of financial markets and institutions, including the licensing of private equity firms. The FSB monitors, regulates and supervises the financial services industry through the Financial Advisory and Intermediary Services Act 37 of 2002 and the General Code of Conduct for Authorised Financial Service Providers

[1635]Part 1 under definitions of the Collective Investment Schemes Control Act 45 of 2002.
[1636]Regulation 28 means the Pensions Fund Act, 24 of 1956: Amendment of Regulation 28 of the Regulations made under Section 36 of the Act (Government Notice 183 of 4 March 2011 which took effect on 1 July 2011).
[1637]With effect from 1 October 2012.

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and Representatives. In addition, specific reference was made above to the Determination of the Fit and Property Requirements in terms of the Financial Advisory and Intermediary Services Act 37 of 2002.[1638] Additional considerations, when forming a private equity fund in South Africa, would be with regard to the Pensions Fund Act 24 of 1956; and Collective Investment Schemes Control Act 45 of 2002; as discussed above. The next paragraph 4.2 will discuss the regulatory and licensing requirements with regard to the private equity industry in the US, because for private equity firms, the impact of US regulation and licensing requirements is often complex and significant. The objective of the discussion to follow is to provide a critical comparison of South Africa's regulatory environment with the regulatory and licensing issues arising from structuring and investing in, US based private equity funds.

4.2 US Regulatory and Licensing Requirements

In the US private equity funds are regulated by or require exemptions from the regulation of a large set of US federal legislation.[1639] For example, the Investment Company Act of 1940 regulates mutual funds and other companies that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public by requiring them to either register with the Securities and Exchange Commission ('SEC') as an investment company or qualify for an exemption from registration.[1640] Private equity firms that form private equity funds in the US typically seek to qualify under certain exemptions of the Investment Company Act of 1940.[1641] Registration would subject them to numerous regulations that would make it impracticable for a private equity firm to administer a fund.[1642] For example, Section 13 of the Investment Company Act of 1940 limits the ability of a registered investment company to borrow money or issue securities.[1643]

[1638]In terms of section 8 of FAIS, the Registrar must after consultation with the Advisory Committee determine the requirements that financial services providers, key individuals and representatives of the provider must comply to. These requirements are termed the Determination of Fit and Proper Requirements for financial services providers and their representatives. The fit and proper requirements were updated in 2008 in terms of Board Notice 106 of 2008 which came into effect on the 31st December 2008. Subsequently, several amendments have been effected. The requirements set the honesty and integrity, competency and operational ability requirements for all FSPs, key individuals and representatives. It also set out the solvency requirements applicable to FSPs.

[1639]Carroll, B. (2015), 'Observations on Judicial Approaches to Discerning Investment Adviser Status under the Investment Advisers Act of 1940', Austrian Law Journal, 1, at pages 99-126.

[1640]It was passed as a US Public Law on 22nd August 1940. Along with the Securities Exchange Act of 1934 and Investment Advisers Act of 1940 and extensive rules issued by the Securities and Exchange Commission, it forms the backbone of US financial regulation. It have been updated by the Dodd-Frank Act of 2010. Discussed in greater detail in chapter four.

[1641]See Appelbaum, E. and Batt, R. (2014), 'Private Equity at Work: When Wall Street Manages Main Street', Russell Sage Foundation. See also Lemke, T.P., Lins, G.T. and Sommer, A.A. (2014), 'The Investment Advisers Act of 1940', Securities Law Techniques, 6.

[1642]See Appelbaum, E. and Batt, R. (2014), 'Private Equity at Work: When Wall Street Manages Main Street', Russell Sage Foundation. See also Lemke, T.P., Lins, G.T. and Sommer, A.A. (2014), 'The Investment Advisers Act of 1940', Securities Law Techniques, 6.

[1643]For an overview of the exemptions under the Investment Company Act of 1940, and why it is important for private equity funds to avoid becoming registered investment companies, See Smith, J.A. (2014), 'Special Issues of Investment Advisers and Investment Companies', Securities Enforcement: Counseling and

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Private equity funds seeking to raise capital from US investors commonly rely on one of two primary exemptions under the Investment Company Act of 1940 for private investment companies. Section 3(c)(1) of the Investment Company Act of 1940 exempts from the definition of an investment company any private equity fund that is not making a public offering of its interests and is beneficially owned by not more than one hundred persons.[1644] Section 3(c)(7) of the Investment Company Act of 1940 exempts from the definition of investment company any private equity fund that: does not make a public offering of its interests; and is beneficially owned exclusively by qualified purchasers, generally, a person owning at least $5 million or more of investments, or an entity with at least $25 million or more of investments.[1645] The exemptions in terms of sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 are complex, including a number of rules requiring the fund to look through certain investors to determine their ultimate beneficial owners.[1646] For example, each exemption requires a fund to disregard, and look through to the beneficial owners of, any entity formed for the purpose of investing in the fund.[1647] Section 3(c)(1) of the Investment Company Act of 1940 requires a fund to look through any investor that is itself an investment company or would be an investment company, but for the section 3(c)(1) and 3(c)(7) exclusions and which has more than ten percent of the voting securities of the fund.[1648] Section 3(c)(1) of the Investment Company Act of 1940 allows non-US issuers to count only US investors for purposes of counting the total number of beneficial owners. Similarly, section 3(c)(7) of the Investment Company Act of 1940 allows non-US issuers to require only that their US investors be qualified purchasers.[1649]

The Investment Advisers Act of 1940 is a US federal law that was created to regulate the actions of investment advisers.[1650] Section 80b–1 of the Investment Advisers Act of 1940, provides:

> 'Upon the basis of facts disclosed by the record and report of the Securities and Exchange Commission made pursuant to section 79z–4 of this title, and facts otherwise disclosed and

Defense, 2. See also Practice Note, Investment Company Act of 1940 Exceptions: Guide for Transactional Lawyers. Available at http://us.practicallaw.com/1-504-8727, accessed in June 2015.

[1644]Baird, J. and Stuart, E. (2013), 'The US Investment Company Act: A legal minefield for non-US issuers', Practical Law Publishing Limited, March 2013, at pages 1-9. See also Anderson, J.E., Bagnall, R.G. and Smythe, M.K. (2014), 'Who is an Investment Adviser?', Investment Advisers: Law & Compliance, Volume 1.

[1645]Baird, J. and Stuart, E. (2013), 'The US Investment Company Act: A legal minefield for non-US issuers', Practical Law Publishing Limited, March 2013, at pages 1-9. See also Anderson, J.E., Bagnall, R.G. and Smythe, M.K. (2014), 'Who is an Investment Adviser?', Investment Advisers: Law & Compliance, Volume 1.

[1646]Baird, J. and Stuart, E. (2013), 'The US Investment Company Act: A legal minefield for non-US issuers', Practical Law Publishing Limited, March 2013, at pages 1-9.

[1647]Baird, J. and Stuart, E. (2013), 'The US Investment Company Act: A legal minefield for non-US issuers', Practical Law Publishing Limited, March 2013, at pages 1-9.

[1648]Baird, J. and Stuart, E. (2013), 'The US Investment Company Act: A legal minefield for non-US issuers', Practical Law Publishing Limited, March 2013, at pages 1-9.

[1649]Baird, J. and Stuart, E. (2013), 'The US Investment Company Act: A legal minefield for non-US issuers', Practical Law Publishing Limited, March 2013, at pages 1-9.

[1650]Carroll, B. (2015), 'Observations on Judicial Approaches to Discerning Investment Adviser Status under the Investment Advisers Act of 1940', Austrian Law Journal, 1, at pages 99-126.

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ascertained, it is found that investment advisers are of national concern, in that, among other things –

(1) their advice, counsel, publications, writings, analyses, and reports are furnished and distributed, and their contracts, subscription agreements, and other arrangements with clients are negotiated and performed, by the use of the mails and means and instrumentalities of interstate commerce;
(2) their advice, counsel, publications, writings, analyses, and reports customarily relate to the purchase and sale of securities traded on national securities exchanges and in interstate over-the-counter markets, securities issued by companies engaged in business in interstate commerce, and securities issued by national banks and member banks of the Federal Reserve System; and
(3) the foregoing transactions occur in such volume as substantially to affect interstate commerce, national securities exchanges, and other securities markets, the national banking system and the national economy.'[1651]

The Investment Advisers Act of 1940 requires that investment advisers register as such with the SEC unless an exemption from registration is available.[1652] Unlike the Investment Company Act of 1940, which regulates the fund itself, the Investment Advisers Act of 1940 regulates the sponsors and advisers (private equity firms) to the fund.[1653] According to Naidech, private equity firms prior to the promulgation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,[1654] avoided registration with the SEC under the Investment Advisers Act of 1940 by relying on an exemption for investment advisers with fewer than fifteen clients with each fund advised counting as only one client.[1655] However, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 amended the Investment Advisers Act of 1940 to eliminate the private investment adviser exemption, requiring advisers/private equity firms to private equity funds to register with the SEC

[1651] Investment Advisers Act of 1940 is codified at section 80b-1 through to section 80b-21 at Title 15, Chapter D, of the US Code. Title 15 of the United States Code outlines the role of the commerce and trade in the United States Code.
[1652] Carroll, B. (2015), 'Observations on Judicial Approaches to Discerning Investment Adviser Status under the Investment Advisers Act of 1940', Austrian Law Journal, 1, at pages 99-126. See also Weiner, P.M., Hunnius, P. and Crain, S.R. (2015), 'SEC Asset Management Unit's Priorities for 2015–Conflicts of Interest', Journal of Investment Compliance, 16(2). See also Smith, J.A. (2014), 'Special Issues of Investment Advisers and Investment Companies', Securities Enforcement: Counseling and Defense, 2.
[1653] Baird, J. and Stuart, E. (2013), 'The US Investment Company Act: A legal minefield for non-US issuers', Practical Law Publishing Limited, March 2013, at pages 1-9. See also US Investment Adviser Registration: Overview available at http://us.practicallaw.com/7-386-4497, accessed in June 2015.
[1654] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 is also discussed in chapter four as part of the discussion on the regulatory developments impacting private equity in the US.
[1655] Naidech, S.W. (2011), 'Private Equity Fund Formation', Practice Note: Chadbourne and Parke LLP, published by Practical Law Company, at page 13.

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unless they can rely on an alternative registration exemption.[1656] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 broadly expand the group of private equity firms that must register with the SEC under the Investment Advisers Act of 1940.[1657] In terms thereof, US private equity firms with assets under management of $150 million or more must register with the SEC as investment advisers.[1658] In addition, foreign private equity firms with US investors or US staff are required to register to take advantage of exemptions from registration in light of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010's narrowing of the foreign private adviser exception.[1659] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 imposes additional recordkeeping and reporting requirements as well as the examination and audit obligations on private equity firm's that are required to register.[1660] In addition to federal regulation in terms of the Investment Advisers Act of 1940, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 also requires private equity firms to be subject to US state registration and conduct regulation requirements.[1661] In terms of the Investment Advisers Act of 1940 prior to the promulgation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, private equity firms with less than $25 million in aggregate assets under management were not required to register with the SEC, but were subject to applicable US state regulation.[1662] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 also amended the Investment Advisers Act of 1940 to require a private equity firm with assets under management between $25 million and $100 million or a higher amount determined by the SEC, to register with the US state of its principal office and place of business, and not with the SEC, but only if the private equity firm is subject to registration and examination as an investment adviser with this US state.[1663]

[1656] Naidech, S.W. (2011), 'Private Equity Fund Formation', Practice Note: Chadbourne and Parke LLP, published by Practical Law Company, at page 13. See also Practice Note, Summary of the Dodd-Frank Act: Private Equity and Hedge Funds, available at http://us.practicallaw. com/1-502-8932, accessed in June 2015.
[1657] Naidech, S.W. (2011), 'Private Equity Fund Formation', Practice Note: Chadbourne and Parke LLP, published by Practical Law Company, at page 13. See also Practice Note, Summary of the Dodd-Frank Act: Private Equity and Hedge Funds, available at http://us.practicallaw. com/1-502-8932, accessed in June 2015.
[1658] Carroll, B. (2015), 'Observations on Judicial Approaches to Discerning Investment Adviser Status under the Investment Advisers Act of 1940', Austrian Law Journal, 1, at pages 99-126.
[1659] See Smith, J.A. (2014), 'Special Issues of Investment Advisers and Investment Companies', Securities Enforcement: Counseling and Defense, 2. See also Practice Note, Summary of the Dodd-Frank Act: Private Equity and Hedge Funds: Foreign Private Advisers, available at http://us.practicallaw. com/1-502-8932, accessed in June 2015.
[1660] Dimitrov, V., Palia, D. and Tang, L. (2015), 'Impact of the Dodd-Frank act on credit ratings', Journal of Financial Economics, 115(3), at pages 505-520. See also Schultz, P.H. (2014), 'Perspectives on Dodd-Frank and Finance', MIT Press.
[1661] Carroll, B. (2015), 'Observations on Judicial Approaches to Discerning Investment Adviser Status under the Investment Advisers Act of 1940', Austrian Law Journal, 1, at pages 99-126. See also Kaal, W.A., Luppi, B. and Paterlini, S. (2014), 'Did the Dodd-Frank Act Impact Hedge Fund Performance?', University of St. Thomas (Minnesota) Legal Studies Research Paper, at 14-09.
[1662] Carroll, B. (2015), 'Observations on Judicial Approaches to Discerning Investment Adviser Status under the Investment Advisers Act of 1940', Austrian Law Journal, 1, at pages 99-126. See Akhigbe, A., Martin, A.D. and Whyte, A.M. (2015), 'Dodd–Frank and risk in the financial services industry', Review of Quantitative Finance and Accounting, at pages 1-21.
[1663] Carroll, B. (2015), 'Observations on Judicial Approaches to Discerning Investment Adviser Status under the Investment Advisers Act of 1940', Austrian Law Journal, 1, at 99-126. See Kaal, W.A., Luppi, B. and Paterlini, S. (2014), 'Did the Dodd-Frank Act Impact Hedge Fund Performance?', University of St. Thomas Legal Studies Research Paper, at 14-09.

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This registration requirement expands the jurisdiction of US state regulators over private equity firms with assets under management of $100 million or less. However, many US states have their own exemptions from state registration, so private equity fund firms with assets under management of $100 million or less may be exempt under both US federal and state laws.[1664] Naidech states that whether or not a private equity firm must register as an investment adviser with the SEC, is subject to a number of provisions under the Investment Advisers Act of 1940, including a fiduciary duty to the fund, in addition to those fiduciary duties that may exist under US state common law.[1665] For example, section 206 of the Investment Advisers Act of 1940 prohibits an investment adviser from engaging in any act or practice that is fraudulent, deceptive or manipulative with respect to the fund.[1666]

A further regulatory consideration when forming a private equity fund in the US, is the Securities Exchange Act of 1934 which requires an issuer with total assets exceeding $10 million to register with the SEC any class of equity securities held of record by five hundred more persons, in the case of a US issuer and two hundred and ninety nine or more US investors, in the case of a non-US issuer.[1667] In this regard, US private equity funds will attempt to restrict the number of record owners to up to four hundred and ninety nine investors so that its securities are not subject to registration under the Securities Exchange Act of 1934.[1668] However, if the private equity fund has to register its securities, it becomes subject to onerous reporting and recordkeeping requirements, as well as Sarbanes-Oxley Act of 2002 compliance requirements.[1669] In addition, Rule 10b-5 of the Securities Exchange Act of 1934 makes it unlawful to make any material misrepresentation or omission in the private equity fund's offering materials.[1670]

[1664]Akhigbe, A., Martin, A.D. and Whyte, A.M. (2015), 'Dodd–Frank and risk in the financial services industry', Review of Quantitative Finance and Accounting, at pages 1-21.

[1665]Naidech, S.W. (2011), 'Private Equity Fund Formation', Practice Note: Chadbourne and Parke LLP, published by Practical Law Company, at page 14.

[1666]Naidech, S.W. (2011), 'Private Equity Fund Formation', Practice Note: Chadbourne and Parke LLP, published by Practical Law Company, at page 14.

[1667]Kaufmann, D.J. (2013), 'Attracting Private Equity', International Franchise Association 46th Annual Symposium, 5-7 May 2013, at pages 1-34.

[1668]Kaufmann, D.J. (2013), 'Attracting Private Equity', International Franchise Association 46th Annual Symposium, 5-7 May 2013 at 1-34. See Practice Note, Exchange Act Registration: Overview, available at http://us.practicallaw.com/7-506-3135, accessed in June 2015.

[1669]See discussion at paragrapgh 3.1 in chapter 1 with regard to the impact the Sarbanes-Oxley Act of 2002 had on the LBO and private equity markets. See also Kaufmann, D.J (2013), 'Attracting Private Equity', International Franchise Association 46th Annual Symposium 5-7 May 2013 at 1-34. Practice Notes, Periodic Reporting and Disclosure Obligations: Overview, available at http://us.practicallaw.com/7-381-0961, accessed in June 2015 and Corporate Governance Standards: Overview available at http://us.practicallaw.com/7-381-0956, accessed in June 2015.

[1670]Kaufmann, D.J. (2013), 'Attracting Private Equity', International Franchise Association 46th Annual Symposium, 5-7 May 2013, at pages 1-34. See also Practice Note, Liability Provisions: Securities Offerings: Section 10(b) of the Exchange Act and SEC Rule 10b-5, available at http://us.practicallaw.com/6-381-1466, accessed in June 2015.

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In terms of Rule 10b-5 of the Securities Exchange Act of 1934, investors and the SEC itself have a private right of action against the private equity fund and private equity firm managing the fund, as well as any individual who orally may make a misrepresentation or omission to investors.[1671] The party seeking civil liability under Rule 10b-5 of the Securities Exchange Act of 1934 must be able to show a misrepresentation of a material fact, or a failure to disclose a material fact that there was a duty to disclose.[1672] Secondly, that the misrepresentation or omission was committed with intent to deceive or was reckless.[1673] Thirdly, it must be shown that there was a reasonable reliance on the misrepresentation or omission and that in the case of investor claims, resulting damages are proximately linked to the misrepresentation or omission.[1674] However, a fund investor may be unable to prove either that a misrepresentation or omission occurred or that it reasonably relied on a misrepresentation or omission, or both, where the potential risks that supposedly led to its loss was fully and adequately disclosed in the private placement memorandum.[1675]

The Securities Exchange Act of 1934 also requires that anyone engaged in the business of effecting transactions in securities for an issuer must be registered as a broker with the SEC.[1676] According to Eisert *et al*, the SEC has noted that anyone who gets paid on a commission basis for raising capital for an issuer, including for example a private equity fund, must be a registered broker.[1677] Thus, if someone is engaged in raising capital for a private equity fund who should be a registered broker but is not registered, there is a risk that the investor potentially could have a rescission right, to unwind the investment and receive a return of its capital contributions possibly plus interest.[1678] For example, if an employee of the private equity firm is compensated on a commission basis for finding

[1671]For example, in statements by the private equity firm's staff at a fund raising road show presentation.
[1672]See Chaffee, E.C. (2015), 'Oak Is an Oak Is an Oak Is an Oak: The Disappointing Entrenchment in Halliburton Co. v Erica P. John Fund of the Implied Private Right of Action under Section 10 (B) and Rule 10B-5', New York University Journal of Law and Liberty, 9, at 92.
[1673]Chalmers, K., Naiker, V. and Navissi, F. (2012), 'Earnings quality and Rule 10b-5 securities class action lawsuits', Journal of Accounting and Public Policy, 31(1), at pages 22-43.
[1674]Chalmers, K., Naiker, V. and Navissi, F. (2012), 'Earnings quality and Rule 10b-5 securities class action lawsuits', Journal of Accounting and Public Policy, 31(1), at pages 22-43.
[1675]Chalmers, K., Naiker, V. and Navissi, F. (2012), 'Earnings quality and Rule 10b-5 securities class action lawsuits', Journal of Accounting and Public Policy, 31(1), at pages 22-43. See also Chaffee, E.C. (2015), 'Oak Is an Oak Is an Oak Is an Oak: The Disappointing Entrenchment in Halliburton Co. v Erica P. John Fund of the Implied Private Right of Action under Section 10 (B) and Rule 10B-5', New York University Journal of Law and Liberty, 9, at 92.
[1676]Kahn, H., Welp, R. and Parrino, R. (2014), 'SEC staff expands relief from broker-dealer registration under US Securities Exchange Act for intermediaries in private M&A transactions', Journal of Investment Compliance, 15(2), at pages 22-25.
[1677]Eisert, E., Katz, T., Carotenuto, G. and Ball, M.F. (2013), 'The extra-territorial reach of the broker-dealer registration requirements under the US Securities Exchange Act of 1934: the staff of the Securities and Exchange Commission addresses asked questions regarding Rule 15a-6 and foreign broker-dealers', Journal of Investment Compliance, 14(2), at pages 50-56.
[1678]Eisert, E., Katz, T., Carotenuto, G. and Ball, M.F. (2013), 'The extra-territorial reach of the broker-dealer registration requirements under the US Securities Exchange Act of 1934: the staff of the Securities and Exchange Commission addresses asked questions regarding Rule 15a-6 and foreign broker-dealers', Journal of Investment Compliance, 14(2), at pages 50-56.

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investors for the private equity fund, that employee could be deemed to be acting as an unregistered broker, which could subject the employee and the sponsor to sanctions.[1679]

A further regulatory consideration when forming a private equity fund in the US, is the Employee Retirement Income Security Act of 1974, which may place restrictions on private equity funds if the fund is deemed to hold 'plan assets' in terms of the Employee Retirement Income Security Act of 1974.[1680] The result hereof is that the Employee Retirement Income Security Act of 1974 treats the private equity firm as directly managing the plan assets of any benefit plan investors, unless the private equity fund meets one of the exceptions from the look-through rules under the Employee Retirement Income Security Act of 1974.[1681] In this regard, US private equity funds try to meet one of the following three exceptions to the Employee Retirement Income Security Act of 1974 look-through rules, namely (a) less than twenty five percent of the value of any class of the private equity fund's equity is held by benefit plan investors; (b) the private equity fund qualifies as a venture capital operating company; and (c) the fund qualifies as a real estate operating company.[1682] Therefore, if one of these exceptions applies, the underlying assets of a private equity fund in which a benefit plan investor makes an investment are not considered plan assets under the Employee Retirement Income Security Act of 1974.[1683] However, should a private equity fund not be exempt from the Employee Retirement Income Security Act of 1974 it will be deemed to hold plan assets subject to the Employee Retirement Income Security Act of 1974. The fund's investment adviser (private equity firm) may be deemed to be a fiduciary with respect to the Employee Retirement Income Security Act of 1974 plan assets invested[1684] by benefit plan investors.[1685] Naidech argues that if the private equity firm breaches its fiduciary duties under the Employee Retirement Income Security Act of 1974, it can lead to substantial liabilities and other penalties for the private equity firm, including a requirement

[1679]Eisert, E., Katz, T., Carotenuto, G. and Ball, M.F. (2013), 'The extra-territorial reach of the broker-dealer registration requirements under the US Securities Exchange Act of 1934: the staff of the Securities and Exchange Commission addresses asked questions regarding Rule 15a-6 and foreign broker-dealers', Journal of Investment Compliance, 14(2), at pages 50-56.
[1680]Allen, C.T. (2014), 'Where Do We Go Now: The Uncertain Future for 29 USC Sec. 1301 (b)(1), Private Equity Funds, and Multiemployer Pension Plans after Sun Capital', Georgia Law Review, 49, at 209.
[1681]Allen, C.T. (2014), 'Where Do We Go Now: The Uncertain Future for 29 USC Sec. 1301 (b)(1), Private Equity Funds, and Multiemployer Pension Plans after Sun Capital', Georgia Law Review, 49, at 209. See also Hartley, A.S. (2006), 'Making the Case for Mandatory Removal of Imprudent Investment Vehicles: Inside Information Can Make Employer Securities a Bad 401 (k) Option', Appalachian Journal of Law, 5, at 99.
[1682]Levine, D. and Mangiero, S. (2014), 'Private Equity Funds and Pension Plans: A Changing Dynamic', CFA Institute Magazine, 25(2), at pages 16-17.
[1683]Levine, D. and Mangiero, S. (2014), 'Private Equity Funds and Pension Plans: A Changing Dynamic', CFA Institute Magazine, 25(2), at pages 16-17. See also Practice Note, ERISA Plan Asset Rules: Effect of Look-through Rule on Plan Investments, available at http://us.practicallaw.com/0-506-0461, accessed in June 2015.
[1684]The capital commitments to the private equity fund.
[1685]Levine, D. and Mangiero, S. (2014), 'Private Equity Funds and Pension Plans: A Changing Dynamic', CFA Institute Magazine, 25(2), at pages 16-17. See also Practice Note, ERISA Plan Asset Rules: Effect of Look-through Rule on Plan Investments, available at http://us.practicallaw.com/0-506-0461, accessed in June 2015.

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to restore losses to the investors or to disgorge most of the profits earned by the private equity firm as a result of the breach of fiduciary duty.[1686]

Furthermore, if the private equity fund is subject to the Employee Retirement Income Security Act of 1974, then the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 restricts transactions between the private equity fund and certain parties in interest, or disqualified persons related to the plan, such as the private equity fund and its affiliates.[1687] Both the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 also prohibit the ability of the private equity firm and its affiliates to engage in affiliated transactions with the private equity fund.[1688] In order to prohibit such conflict of interest transactions, the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code provisions provide that prohibited transaction limits may be imposed on management and performance fees and investments in illiquid securities; assets held outside the US, depending on the fund structure and prime brokerage or custody arrangements; and the administrative and operational expenses that may be borne by the fund.[1689] According to Naidech, the consequences of a prohibited transaction are quite burdensome, for example, the transaction may be required to be unwound and any profits returned, regardless of whether the benefit plan investors benefited economically from the transaction.[1690] Nevertheless, regardless of whether the private equity fund is subject to the Employee Retirement Income Security Act of 1974, if benefit plan investors invest in the fund, the private equity fund is still required to disclose service provider compensation and fee disclosure information to benefit plan investors.[1691]

[1686]Naidech, S.W. (2011), 'Private Equity Fund Formation', Practice Note: Chadbourne and Parke LLP, published by Practical Law Company, at page 15. See also Practice Note, ERISA Fiduciary Duties: Overview: Penalties for Breaching Fiduciary Duties. Available at http://us.practicallaw.com/5-504-0060, accessed in June 2015.

[1687]IsenBerg, A.H. and DiSabatino, M.B. (2013), 'Private-Equity Funds Beware', American Bankruptcy Institute Journal, 32(9), at 20. See Flint, G.L. (2013), 'Moench Presumption: Butchering ERISA', Wayne Law Review, 59, at 461.

[1688]IsenBerg, A.H. and DiSabatino, M.B. (2013), 'Private-Equity Funds Beware', American Bankruptcy Institute Journal, 32(9), 20. See also Flint, G.L. (2013), 'Moench Presumption: Butchering ERISA', Wayne Law Review, 59, at 461. See also Hughes, V.M. (2013), 'Flip This Company, but Don't Leave Its Pensioners Out in the Cold: Sun Capital as a Call to Action to Change Taxation of Private Equity Funds', North Carolina Law Review, 92, at 1322.

[1689]See also Practice Note, ERISA Plan Asset Rules: Effect of Look-through Rule on Plan Investments, available at http://us.practicallaw.com/0-506-0461, accessed in June 2015.

[1690]Naidech, S.W. (2011), 'Private Equity Fund Formation', Practice Note: Chadbourne and Parke LLP, published by Practical Law Company, at page 16. See also Practice Note, ERISA Plan Asset Rules: Effect of Look-through Rule on Plan Investments, available at http://us.practicallaw.com/0-506-0461, accessed in June 2015.

[1691]Naidech, S.W. (2011), 'Private Equity Fund Formation', Practice Note: Chadbourne and Parke LLP, published by Practical Law Company, at page 16. See Practice Note, ERISA Plan Asset Rules: Effect of Look-through Rule on Plan Investments, available at http://us.practicallaw.com/0-506-0461, accessed in June 2015 and Legal Update, New fee disclosure rules in effect for certain US benefit plans, available at http://us.practicallaw.com/1-501-8594, accessed in June 2015.

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In order to avoid the burdensome provisions of the Employee Retirement Income Security Act of 1974, benefit plan investors in a private equity fund may require that the private equity fund provide assurances that it will be exempt from the Employee Retirement Income Security Act of 1974, for example by way of legal opinions that the fund is exempt from the Employee Retirement Income Security Act of 1974.[1692] A further practical consideration is that the benefit plan investors in a private equity fund may also negotiate special withdrawal rights and other remedies in the event that the private equity fund becomes subject to the Employee Retirement Income Security Act of 1974.[1693] On the other hand, private equity firms that intend to ensure that the private equity fund is exempt from the Employee Retirement Income Security Act of 1974 could in practice include provisions in the fund operating agreement that restrict, or reduce investment by, benefit plan investors to the extent necessary to prevent the application of the Employee Retirement Income Security Act of 1974.[1694]

4.3 UK Regulatory and Licensing Requirements

As mentioned in paragraph 3.3 of this chapter, in the UK the private equity firm will typically need to apply to the Financial Conduct Authority ('FCA'). The FCA is a financial regulatory body in the UK, but operates independently of the UK government, and is financed by charging fees to members of the financial services industry.[1695] The FCA regulates financial firms providing services to consumers and maintains the integrity of the UK's financial markets.[1696] It focuses on the regulation of conduct by both retail and wholesale financial services firms.[1697] Similar to its predecessor the Financial Services Authority ('FSA'), the FCA is structured as a company limited by guarantee.[1698] The Financial Services Act of 2012 created a new regulatory framework for financial services and abolished the FSA.[1699] Specifically, the Financial Services Act of 2012 gave the Bank of England

[1692]See IsenBerg, A.H. and DiSabatino, M.B. (2013), 'Private-Equity Funds Beware', American Bankruptcy Institute Journal, 32(9), 20.

[1693]See IsenBerg, A.H. and DiSabatino, M.B. (2013), 'Private-Equity Funds Beware', American Bankruptcy Institute Journal, 32(9), 20.

[1694]Naidech, S.W. (2011), 'Private Equity Fund Formation', Practice Note: Chadbourne and Parke LLP, published by Practical Law Company, at page 16. For example, by including in the operating agreement mandatory distribution rights and prohibitions on transfers to benefit plan investors.

[1695]UK: Law Commission, (2013), 'Law Commission: Fiduciary Duties of Investment Intermediaries: A Consultation Paper', Consultation Paper No 215: Great Britain Law Commission Consultation, The Stationery Office, at chapter 8.

[1696]UK: Law Commission, (2013), 'Law Commission: Fiduciary Duties of Investment Intermediaries: A Consultation Paper', Consultation Paper No 215: Great Britain Law Commission Consultation, The Stationery Office, at chapter 8.

[1697]UK: Law Commission, (2013), 'Law Commission: Fiduciary Duties of Investment Intermediaries: A Consultation Paper', Consultation Paper No 215: Great Britain Law Commission Consultation, The Stationery Office, at chapter 8.

[1698]UK: Law Commission, (2013), 'Law Commission: Fiduciary Duties of Investment Intermediaries: A Consultation Paper', Consultation Paper No 215: Great Britain Law Commission Consultation, The Stationery Office, at chapter 8.

[1699]On 19th December 2012, the Financial Services Act of 2012 received royal assent and came into force on 1st April 2013.

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responsibility for financial stability, bringing together macro and micro prudential regulation, created a new regulatory structure consisting of the Bank of England's Financial Policy Committee, the Prudential Regulation Authority and the FCA.[1700] The FCA has significant powers, including the power to regulate conduct related to the marketing of financial products; specify minimum standards and to place requirements on products; investigate organisations and individuals; ban financial products for up to a year while considering an indefinite ban; instruct firms to immediately retract or modify promotions which it finds to be misleading, and to publish such decisions.[1701] In addition hereto, the FCA has power to take enforcement action, such as disciplining authorised persons and approved persons; imposing civil penalties for market abuse; apply to court for injunctions against persons contravening relevant requirements; or order restitution of profits arising from contravening relevant requirements.[1702] Furthermore, the UK tax authorities also have rights of audit and inspection over the books and financial records of the private equity firm and the limited partnership.[1703] Nevertheless, the private equity firm that manages the private equity limited partnership must be authorised by the FCA in order to operate and manage in the UK a private equity fund. In addition to such authorisation, authorised persons must themselves take reasonable care not to allow individuals to perform ‘controlled functions’ without the approval of the FCA.[1704] In terms of the FCA, controlled functions include the following: director, chief executive, partner, apportionment and oversight, compliance oversight, money laundering reporting and customer functions, such as advising and managing investments.[1705] The FCA no longer requires that examinations must be passed in the non-retail context, however an FCA-authorised fund manager must ensure that its partners and employees have the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them.[1706]

[1700]See Kovas, A. (2015), ‘Understanding the Financial Conduct Authority: A Guide for Senior Managers’, Troubador Publishing Limited.

[1701]See https://fshandbook.info/FS/html/FCA, accessed at June 2015. See also Barry, B. (2011), ‘Fund Formation: England and Wales’, in Private Equity in 33 Jurisdictions Worldwide’, contributing editor Cogut, C., published by Getting the Deal Through, at pages, at pages 67-73. See also Innes, D., Lewin-Smith, G., and Raven, D. (2012), ‘Fund Formation: United Kingdom’, in Private Equity in 32 Jurisdictions Worldwide’, contributing editor Cogut, C., published by Getting the Deal Through, at pages 321-326. See also Kovas, A. (2015), ‘Understanding the Financial Conduct Authority: A Guide for Senior Managers’, Troubador Publishing.

[1702]See https://fshandbook.info/FS/html/FCA, accessed at June 2015. See also Barry, B. (2011), ‘Fund Formation: England and Wales’, in Private Equity in 33 Jurisdictions Worldwide’, contributing editor Cogut, C., published by Getting the Deal Through, at pages, at pages 67-73. See also Innes, D., Lewin-Smith, G., and Raven, D. (2012), ‘Fund Formation: United Kingdom’, in Private Equity in 32 Jurisdictions Worldwide’, contributing editor Cogut, C., published by Getting the Deal Through, at pages 321-326. See also Kovas, A. (2015), ‘Understanding the Financial Conduct Authority: A Guide for Senior Managers’, Troubador Publishing.

[1703]Hudson, M. (2014), ‘Funds: Private Equity, Hedge and All Core Structures’, First Edition, The Wiley Finance Series, John Wiley and Sons, at paragraph 2.2.4.

[1704]Hill-Smith, A. (2015), ‘Consumer Credit: Law and Practice’, Practical Finance and Banking Guides, CRC Press at 35-95.

[1705]Hill-Smith, A. (2015), ‘Consumer Credit: Law and Practice’, Practical Finance and Banking Guides, CRC Press at 35-95. See also Barry, B. (2011), ‘Fund Formation: England and Wales’, in Private Equity in 33 Jurisdictions Worldwide’, contributing editor Cogut, C., published by Getting the Deal Through, at page 69.

[1706]Hill-Smith, A. (2015), ‘Consumer Credit: Law and Practice’, Practical Finance and Banking Guides, CRC Press, at pages 35-95. See also Barry, B. (2011), ‘Fund Formation: England and Wales’, in Private Equity in 33 Jurisdictions Worldwide’, contributing editor Cogut, C., published by Getting the Deal Through, at page 69.

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An additional regulatory consideration to be had with regard to forming a private equity fund in the UK, pertains to collective investment schemes. According to Barry, in relation to the limited partnership itself, limited partnerships are usually specifically designated as 'unregulated collective investment schemes' for the purposes of the UK Financial Services and Markets Act 2000.[1707] In relation to the general partner or, where appointed, the manager of a limited partnership, where it acts in the UK as the manager of a limited partnership, it will require to be authorised and regulated by the FCA in terms of the Financial Services and Markets Act 2000.[1708] As mentioned above, private equity firms that are authorised by the FCA must comply with applicable regulatory requirements. These include the FCA Principles for Businesses as mentioned earlier in paragraph 3.3 of this chapter, which are intended as concise statements of the fundamental standards expected of all firms; rules requiring effective systems and controls and adequate risk management arrangements; division of roles between its senior management to ensure that their individual responsibilities for the various aspects of the business are always clear; designation of an individual as having responsibility for oversight of the firm's compliance function; business standards in the areas of conduct of business, client assets and market conduct; and prudential standards setting the financial resources requirements applicable to authorised firms by type.[1709]

Section 235(1) of the Financial Services and Markets Act 2000 defines a collective investment scheme as follows:

> 'any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.'

[1707]Barry, B. (2011), 'Fund Formation: England and Wales', in Private Equity in 33 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages, at page 68. Financial Services and Markets Act 2000 is concerned with the regulation of financial services and markets in the UK. In terms of section 19 of the Financial Services and Markets Act 2000, any person who carries on a regulated activity in the UK must be authorised by the FCA or exempt (an appointed representative or some other exemption). Breach of section 19 of the Financial Services and Markets Act 2000 may be a criminal offence and punishable on indictment by a maximum term of two years imprisonment and/or a fine.
[1708]Hudson, A. (2014), 'Equity and Trusts', Eighth Edition, Routledge Publishers, at page 455.
[1709]See https://fshandbook.info/FS/html/FCA, accessed at June 2015. See also Barry, B. (2011), 'Fund Formation: England and Wales', in Private Equity in 33 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages, at pages 67-73. See also Innes, D., Lewin-Smith, G., and Raven, D. (2012), 'Fund Formation: United Kingdom', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 321-326. See also Kovas, A. (2015), 'Understanding the Financial Conduct Authority: A Guide for Senior Managers', Troubador Publishing.

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On the other hand, an unregulated collective investment schemes is described as unregulated because they are not subject to the same restrictions as a regulated collective investment scheme in terms of their investment powers and how they are run.[1710] According to the FCA, if:

> 'a CIS is not authorised or recognised it is considered an unregulated collective investment scheme (UCIS). UCIS are not subject to the same restrictions in terms of their investment powers and how they are run.'[1711]

An unregulated collective investment scheme is an investment vehicle set up for asset classes that are unable to follow the FCA specific rules on matters such as liquidity, leverage or cash reserves.[1712] As mentioned above, although unregulated collective investment schemes themselves are not directly authorised by the FCA, persons carrying on activities related to unregulated collective investment schemes are themselves subject to FCA regulation.[1713] According to the FCA:

> 'UCIS and close substitutes such as qualified investor schemes, traded life policy investments and certain funds structured as corporate vehicles – which are collectively described as non-mainstream pooled investments (NMPIs) – are not subject to the rules that apply to retail-oriented investment funds. In our view, these products are unlikely to be suitable for the vast majority of retail investors. The marketing of UCIS and other NMPIs is regulated and subject to complex rules, including a restriction on UCIS imposed by s. 238 of the Financial Services and Markets Act 2000 and our rules about NMPIs in COBS 4.12, in addition to provisions in secondary legislation. These products may not be promoted to the general public and can only be marketed where an exemption is available.'[1714]

However, as of the 1st January 2014 the FCA banned the promotion of unregulated collective investment schemes, however venture capital trusts, enterprise investment schemes ('EIS')[1715] and real estate investment trusts are exempt from the ban. In this regard, the FCA stated the following:

[1710] Ghanty, J., Cornelius, J., Baker, M. and Ormond, C. (2014), 'Marketing funds in Europe: a practical look at the marketing regime under the Alternative Investment Fund Managers Directive 2011/61/EU and other regulatory requirements', Journal of Investment Compliance, 15(3), at pages 20-27. See also Innes, D., Lewin-Smith, G., and Raven, D. (2012), 'Fund Formation: United Kingdom', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 321-326.

[1711] Sourced and available at www.fca.org.uk/consumers/financial-services-products/investments/types-of-investment/ucis, accessed in June 2015.

[1712] Fisher, J. (2003), 'The Law of Investor Protection', Second Edition, Sweet and Maxwell Limited Publishers, at page 156.

[1713] Fisher, J. (2003), 'The Law of Investor Protection', Second Edition, Sweet and Maxwell Limited Publishers, at page 156.

[1714] Available at www.fca.org.uk/firms/financial-services-products/investments/ucis, accessed in June 2015.

[1715] Discussed in paragraph 2.1(d) at chapter four.

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> 'The FSA published a consultation paper in August 2012 proposing rule changes aimed at improving retail consumer outcomes by banning the promotion of UCIS and close substitutes to retail investors other than where specific exemptions apply. For example, promotions are still allowed for individuals certified as sophisticated or high net worth investors. The new marketing restriction rules came into force on 1 January 2014 and aim to ensure that NMPIs are recognised as specialist products unsuitable for general promotion in the UK retail market. As providing financial advice generally includes making a financial promotion, by limiting the promotion of UCIS we aim to limit the number of retail clients being wrongly advised to invest in UCIS.'[1716]

In terms of an unregulated collective investment scheme, the investor takes no responsibility for the day-to-day running of the scheme.[1717] Despite the name, unregulated collective investment schemes might not be authorised in themselves but the 'establishing, operating and winding up' of the scheme is a regulated activity and the rules on promoting such schemes are very clear.[1718] However, the primary consideration is that they must not be promoted to the general public.[1719]

4.4 Australian Regulatory and Licensing Requirements

A private equity fund vehicle formed in Australia could have a domestic or international private equity fund manager, although to access the tax treatment afforded by the VCLP, ESVCLP and MIT regimes,[1720] the specific requirements associated with those regimes must be complied with.[1721] For example, the MIT regime requires that the trustee of the trust be an Australian resident for tax purposes.[1722] A domestic private equity firm will generally be required to hold an Australian Financial Services Licence ('AFSL'), which will set out the authorised activities that the manager may undertake.[1723] Depending on the circumstances, the licensed entity may be the manager of the fund, the trustee of the trust or general partner of the VCLP or ESVCLP.[1724]

[1716]Available at www.fca.org.uk/firms/financial-services-products/investments/ucis, accessed in June 2015.
[1717]See Athanassiou, P. (2012), 'Research Handbook on Hedge Funds, Private Equity and Alternative Investments', Research handbooks in financial law, Edward Elgar Publishing, at pages 139-290.
[1718]Barry, B. (2011), 'Fund Formation: England and Wales', in Private Equity in 33 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages, at pages 67-73.
[1719]Available at www.fca.org.uk/firms/financial-services-products/investments/ucis, accessed in June 2015. See also Barry, B. (2011), 'Fund Formation: England and Wales', in Private Equity in 33 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages, at pages 67-73. See also Innes, D., Lewin-Smith, G., and Raven, D. (2012), 'Fund Formation: United Kingdom', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 321-326.
[1720]Discussed in paragraph 3 of this chapter.
[1721]Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', Private Equity in 29 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 6-12.
[1722]Australian Private Equity and Venture Capital Association Limited (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014.
[1723]As discussed earlier in paragraph 3 of this chapter
[1724]Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', Private Equity in 29 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 6-12.

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A domestic private equity firm will generally have a head office in Australia, be structured as a proprietary limited company, which requires at least one resident director and have a company secretary.[1725] Apart from the compliance requirements associated with AFSLs, limited financial records and statutory registers are required to be kept.[1726] VCLPs and ESVCLPs are able to hold assets directly, but in the case of trusts,[1727] trustees hold the title and, where they have more than twenty clients, may need an AFSL with a custody authorisation to enable them to do so.[1728] Alternatively, a licensed custodian can be hired to provide this service to the fund.[1729] Where the trustee has fewer than twenty clients, there are some exemptions from the requirement for a fund manager to either hold an AFSL with an authorisation to provide custody services or use an external custodian.[1730]

The Australian Securities and Investments Commission ('ASIC') is an Australian government body that acts as Australia's corporate regulator.[1731] ASIC's role is to enforce and regulate company and financial services laws to protect Australian consumers, investors and creditors.[1732] ASIC is the principle regulatory authority that has oversight of the operation of private equity funds in Australia.[1733] In terms of the AFSL licensing regime, licensed entities are required to prepare and publicly lodge audited accounts and comply with stringent ASIC requirements relating to compliance and compliance auditing.[1734] For example, the ASIC has the right at any time to inspect books and records of a licensed entity in relation to their compliance with these provisions of the Corporations Act of 2001.[1735]

In addition, the Australian Private Equity and Venture Capital Association Limited have released a code of private equity governance that sets out principles and guidance to inform decisions about how Australian private equity funds and their portfolio companies might be better governed.[1736] Compliance with these codes are not compulsory for private equity firms, general partners and trustees, however, industry practice dedicates that most investors expect that private equity firms, general partners and trustees follow the principles set out in the code and report to investors where

[1725]Available at http://asic.gov.au/for-finance-professionals/afs-licensees/, accessed in June 2015.
[1726]Available at http://asic.gov.au/for-finance-professionals/afs-licensees/, accessed in June 2015.
[1727]Including MITs.
[1728]Available at http://asic.gov.au/for-finance-professionals/afs-licensees/, accessed in June 2015.
[1729]Available at http://asic.gov.au/for-finance-professionals/afs-licensees/, accessed in June 2015.
[1730]Available at http://asic.gov.au/for-finance-professionals/afs-licensees/, accessed in June 2015.
[1731]Available at http://asic.gov.au/about-asic/what-we-do/our-role/, accessed in June 2015.
[1732]Available at http://asic.gov.au/about-asic/what-we-do/our-role/, accessed in June 2015. ASIC was established on 1st July 1998 and its authority and scope is determined pursuant to the Australian Securities and Investments Commission Act of 2001.
[1733]Available at http://asic.gov.au/about-asic/what-we-do/our-role/, accessed in June 2015.
[1734]Available at http://asic.gov.au/about-asic/what-we-do/our-role/, accessed in June 2015.
[1735]Available at http://asic.gov.au/about-asic/what-we-do/our-role/, accessed in June 2015.
[1736]Australian Private Equity and Venture Capital Association Limited (AVCAL), (2011), 'Code of Private Equity Governance', Australian Private Equity and Venture Capital Association Limited Report, September 2011, at pages 1-11.

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they have not followed the principles.[1737] Nevertheless, most private equity funds in Australia target predominantly institutional or wholesale investors, meaning there are no registration requirements for the fund in terms of corporate law legislation.[1738] If a private equity fund were to target retail investors, however, the Australian regulations would require the fund to be registered and the constituent documents to comply with strict requirements.[1739] Therefore, VCLPs and ESVCLPs established in Australia must be registered as an incorporated limited partnership in a particular state and as a VCLP or ESVCLP with the federal government body that oversees the VCLP and ESVCLP regimes.[1740] The trustee of an MIT must elect for the trust to be treated as an MIT, otherwise the AFSL requirements described above are the main licensing requirements applicable to private equity firms.[1741] In addition, the AFSL registration requirements as described above need to be satisfied and the entity managing the fund must have organisational capacity and relevant experience with dealing in and advising on securities to wholesale clients at a minimum.[1742] These requirements set out detailed tests that need to be satisfied by the persons responsible for the day-to-day management and operation of the private equity fund.[1743]

4.5 Canadian Regulatory and Licensing Requirements

As mentioned earlier in paragraph 3.5 of this chapter, Canada has a federal system of government whereby the authority to enact legislation is divided between the federal and the provincial and territorial governments.[1744] The Canadian securities markets are regulated solely by the provincial and territorial governments, therefore each of Canada's ten provinces and three territories has its own legislative scheme for regulating the securities market within its own provincial or territorial jurisdiction and its own securities commission or regulatory authority for administering and enforcing such legislation.[1745] Securities regulatory requirements in Canada can therefore vary from jurisdiction to jurisdiction, which are complex and extensive, and beyond the scope of this discussion. Canadian

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[1737]Australian Private Equity and Venture Capital Association Limited (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014.
[1738]Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', Private Equity in 29 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 6-12.
[1739]Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', Private Equity in 29 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 6-12.
[1740]Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', Private Equity in 29 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 6-12.
[1741]Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', Private Equity in 29 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 6-12.
[1742]Available at http://asic.gov.au/for-finance-professionals/afs-licensees/applying-for-and-managing-an-afs-licence/, accessed in June 2015.
[1743]Available at http://asic.gov.au/for-finance-professionals/afs-licensees/applying-for-and-managing-an-afs-licence/, accessed in June 2015.
[1744]Nicholas, M.C., Sadler, S.D. and Struthers, S.J. (2012), 'Canadian Securities Regulatory Requirements applicable to Non Resident Broker-Dealers, Advisers and Investment Fund Managers', Securities Regulation and Investment Products Group, 4th September 2012, at page 1.
[1745]Nicholas, M.C., Sadler, S.D. and Struthers, S.J. (2012), 'Canadian Securities Regulatory Requirements applicable to Non Resident Broker-Dealers, Advisers and Investment Fund Managers', Securities Regulation and Investment Products Group, 4th September 2012, at page 1.

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securities legislation generally regulates the trading of, and advising in respect of, securities within a province or territory by requiring those who engage in, or hold themselves out as being engaged in, the business of trading in, or advising in respect of, securities to become registered or licensed as a dealer or adviser, respectively, with the applicable Canadian Securities Regulators unless: (a) the securities legislation provides for an express statutory exemption from the relevant requirement; or (b) an order or ruling can be obtained from the applicable Securities Regulator which exempts a trade, a security or a person or company from the relevant requirement.[1746]

In terms of the adviser registration requirement set out above, what constitutes carrying on the business of an adviser has, for example, been the subject of two decisions of the Ontario Securities Commission.[1747] *In The Matter of Jack Maguire and J.K. Maguire and Associates*,[1748] the Ontario Securities Commission confirmed the statement of the British Columbia Securities Commission made *In The Matter of Robert Anthony Donas*, which reads as follows:

> 'A person who does nothing more than provide factual information about an issuer and its business activities is not advising in securities. A person who recommends an investment to an issuer or a purchase or sale of an issuer's securities, or who distributes or offers an opinion on the investment merits of an issuer or an issuer's securities, is advising in securities. If a person advising in securities is distributing or offering the advice in a manner that reflects a business purpose, the person is required to be registered under the Act.'[1749]

Furthermore, *In The Matter of Brian K. Costello*,[1750] the Ontario Securities Commission held:

> 'the trigger for registration as an adviser is not doing one or more acts that constitute the giving of advice but engaging in the business of advising … Providing mere financial information in relation to specific securities does not constitute the giving of advice, but providing an opinion on the wisdom or value or desirability of investing in specific securities does: *Re Canadian Shareholders Association* (1992), 15 OSCB 617. In *Lowe v Securities and Exchange Commission*, 472 U.S. 181 (1985), a 'one-on-one' relationship involving the giving of advice on specific securities to specific individuals was found to be required to qualify as the giving of advice under US law. Such a direct one-on-one relationship with an investor is not required to qualify as the giving of advice under Ontario law.'[1751]

[1746] See also Johnston, D.L. (2014), 'Canadian Securities Regulation', Fifth Edition, LexisNexis, Butterworths.
[1747] Available at www.osc.gov.on.ca/en/Proceedings_rad_20110121_goldbridge2.htm, accessed at June 2015. Available at http://do.bcsc.bc.ca/Enforcement/Decisions/Robert_Anthony_Donas__Decision_/, accessed at June 2015.
[1748] *In the Matter of Jack Maguire and J.K. Maguire and Associates* 1995, 18 OSCB 4623.
[1749] *In The Matter of Robert Anthony Donas* 1995 BC Weekly Summary, 7th April, at page 39.
[1750] *In The Matter of Brian K. Costello* 2003, 26 OSCB 1617.
[1751] *In The Matter of Brian K. Costello* 2003, 26 OSCB 1617.

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Nevertheless, the general rule is that any person who is in the business of advising another about the sale or purchase of securities must be registered as an adviser. Accordingly, managers must be registered as advisers, unless there is an applicable exemption.[1752] In terms of the laws of certain jurisdictions only Canadian corporations or partnerships can be registered as advisers.[1753] A partner, director or officer of an adviser who advises on securities must also be personally registered as an adviser.[1754] The applicable exemption being that general partners and offshore managers of a private equity fund that are actively involved in managing its portfolio investments need not be registered in this way.[1755]

However, any person who acts as a manager of an investment fund must be registered as an investment fund manager.[1756] An investment fund is defined as a mutual fund, or a fund whose primary purpose is to invest money, but that is not formed for the purposes of exercising control over or managing an issuer (in this context, an underlying portfolio investee company).[1757] Therefore a private equity fund is not an investment fund as defined, because it is formed for the purposes of exercising control over or managing the issuer. Nicholas *et al* defines an investment fund as follows:

> '… a mutual fund or a non-redeemable investment fund, and, for greater certainty in British Columbia, includes an employee venture capital corporation that does not have a restricted constitution, and is registered under Part 2 of the Employee Investment Act (British Columbia) and whose business objective is making multiple investments, and a venture capital corporation

[1752]See Kirsch, C.E. (2011), 'Investment Adviser Regulation: A Step-by-step Guide to Compliance and the Law, First Edition, Volume 1, Practising Law Institute's corporate and securities law library, Practising Law Institute.
[1753]Hernandez, M. (2012), 'The Directive on Alternative Investment Fund Managers: Comparative Analysis of Certain Aspects of Regulatory Regimes in Europe, Canada and the USA', University of Toronto, Doctoral Dissertation.
[1754]Hernandez, M. (2012), 'The Directive on Alternative Investment Fund Managers: Comparative Analysis of Certain Aspects of Regulatory Regimes in Europe, Canada and the USA', University of Toronto, Doctoral Dissertation.
[1755]Hernandez, M. (2012), 'The Directive on Alternative Investment Fund Managers: Comparative Analysis of Certain Aspects of Regulatory Regimes in Europe, Canada and the USA', University of Toronto, Doctoral Dissertation.
[1756]Canadian securities legislation also requires any person or company who acts as an investment fund manager in a province or territory of Canada to become registered as such with the relevant Securities Regulator subject to certain relief that have been granted pursuant to National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Obligations ('NI 31-103'). In an effort to harmonize Canadian securities laws, each of the 13 Securities Regulators in Canada have, under rule making authority granted by the provincial and territorial governments, established numerous rules, referred to as national instruments that operate in a substantially identical manner in each province and territory. NI 31-103 is a product of this harmonization effort.
[1757]Nicholas, M.C., Sadler, S.D. and Struthers, S.J. (2012), 'Canadian Securities Regulatory Requirements applicable to Non Resident Broker-Dealers, Advisers and Investment Fund Managers', Securities Regulation and Investment Products Group, 4th September 2012, at page 21.

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registered under Part 1 of the Small Business Venture Capital Act (British Columbia) whose business objective is making multiple investments.'[1758]

Since a private equity fund typically seeks to exercise some degree of control over their portfolio companies, the private equity firm is exempt from the above mentioned registration requirement. Active management in an underlying portfolio investee company would include a private equity fund having representation on the board of directors of such underlying company; having direct involvement in the appointment of managers of such underlying company; and/or having a say in material management decisions of such underlying company.[1759] As mentioned throughout chapter one and two thus far, the private equity fund aims to realize on the underlying portfolio investment, for instance, via a sale of its ownership interest in the underlying portfolio investee company. It is at such point that the investors' money can be returned to them together with any profit. Furthermore, the investors depend on the private equity firm's skill and expertise in selecting and managing underlying portfolio investee companies into which the private equity will invest.[1760] In return, the private equity firm receives a management fee and carried interest in the profits generated from such investments.[1761] A key feature of private equity investing is that the private equity firm does not receive compensation for raising capital or trading in securities.[1762] Therefore, as Nicholas *et al* states:

'investors rely on the private equity firm to manage a private equity fund but not to manage in any way the underlying businesses that are included in the investment portfolio of the fund.'[1763]

By taking the above considerations into account, Canadian Securities Regulators have advised that if a private equity firm is not compensated for either the raising or investment of money received from investors, and the investment of such money is occasional, the dealer registration requirement mentioned earlier should not apply to the private equity firm in respect of its capital raising activities

[1758]Nicholas, M.C., Sadler, S.D. and Struthers, S.J. (2012), 'Canadian Securities Regulatory Requirements applicable to Non Resident Broker-Dealers, Advisers and Investment Fund Managers', Securities Regulation and Investment Products Group, 4th September 2012, at page 21.
[1759]See paragraphs 2 and 3 of chapter one for a discussing of the salient features of private equity investing.
[1760]See paragraphs 2 and 3 of chapter one for a discussing of the salient features of private equity investing.
[1761]See Nicholas, M.C., Sadler, S.D. and Struthers, S.J. (2012), 'Canadian Securities Regulatory Requirements applicable to Non Resident Broker-Dealers, Advisers and Investment Fund Managers', Securities Regulation and Investment Products Group, 4th September 2012, at page 13. See also Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at 28-33.
[1762]See Nicholas, M.C., Sadler, S.D. and Struthers, S.J. (2012), 'Canadian Securities Regulatory Requirements applicable to Non Resident Broker-Dealers, Advisers and Investment Fund Managers', Securities Regulation and Investment Products Group, 4th September 2012, at page 13. See also Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at 28-33.
[1763]Nicholas, M.C., Sadler, S.D. and Struthers, S.J. (2012), 'Canadian Securities Regulatory Requirements applicable to Non Resident Broker-Dealers, Advisers and Investment Fund Managers', Securities Regulation and Investment Products Group, 4th September 2012, at page 13.

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on behalf of the private equity fund.[1764] Similarly, the private equity firm would not be subject to the investment fund manager registration requirement because it would be managing a private equity fund rather than an investment fund.[1765] Nicholas *et al* states that:

> 'For Canadian securities regulatory purposes, an investment fund is either an open end or closed end investment fund that offers liquidity, takes passive positions in securities and does not try to exercise control or otherwise influence the day-to-day business of the investee issuer. Unlike investment funds, a private equity fund raises capital for the purpose of investing in issuers that are not publicly traded and becoming actively involved in the management of such issuers, often over a period of several years. As a result, persons or companies that invest in a private equity fund must generally agree to remain invested in the private equity fund for a period of time and thereby agree to forego the liquidity that is generally characteristic of an investment in an investment fund.'[1766]

As described above, a typical private equity fund generally would not qualify as an 'investment fund' and, as a result, its manager would not need to be registered in Canada. The general rule is that private equity firms/general partners and offshore managers of a private equity fund that are actively involved in managing its portfolio investments need not normally be registered in terms of the dealer registration and investment fund manager registration requirements under Canadian securities regulations.[1767] In practice, Canadian securities regulators would typically have authority over the offering and sale of securities of a private equity fund to investors in the jurisdiction where such investors reside.[1768] Such securities regulators may, in certain circumstances when there is a perceived breach of securities laws, also exercise broader regulatory powers. However, they would not have jurisdiction over the operation of a 'typical' private equity fund itself.[1769] There generally are

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[1764]By way of interpretive guidance. See also National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Obligations ('NI 31-103').

[1765]This dealer registration and investment fund manager registration analysis may be different if the private equity fund engages in activities other than those described above.

[1766]Nicholas, M.C., Sadler, S.D. and Struthers, S.J. (2012), 'Canadian Securities Regulatory Requirements applicable to Non Resident Broker-Dealers, Advisers and Investment Fund Managers', Securities Regulation and Investment Products Group, 4th September 2012, at page 13.

[1767]Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2011), 'Fund Formation: Canada', in Private Equity in 33 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at 34-39. See also Carroll, C. and Kay, S. (2011), 'Investment Funds: Jurisdictional Comparisons', First Edition, Sweet and Maxwell Publishers, at pages 49-60.

[1768]See Hernandez, M. (2012), 'The Directive on Alternative Investment Fund Managers: Comparative Analysis of Certain Aspects of Regulatory Regimes in Europe, Canada and the USA', University of Toronto, Doctoral Dissertation.

[1769]See Philipps, L. (1993), 'The Amazing Three-Headed Limited Partner: Reflections on Old Loopholes and New Jurisprudence', Canadian Business Law Journal, 21(3), at pages 410-428. See also Kirsch, C.E. (2011), 'Investment Adviser Regulation: A Step-by-step Guide to Compliance and the Law, First Edition, Volume 1, Practising Law Institute's corporate and securities law library, Practising Law Institute. See also Nicholas, M.C., Sadler, S.D. and Struthers, S.J. (2012), 'Canadian Securities Regulatory Requirements applicable to Non Resident Broker-Dealers, Advisers and Investment Fund Managers', Securities Regulation and Investment Products Group, 4th September 2012, at pages 1-26.

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no ongoing regulatory audit requirements and inspection rights in respect of a private equity fund; as well as no regulatory reporting requirements to investors or regulators by the private equity firm, provided that the private equity firm is not required to be registered as an advisor or dealer as discussed above.[1770]

4.6 Summary

It is evident from the discussion in this paragraph 4, that there has been an increase in scrutiny and regulation of private equity firms and their activities in all the jurisdiction discussed above. In terms of the South African regulatory framework, the Registrar of Pension Funds published conditions for investment in private equity funds in March 2012 that stipulate requirements for a private equity fund to qualify for investment by a pension fund. Despite these requirements not binding private equity funds, pension funds are significant investors and therefore private equity funds have an incentive to comply. In addition, managers of South African private equity funds must be regulated as FSPs in terms of FAIS. Therefore, a fund manager managing private equity funds, whether local or foreign, with South African pension fund investors must have a Category II FSP license. The FSB have engaged with the private equity industry representatives with the view of developing industry specific regulations. However, there is no certainty as to when such draft private equity specific regulations will be published.

Also evident from this discussion, is that private equity firms in all these foreign jurisdictions have faced increased legislative pressure to deliver greater transparency, better reporting, more onerous licensing and registration conditions, and tighter accounting controls. One notable trend when analysing the licensing and regulatory developments in South Africa compared with those of the foreign jurisdictions is that all the foreign jurisdictions can be characterised as having consistent regulatory developments and transformation, whereas the South African regulatory development is uncertain and lacks industry specific regulation. Continuous regulatory transformation in these foreign jurisdictions have and will lead to structural changes in the way in which private equity firms operate. Private equity always has been fairly private, characterised as having less regulatory oversight than other more tightly regulated sectors of the financial services industry. Nevertheless, financial regulation and pending reforms in South Africa, UK, US, Australia and Canada have to a large extent changed this view.

5. Conclusion

[1770] Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2011), 'Fund Formation: Canada', in Private Equity in 33 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 34-39. See also Carroll, C. and Kay, S. (2011), 'Investment Funds: Jurisdictional Comparisons', 1st Edition, Sweet and Maxwell Publishers, at pages 49-60.

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As mentioned throughout this chapter, the two main legal vehicles used in South Africa to structure a private equity fund is the *bewind* trust and *en commandite* partnership. The first part of this chapter dealt with the pertinent legal characteristics of the *en commandite* partnership and *bewind* trust, and examined the rationale behind these two legal structures and their tax implications. It is submitted, that the reasons for the use of these two legal structures, are that they both (a) are fiscally transparent which allows for the income and capital gains of the private equity fund to be taxed in the hands of investors according to the tax status of each investor; (b) allow for the appointment of a private equity firm, which will be responsible for the daily administration of the private equity fund; (c) provide investors into the private equity fund with limited liability; and (d) afford contractual flexibility in structuring and documenting the commercial arrangements between the investors and the private equity firm.

The second part of this chapter addressed the regulatory and licensing considerations as it pertains to South Africa, however reference was made to the commonly used private equity fund vehicles in foreign jurisdictions such the US, UK, Australia, and Canada. Furthermore, it must be noted that there are a number of regulatory provisions and licensing requirements that govern private equity firms, fund formation and operation, and investment activities in South Africa. In addition, private equity investors and fund managers must take into account the specific provisions of the Companies Act 71 of 2008, the Financial Advisory and Intermediary Services Act 37 of 2002,[1771] Pensions Fund Act 24 of 1956, and the Collective Investment Schemes Control Act 45 of 2002.

Nevertheless, to restate what was stated at the beginning of this chapter, it is beyond the scope of this thesis to undertake a critical analysis of the taxation of private equity funds. Therefore, whether private equity funds should pay higher taxes or lower taxes, is not a matter of substantial critical analysis in this thesis, however chapter four does examine the key impediments to the development of a private equity market and argues that tax legislation is one such impediment. For instance, it argued in chapter four that if a private equity fund is treated as an operating business rather than a long term passive investor, then the returns to the private equity firm could be taxed as ordinary income, rather than at lower capital gains rates. This would mean that the compensation of private equity firms, namely carried interest, would be taxed at higher rates, which implies that private equity firms would be paying higher taxes under current South African tax legislation, without the need for new legislation. However, chapter four argues for the current status quo to remain, which means that private equity funds are taxed at the lower capital gains tax rates.

[1771]Including the General Code of Conduct for Authorised Financial Service Providers and Representatives and the determination of fit and property requirements in terms of the Financial Advisory and Intermediary Services Act 37 of 2002.

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It has been noted above that a principal advantage of using either a *bewind* trust or an *en commandite* partnership as a fund vehicle is because both these vehicles are 'pass-through' entities for income tax purposes and, therefore, are not subject to income tax in terms of the Income Tax Act 58 of 1962. Instead, the *bewind* trust or *en commandite* partnership's income, gains, losses and deductions are passed through to the investor's and taxed only once at the investor level.[1772] However, this thesis does not argue for the altering the tax treatment of a single industry (private equity industry) because it raises tax policy concerns which is beyond the scope of this thesis. Nevertheless, changing the way private equity firms, *bewind* trusts and *en commandite* partnerships in general are taxed is a subject that should only be undertaken after very careful consideration of the real and potential consequences.

The next chapter will examine the application of effective corporate governance systems as an important risk management tool available to investors in safeguarding their investment in a private equity fund. As part of a private equity manager marketing its skills to investors as a fund manager, it needs to demonstrate how it will address sound corporate governance practices in a business from the day when it first meets with management to consider an investment in the underlying investee company, right up to the time when it exits from the investment. Private equity managers could become involved, for example via their participation on the board and engagement with management, in a wide variety of governance practices, such as making the board more effective or improving financial reporting and disclosure, to unusual undertakings, such as assisting management in corporate restructuring or acquisitions. In addition, private equity managers take a long term view with regard to the investments they make and are ideally placed to play an active role in promoting sound corporate governance practices. Chapter three will discuss the two levels of corporate governance involved in private equity investing. The first level of governance relates to the relation between the private equity fund and the underlying investee company, and will include a discussion on the duties of the fund manager, particularly in their capacity as serving as directors on the boards of such companies. The second level of governance relates the relationship between the private equity firm and the investors that invest in the private equity fund.

[1772]See discussion on tax considerations impacting private equity in chapter four.

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Chapter Three: Corporate Governance

1. Introduction

Chapter three will analyse corporate governance in relation to the private equity business model. Chapter three seeks to explain the link between the private equity business model and corporate governance that is based on the assertion that there are two levels of corporate governance involved in private equity investing. The first level of governance relates to the private equity fund's underlying portfolio investee companies and this will include *inter alia*, a discussion on the duties of the fund manager, particularly in their capacity as serving as directors on the boards of such companies. A discussion on fiduciary duties includes various principles and arguments and for this reason this chapter will only analyse the relevant authority necessary for establishing the fiduciary duty owed by a director to a company, because the private equity firm typically appoints a staff member(s) or independent experts to serve on the board of the investee companies in which the firm invests on behalf of the private equity fund which it is contracted to manage. Nevertheless, the modest goal of this chapter, *inter alia*, is to analyse the law of fiduciary duties with respect to corporate directors and officers of limited liability companies and to illustrate the extent to which corporate law concepts and precedents should be applied (or not applied) in the context of advancing higher standards of corporate governance to the private equity business model.

The second level of governance relates to the private equity fund itself which focuses on the relationship between the private equity firm and the investors that invest in the private equity fund. For instance, it is evident from the discussion on fiduciary duties to follow and in terms of the discussion in chapter two, that an agency relationship exists between the investors and the fund manager, namely that the private equity firm act as agents for external investors, who choose to invest in underlying portfolio investee companies via an intermediary rather than directly.[1773] The discussion and analysis will be restricted to the risks inherent to the private equity fund investors from potential conflicts of interest which may exist within the private equity firm or within the private equity fund and will outline possible mitigating measures alongside the potential conflict of interest risks.[1774] In addition, this chapter will not attempt the homogenisation of fiduciary duty law as applied to different forms of legal vehicles with respect to partnerships and trust, and the numerous side line issues that emanate from a discussion of the concept of fiduciary duties. Chapter two discussed the

[1773]Metrick, A., (2007), 'Venture Capital and the Finance of Innovation', John Wiley and Sons, 2007. This agency problem stems from inevitably high degree of information asymmetry between the private equity firm, who play an active role in the portfolio companies and the passive investors, who have no involvement in managing the underlying investee companies.

[1774]See discussion with regard to *Gatz Properties LLC v Auriga Capital Corporation* 2012, 59 A. 3d 1206, Delaware Supreme Court, at paragraph 3.2 in chapter two earlier. See also Strine, L.E. and Travis, L.J. (2014), 'The Siren Song of Unlimited Contractual Freedom', Harvard Law School John M. Olin Center Discussion Paper No. 789, 1st August 2014.

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most appropriate legal vehicles used to structure a private equity fund. In this regard chapter two discussed the legal principles relating to the trust and limited partnership. The latter two legal vehicles were emphasized as the two most suitable legal vehicles.

Private equity funds differ from other investment funds, such as hedge funds and collective investment schemes, mainly in the larger size of their stakes in underlying investee companies, their longer investment horizons and the fewer number of companies in individual fund portfolios.[1775] The private equity firms have a greater involvement in their investee companies compared to other investment managers and fulfil a greater role in influencing the corporate governance practices of their investee companies. For instance, there is no certainty that an effectively governed company will produce more effective exits and higher returns for private equity firms, but there is an understanding that poorly governed companies are more at risk of failure.[1776] Therefore it is important for private equity firms to ensure that their funds are invested in properly governed companies which demonstrate an inclination to improve their governance. According to a report by the European Private Equity and Venture Capital Association ('EVCA'):

> 'Successful investment requires well informed decision making at all levels and by all parties. At its core, good governance creates the environment for the attitudes, mechanisms and behaviours that allow this well informed decision making to take place. Failures of governance lead to bad decisions and business failures. Where individuals can be relied upon to act with integrity a proliferation of guidance and the imposition of regulation is unnecessary ... Private equity investing as represented by the EVCA membership is characterised by a number of features. The private equity and venture capital investor brings deep industry focus and understanding to the particular business and its investments are characterised by a great deal of shareholders involvement in the particular business and its investments are characterised by a great deal of shareholders involvement in strategy and direction of the investee company. The private equity and venture capital investor takes a long term view of value creation and is seeking, as much as possible, the alignment of stakeholder interests in order to maximise value ... and the industry has been hugely successful in promoting the concept that good corporate governance is a key element in value creation.'[1777]

[1775] Stowell, D. (2012), 'Investment Banks, Hedge Funds, and Private Equity', Academic Press Publishers, at pages 217-219.

[1776] See Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', Second Edition, John Wiley and Sons.

[1777] European Private Equity and Venture Capital Association Report (2005) updated in 2010, 'EVCA Corporate Governance Guidelines: Guidelines and good practice in the management of privately held companies in the private equity and venture capital industry', European Private Equity and Venture Capital Association, at page 6.

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The above mentioned report also made reference to a report by the Organisation for Economic Co-Operation and Development ('OECD')[1778] which stated that:

> 'Corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence. Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined.'[1779]

It is clear from the above introduction, that there is a strong investment case for driving corporate governance in the private equity fund management industry. This investment case raises an important question; namely whether the inclusion of corporate governance principles into the investment policy of a private equity firm is a legal requirement or rather nothing more than a voluntary consideration. In raising this question, the issue that needs to be understood is whether the commonly held view that fiduciary duties require a private equity firm solely to pursue the maximum profit is a correct interpretation of the law or whether acting in the interests of investors can also incorporate other objectives? As stated earlier, this chapter will therefore comprise of two parts because there are two levels of governance involved in private equity investing. The first level of governance relates to the private equity fund's underlying portfolio investee companies. The second level relates to the private equity fund itself which focuses on the relationship between the private equity firm and the investors that invest in the private equity fund. The first part will discuss the broader corporate governance compliance framework, more notable the common law and legislated grounds for corporate governance adherence. In addition, the first part will discuss the relationship between corporate governance principles and law. For example, equity investors invest their capital in enterprises with the intention of obtaining a return on that capital and a goal of company law should be to ensure that shareholders, as the investors of equity, are granted explicit rights and that they have effective recourse when those rights are violated. While the clear statement of such rights and recourse does provide protection to shareholders, it is equally important that investors be educated about those rights and that their statement is easily accessible in the law. The legal protection of investors is one way of thinking about corporate governance and the first part of this chapter will discuss *inter alia* investor protection and fiduciary duties as part of the broader

[1778]Organisation for Economic Co-Operation and Development ('OECD') Report (2004), 'OECD Principles of Corporate Governance', OECD publications, Paris, France.
[1779]European Private Equity and Venture Capital Association Report (2005) updated in 2010, 'EVCA Corporate Governance Guidelines: Guidelines and good practice in the management of privately held companies in the private equity and venture capital industry', European Private Equity and Venture Capital Association, at page 6.

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corporate governance compliance framework. Such a discussion emanates as a result of the principal (investor) and agent (private equity firm) relationship.[1780]

The second part of this chapter will discuss the role of corporate governance in terms of the relationship between the private equity firm and the investors that invest in the private equity fund. This will include a discussion of the practical corporate governance contracting techniques employed between the private equity firm and investors. In addition, the second part of this chapter will also include several key practical recommendations that could be applied within the private equity firm itself to improve its own internal corporate governance framework. As mentioned earlier, this discussion will be restricted to the risks inherent to the private equity fund investors from potential conflicts of interest which may exist within the private equity firm or within the private equity fund and will not address potential conflicts of interest which are not specific to the private equity business model or those potential conflicts of interest which are not usually within the ambit of securities market regulators. Furthermore, it will be recommended that corporate governance mechanisms should be put in place by the private equity firm in order to mitigate the conflicts of interest that may arise within the firm itself.

2(a) Corporate Governance in Relation to Investor Protection

The first part of the discussion to follow is not an exclusive discussion on fiduciary duties *per se*, despite the fact it is extensively discussed below (at paragraph 2(b) of this chapter), but rather the intention is to argue the point that the legal protection of investors is one way of approaching corporate governance as part of a broader private equity industry governance framework. According to Claessens and Yurtoglu:

> 'Many other factors dictate the success of firms and the economies in which they operate. Well functioning legal and judicial systems are also necessary for improving financial markets, securing external financing, and ensuring that economic development is shared by many ... Property rights must be clearly defined and enforced, and key regulations covering disclosures and accounting, among other things, must be in place, with effective and competent supervision to ensure proper compliance ... legal and other reforms - from mandatory internal and external controls to competent, adequately staffed regulators to securities laws ... strongly protect shareholders from dilutive offers, freeze-outs, and fraud - can provide benefits, since they are the necessary foundations for an effective corporate governance system. The level of competition in a market is also a factor, given that good corporate governance behavior can distinguish one company within

[1780] The relationship between a private equity fund manager and the investors is that of principal and agent in terms of which the investor (principal) engages the fund manager (as agent) to invest in investee companies for the benefit of the investors.

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a crowded field. Vigorous competition imposes a discipline that supports adherence to corporate governance best practice.'[1781]

According to La Porta *et al*, corporate failures in relation to governance are, at least in part, due to an absence of active institutional investors. Institutional investors should be encouraged to engage with companies, or require their agents through mandates to vote and engage.[1782] This will ensure that governance best practice principles are more consistently applied. La Porta *et al* argue that corporate governance is a set of mechanisms through which outside investors protect themselves against expropriation by the insiders.[1783] The expropriation is related to the agency problem described by Jensen and Meckling, who argue that the insiders use the profits of the company to benefit themselves rather than return the money to the outside investors.[1784]

According to Blackman, one of the key functions of company law is to provide protection for investors.[1785] Blackman broadly describes investors in companies as equity investors, employees and creditors and argues that employee rights are generally protected in labour law, while large creditors increasingly rely on contract to protect their investment, leaving equity investors at the greatest risk.[1786] According to Haidar, the level of investor protection in an economy matters and that countries with stronger investor protection tend to grow faster than those with poor investor protection.[1787] In addition, countries with poorer investor protections have smaller and narrower capital markets. These findings were obtained by measuring both the character of the legal rules and the quality of law enforcement in the countries used in their study.[1788] The findings apply to both equity and debt markets and particularly highlight that French civil-law countries have both the weakest investor protections and the least developed capital markets, especially as compared to

[1781]Claessens, S., and Yurtoglu, B. (2012), 'Corporate Governance and Development: An Update', Global Corporate Governance Forum Publication (Focus 10), IFC, Washington, DC., at vi. Forward by Millstein, I.R.
[1782]La Porta, R., Lopez-De-Silanes, F., Shleifer, A. and Vishny, R.W. (1999), 'Investor Protection and Corporate Governance', Department of Economics, Harvard University, Cambridge, MA 02138. See Claessens, S., and Yurtoglu, B. (2012), 'Corporate Governance and Development-An Update', Global Corporate Governance Forum Publication (Focus 10), International Finance Corporation, Washington, DC.
[1783]La Porta, R., Lopez-De-Silanes, F., Shleifer, A. and Vishny, R.W. (1999), 'Investor Protection and Corporate Governance', Department of Economics, Harvard University, Cambridge. Bruno, V., and Claessens, S. (2010), 'Corporate governance and regulation: Can there be too much of a good thing?', Journal of Financial Intermediation, 19, at 461–82.
[1784]Jensen, M. and Meckling, W. (1976), 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', 3 Journal of Financial Economics 305. See article by Bebchuk, L.A., and Weisbach, M.S. (2010), 'The state of corporate governance research', Review of Financial Studies, 23, 939–961.
[1785]Blackman, M.S. (2002), 'Commentary on the Companies Act', Cape Town, Juta and Co., Volume 1 at 5-408. See also Brink, A. (2009), 'Corporate governance and the Companies Act', 25 Management Today at page 6. See also Esser, I.M. (2009), 'The protection of stakeholder interests in terms of the South African King III Report on Corporate Governance: an improvement on King II?', 21 SA Mercantile Law Journal 188.
[1786]Blackman, M.S. (2002), 'Commentary on the Companies Act', Cape Town, Juta and Co., Vol 1 at 5-408. See Brink, A. (2009), 'Corporate governance and the Companies Act', 25 Management Today at page 6. See also Esser, I.M. (2009), 'The protection of stakeholder interests in terms of the South African King III Report on Corporate Governance: an improvement on King II?', 21 SA Mercantile Law Journal 188.
[1787]Haidar, J.I. (2009), 'Protections and Economic Growth', Economics Letters, 103(1), April 2009, at 1-4.
[1788]170 countries were studied in the sample.

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common-law countries.[1789] South Africa is a common-law country. According to David and Brierly, the commercial legal systems of most countries originate from three groups, namely the English (common law), the French, and the German, the latter two derived from Roman Law.[1790] England and its former colonies, including the US, Canada, Australia, New Zealand, South Africa and many countries in Africa and South East Asia, ended up with the common-law system. France and many countries Napoleon conquered ended up with French civil law tradition.[1791] This extends to the former French, Dutch, Belgian, and Spanish colonies, including Latin America. Germany, Germanic countries in Europe, and several countries in East Asia are part of the German civil law tradition.[1792]

Prior to the global corporate sector scandals, the widely accepted view was that the common-law systems protect investors better than civil law and that the legal rules in the common-law system are usually made by judges, based on precedents and general principles such as fiduciary duties or fairness.[1793] These judges are expected to rule on unprecedented matters by applying these general principles even when specific conduct has not yet been described or prohibited in the statutes.[1794] In addition, the expansion of legal precedents with regard to fiduciary duty, and the fear of such expansion, limit the expropriation by the insiders in common-law countries.[1795] On the other hand, laws in civil-law systems are made by legislatures, and judges are not supposed to go beyond the statutes which result in the corporate insider finding ways not explicitly forbidden by the statutes to expropriate outside investors and can proceed without fear of an adverse judicial ruling.[1796] However, because of the corporate governance scandals in the US and Europe (common-law systems), the argument that common-law systems protect investors better than civil law seemed to be not that

[1789]Haidar, J.I. (2009), 'Protections and Economic Growth', Economics Letters, 103(1), April 2009, at 1-4.
[1790]David, R., and Brierley, J., (1985), 'Major Legal Systems in the World Today', Stevens and Sons: London, 1985. See also an article by Ararat, M., and Dallas, G. (2011), 'Corporate governance in emerging markets: Why it matters to investors—and what they can do about it', Forum Private Sector Opinion 22. Available at www.gcgf.org/ifcext/cgf.nsf/Content/PSO_22_Melsa, accessed in June 2015.
[1791]David, R., and Brierley, J., (1985), 'Major Legal Systems in the World Today', Stevens and Sons, 1985.
[1792]David, R., and Brierley, J., (1985), 'Major Legal Systems in the World Today', Stevens and Sons, 1985.
[1793]See Cuomo, F., Zattoni, A., and Valentini, G. (2013), 'The Effects of Legal Reforms on the Ownership Structure of Listed Companies', Industrial and Corporate Change, Volume 22, Issue 2, at pages 427-458. Their findings show an increase in the protection of investors' rights is associated with a lower use of control enhancing mechanisms and a lower separation of control and cash flow rights, while it is less evident if it is associated with a more dispersed ownership.
[1794]Cuomo, F., Zattoni, A., and Valentini, G. (2013), 'The Effects of Legal Reforms on the Ownership Structure of Listed Companies', Industrial and Corporate Change, Volume 22, Issue 2, at pages 427-458.
[1795]Foley, F., and Greenwood, R. (2010), 'The Evolution of Corporate Ownership after IPO: The Impact of Investor Protection', Review of Financial Studies 23(3), at 1231-1260. Doidge, C., Karolyi, G.A., and Stulz, R.M. (2007), 'Why Do Countries Matter So Much for Corporate Governance?', Journal of Financial Economics 86(1), at 1-39. This paper develops and tests a model of how country characteristics, such as legal protections for minority investors and the level of economic and financial development, influence firms' costs and benefits in implementing measures to improve their own governance and transparency. Further, the study show that firm characteristics explain almost none of the variation in governance ratings in less-developed countries and that access to global capital markets sharpens firms' incentives for better governance.
[1796]Mallin, C. (2013), 'Corporate Governance', Fourth Edition, Oxford University Press, at pages 15-68.

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plausible.[1797] Claessens argues that many of the assumptions and prejudgments that were made at the start of the transition ('pre-scandals') regarding the reform process have proved to be incorrect.[1798] Instead, Fox and Heller argue that corporate governance should be defined by looking at the firm's economic functions, rather than any particular set of corporate laws.[1799] According to Fox and Heller:

> 'firms exhibit good corporate governance when they both maximize the firm's residuals – the wealth generated by the real operations of the firm –and, in the case of investor-owned firms, distribute the wealth so generated to shareholders in a *pro rata* fashion ...'[1800]

These authors argue that ineffective corporate governance is rooted in a firm's inability to meet one or both of these conditions.[1801] Mahoney also challenged the assertion that suggests that countries with common-law systems have better developed financial systems than do civil law countries.[1802] Mahoney argues that the reason for the better developed financial systems is because of their economic growth performance. He agrees that legal origin affects economic growth, but argues that the rules of investor protection are not the sole or principal challenge through which legal origin affects growth. Instead, the difference between common-law and civil-law countries originate from each system's different philosophies of government. [1803] According to Mahoney:

> 'Legal origin does not affect economic growth solely, or even principally, through its effect on financial markets. The major families of legal systems were created as a consequence of debates about government structure, not merely about the rules that should govern particular transactions.

[1797]Mallin, C. (2013), 'Corporate Governance', Fourth Edition, Oxford University Press, at pages 15-68. See also Du Plessis, J.J., Hargovan, A. and Bagaric, M. (2010), 'Principles of Contemporary Corporate Governance', Second Edition, Cambridge University Press, at paragraph 2.3.2.7.

[1798]Claessens, S., (2006), 'Corporate Governance and Development', The World Bank Research Observer, at pages 91-122.

[1799]Fox, M.B, and Heller, M.A. 2006), 'Corporate Governance Lessons From Transition Economy Reforms', Princeton University Press.

[1800]Fox, M.B, and Heller, M.A. (2006), 'Corporate Governance Lessons From Transition Economy Reforms', Princeton University Press, at page 4.

[1801]Fox, M.B, and Heller, M.A. (2006), 'Corporate Governance Lessons From Transition Economy Reforms', Princeton University Press, at page 4.

[1802]Mahoney, P.G. (2001), 'The Common Law and Economic Growth: Hayek Might Be Right', Journal of Legal Studies 30, at 503–525. McCahery, J.A., Sautner, Z., and Starks, L.T. (2010), 'Behind the scenes: The corporate governance preferences of institutional investors', Tilburg Law School Research Paper No. 010/2010; and Kose, A., Prasad, E., Rogoff, K., and Wei, S. (2010), 'Financial globalization and economic policies', Discussion Paper 7117, Centre for Economic Policy Research.

[1803]Mahoney, P.G. (2001), 'The Common Law and Economic Growth: Hayek Might Be Right', Journal of Legal Studies 30, at pages 503–525. See McCahery, J.A., Sautner, Z., and Starks, L.T. (2010), 'Behind the scenes: The corporate governance preferences of institutional investors', Tilburg Law School Research Paper No. 010/2010; and see Kose, A., Prasad, E., Rogoff, K., and Wei, S. (2010), 'Financial globalization and economic policies', Discussion Paper 7117, Centre for Economic Policy Research. See Bloomfield, S. (2013), 'Theory and Practice of Corporate Governance: An Integrated Approach', First Edition, Cambridge University Press.

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> A country's legal system accordingly reflects, albeit remotely and indirectly, a set of prior choices about the role of the state and the private sector in responding to change.'[1804]

Nevertheless, common-law countries experienced higher growth during the 1980s and 1990s because common law is associated with fewer governmental restrictions on liberty, more judicial power, and more secure property and contract rights.[1805] According to Doidge *et al*, changes in law and the enforcement thereof is the core to understanding the reasons companies raise more funds in some countries than in others.[1806] Doidge *et al* argue that investors finance companies because their rights are protected by the law and that these outside investors are more dependent on the law.[1807] For instance, company and insolvency laws specifically describe certain rights to investors on the one hand, as well as to directors and managers on the other. The quality of these laws and the quality of their enforcement by the regulators and courts are essential elements of corporate governance and finance.[1808] If investor rights, for example the voting rights and liquidation rights of the creditors are well enforced by courts, then investors are more willing to invest. On the other hand, when the legal system does not protect outside investors, corporate governance and external finance do not work well.[1809] This emphasis on legal rules and regulations protecting outside investors stands in sharp contrast to the view of financial contracting, which postulates that most regulations of financial markets are unnecessary because financial contracts take place between sophisticated issuers and sophisticated investors.[1810] However, whether contracts or court enforced legal rules and regulations are the most efficient form of protecting financial arrangements is largely an empirical question.[1811] Franks *et al*, reject the hypothesis that private contracting is sufficient and their findings

[1804]Mahoney, P.G. (2001), 'The Common Law and Economic Growth: Hayek Might Be Right', Journal of Legal Studies 30, at pages 503–525. See also Mallin, C. (2013), 'Corporate Governance', Fourth Edition, Oxford University Press, at 15-68.

[1805]Mahoney, P.G. (2001), 'The Common Law and Economic Growth: Hayek Might Be Right', Journal of Legal Studies 30, at pages 503–525. See also Mallin, C. (2013), 'Corporate Governance', Fourth Edition, Oxford University Press, at 15-68.

[1806]Doidge, C., Karolyi, G.A., and Stulz, R.M. (2007), 'Why Do Countries Matter So Much for Corporate Governance?', Journal of Financial Economics 86(1), at pages 1-39. See also Bloomfield, S. (2013), 'Theory and Practice of Corporate Governance: An Integrated Approach', First Edition, Cambridge University Press.

[1807]Doidge, C., Karolyi, G.A., and Stulz, R.M. (2007), 'Why Do Countries Matter So Much for Corporate Governance?', Journal of Financial Economics 86(1), at pages 1-39.

[1808]Doidge, C., Karolyi, G.A., and Stulz, R.M. (2007), 'Why Do Countries Matter So Much for Corporate Governance?', Journal of Financial Economics 86(1), at pages 1-39.

[1809]Doidge, C., Karolyi, G.A., and Stulz, R.M. (2007), 'Why Do Countries Matter So Much for Corporate Governance?', Journal of Financial Economics 86(1), at 1-39. The authors argue that the incentives to adopt better governance mechanisms at the company level increase with a country's financial and economic development. When economic and financial development is poor, the incentives to improve company level governance are low because outside finance is expensive and the adoption of better governance mechanisms is expensive. The authors state that almost all of the variation in governance ratings across companies in less developed countries is attributable to country characteristics rather than company characteristics typically used to explain governance choices. Secondly, company characteristics explain more of the variation in governance ratings in more developed countries; and thirdly access to global capital markets sharpens company incentives for better governance, but decreases the importance of home-country legal protections of minority investors.

[1810]Fligstein, N and Choo, J (2005),'Law and Corporate Governance' Review of Law and Social Science at 61-83.

[1811]Fligstein, N and Choo, J (2005),'Law and Corporate Governance' Review of Law and Social Science at 61-83.

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prove that even among countries with well functioning judiciaries, those with laws and regulations more protective of investors have better developed capital markets.[1812]

Aguilera *et al*, supported the above mentioned view postulated by La Porta *et al* and highlighted three broad areas in which investor protection has been shown to matter, namely ownership and control patterns of companies, the development of financial markets and the allocation of real resources.[1813] Aguilera *et al* argue that the focus on expropriation of investors and its prevention has a number of implications for the ownership structures of companies.[1814] The evidence put forward in their paper on corporate ownership patterns around the world supports the importance of investor protection, and that countries with poor investor protection display more concentrated control of companies than do countries with good investor protection. This evidence is consistent with their proposition that the legal environment shapes the value of the private benefits of control and thereby determines the equilibrium ownership structures.[1815]

The most basic predictor of the legal approach is that investor protection encourages the development of financial markets.[1816] Creditor rights encourage the development of lending and the exact structure of these rights may alternatively favour bank lending or market lending; while on the other hand shareholder rights encourage the development of equity markets as measured by the valuation of companies, the number of listed companies and the rate at which firms go public.[1817] Therefore both shareholders and creditors' protection includes not only the rights written into the laws and regulations, but also the effectiveness of their enforcement. In terms of the above discussion, it is submitted that countries that protect shareholders have more valuable stock markets, larger numbers of listed companies and a higher rate of stock market listing activity than countries that do not protect shareholders. In addition, investor protection influences what is described as the

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[1812]Franks, J., Volpin, P. and Wagner, H.F. (2012), 'The Life Cycle of Family Ownership', Review of Financial Studies, 25(6), at pages 1675-1712.
[1813]Aguilera, R.V., de Castro, L.R.K., Lee, J.H. and You, J. (2011), 'Corporate Governance in Emerging Markets', forthcoming in Morgan, G., and R. Whitley, R. (2011), 'Capitalisms and Capitalism in the 21st Century', Oxford: Oxford University Press, 2011.
[1814]Aguilera, R.V., de Castro, L.R.K., Lee, J.H. and You, J. (2011), 'Corporate Governance in Emerging Markets', forthcoming in Morgan, G., and R. Whitley, R. (2011), 'Capitalisms and Capitalism in the 21st Century', Oxford: Oxford University Press, 2011.
[1815]Aguilera, R.V., de Castro, L.R.K., Lee, J.H. and You, J. (2011), 'Corporate Governance in Emerging Markets', forthcoming in Morgan, G., and R. Whitley, R. (2011), 'Capitalisms and Capitalism in the 21st Century', Oxford: Oxford University Press, 2011.
[1816]Burkart, M., Gromb, D., Mueller, H.M. and Panunzi, F. (2014), 'Legal investor protection and takeovers. The Journal of Finance, 69(3), at pages 1129-1165. See also Claessens, S., (2006), 'Corporate Governance and Development', The World Bank Research Observer, at pages 91-122. See also Claessens, S., and Yurtoglu, B. (2012), 'Corporate Governance and Development - An Update', Global Corporate Governance Forum Publication (Focus 10), International Finance Corporation, Washington, DC.
[1817]Burkart, M., Gromb, D., Mueller, H.M. and Panunzi, F. (2014), 'Legal investor protection and takeovers. The Journal of Finance, 69(3), at pages 1129-1165. See also Claessens, S., (2006), 'Corporate Governance and Development', The World Bank Research Observer, at pages 91-122.

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real economy.[1818] To this end, financial development can accelerate economic growth in three ways. The first is that it can enhance savings; secondly it can channel these savings into real investment and thereby foster capital accumulation. Thirdly, financial development allows capital to flow toward the more productive uses, which improves the efficiency of resource allocation, provided that the financiers exercise some control over the investment decisions of the entrepreneurs.[1819]

According to Claessens and Yurtoglu, the more traditional comparisons of corporate governance systems focus on the institutions financing companies rather than on the legal protection of investors.[1820] The former are commonly referred to as bank centred corporate governance systems, in contrast to the latter, which are referred to as market centred systems. The characteristics of the two have been central to the evaluation of alternative corporate governance policy proposals for improvement.[1821] For example, in the 1980s the Japanese economy could do no wrong and its bank centred governance system was viewed as superior. The tide turned in the 1990s, as the Japanese economy collapsed. This led to dramatic corporate governance reform in Japan in 2002.[1822] According to Aoki and Patrick, Japanese corporate governance in the post-war period was both insular and conservative.[1823] It was insular in that Japanese corporate governance had a unique structure that reflected the special characteristics of Japan, whether cultural or industrial. It was conservative in that in the familiar account, Japanese corporate governance largely walled off company management from external pressure, whether from the market or from shareholders.[1824] While a main bank may intervene in circumstances of distress, intervention comes from within rather than from without and later in the process than would be the case with US and UK.[1825] Instead of adopting a blanket reform of its corporate law that applied to all corporations, as has been the

[1818]See Aguilera, R.V., de Castro, L.R.K., Lee, J.H. and You, J. (2011), 'Corporate Governance in Emerging Markets', forthcoming in Morgan, G., and R. Whitley, R. (2011), 'Capitalisms and Capitalism in the 21st Century', Oxford: Oxford University Press, 2011.

[1819]See Aguilera, R.V., de Castro, L.R.K., Lee, J.H. and You, J. (2011), 'Corporate Governance in Emerging Markets', forthcoming in Morgan, G., and R. Whitley, R. (2011), 'Capitalisms and Capitalism in the 21st Century', Oxford: Oxford University Press, 2011.

[1820]Claessens, S., and Yurtoglu, B. (2012), 'Corporate Governance and Development - An Update', Global Corporate Governance Forum Publication (Focus 10), International Finance Corporation, US, at pages 8-13.

[1821]Claessens, S., and Yurtoglu, B. (2012), 'Corporate Governance and Development: An Update', Global Corporate Governance Forum Publication (Focus 10), International Finance Corporation, US, at pages 8-13.

[1822]Claessens, S., and Yurtoglu, B. (2012), 'Corporate Governance and Development: An Update', Global Corporate Governance Forum Publication (Focus 10), International Finance Corporation, US, at pages 8-13.

[1823]Aoki, M., and Patrick, H. (1993), 'The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies', Oxford University Press: New York. See also Amaeshi, K., Osuji, O.K., and Doh, J.P. (2011), 'Corporate social responsibility as a market governance mechanism: Any implications for corporate governance in emerging economies?', Paper presented at the Third International Conference on Corporate Governance in Emerging Markets, Korea University Business School, Seoul.

[1824]Aoki, M., and Patrick, H. (1993), 'The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies', Oxford University Press: New York. See also Amaeshi, K., Osuji, O.K., and Doh, J.P. (2011), 'Corporate social responsibility as a market governance mechanism: Any implications for corporate governance in emerging economies?', Paper presented at the Third International Conference on Corporate Governance in Emerging Markets, Korea University Business School, Seoul.

[1825]Amaeshi, K., Osuji, O.K., and Doh, J.P. (2011), 'Corporate social responsibility as a market governance mechanism: Any implications for corporate governance in emerging economies?', Paper presented at 3rd International Conference on Corporate Governance in Emerging Markets, Korea University Business School.

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strategy, for example, in the transition economies arising out of the break-up of the Soviet Union or Korea following the Asian financial crisis, Japan followed an enabling strategy of reform.[1826] Since 2003, Japanese companies have had the option of choosing features of a US/UK style governance structure. According to Gilson and Milhaupt, this reform permits companies to change from a 'Japanese' to a 'US' board structure, featuring independent committees of the board for audit, compensation, and nomination.[1827] These authors examined why Japanese companies might make the change and found that the belief that US corporate governance structures are superior to Japanese structures (one would assume at least before the US corporate governance scandals), so that the adoption serves a signalling and bonding function. According to Gilson and Milhaupt:

> 'The most straightforward explanation for a Japanese company adopting a board centered governance structure is the belief ... that the Anglo-Saxon governance structure was better suited to the current economic environment and therefore reform would lead to better corporate performance. From this perspective, companies would adopt the board committee structure to improve their performance. The difficulty with this analysis is the data. Studies of governance differences within developed countries in general, and of board composition in particular, do not show that "better" governance results in better performance. Only with respect to takeover defenses does there seem to be clear evidence that governance matters.'[1828]

Milhaupt argues that the 2002 amendment to the Japanese Commercial Code, which permits choice in board structure, caps several years of corporate governance reform in Japan.[1829] Milhaupt

[1826] Gilson, R.J., and Milhaupt, C.J. (2004), 'Choice as Regulatory Reform: The Case of Japanese Corporate Governance', Columbia Law and Economics Working Paper No. 251; Stanford Law and Economics Olin Working Paper No. 282. See also Bebchuk, L.A., and Weisbach, M.S. (2010), 'The state of corporate governance research', Review of Financial Studies, 23, at pages 939–961.

[1827] Gilson, R.J., and Milhaupt, C.J. (2004), 'Choice as Regulatory Reform: The Case of Japanese Corporate Governance', Columbia Law and Economics Working Paper No. 251; Stanford Law and Economics Olin Working Paper No. 282.

[1828] Gilson, R.J., and Milhaupt, C.J. (2004), 'Choice as Regulatory Reform: The Case of Japanese Corporate Governance', Columbia Law and Economics Working Paper No. 251; Stanford Law and Economics Olin Working Paper No. 282, at pages 25-27. See also Carney, R.W., and Child, T.B. (2011), 'Changes to the ownership and control of East Asian corporations between 1996 and 2008', Working Paper, S. Rajaratnam School of International Studies, Singapore, and the Australian National University.

[1829] Milhaupt, C.J. (2003), 'A Lost Decade for Japanese Corporate Governance Reform?: What's Changed, What Hasn't, and Why', Columbia Law and Economics Working Paper No. 234. See also Kose, A., Prasad, E., Rogoff, K., and Wei, S. (2010), 'Financial globalization and economic policies', Discussion Paper 7117, Centre for Economic Policy Research. See also Kato, K., Li, M. and Skinner, D.J. (2014), 'Is Japan Really a 'Buy'? The Corporate Governance, Cash Holdings, and Economic Performance of Japanese Companies', Chicago Booth Research Paper, 1st Octber 2014, (13-06).

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highlights the sheer volume of reform, evidenced by the most extensive amendments to Japanese corporate law found principally in the Commercial Code.[1830] According to Gilson and Milhaupt:

> 'The 2002 amendment to the Commercial Code that enabled choice in the selection of board structure occurred in the midst of worldwide fallout from the Enron and WorldCom scandals. Ironically, at the precise moment Japanese firms were given the option of adopting "US-style" corporate governance (and that is how the new system is commonly, if controversially, referred to in Japan), the United States was undergoing its most serious corporate governance crisis in at least a generation. This, together with uncertainty about the stability of the political balance reflected in the 2002 amendment, may have slowed the migration to the new governance structure.'[1831]

Milhaupt noted that the signs of change in response to the corporate law reform in Japan can be found in the areas of shareholder activism, corporate mergers and acquisitions and other organisational changes, board structure, and corporate finance.[1832] At the same time, however, domestic institutional investors remained passive, management remained largely insulated from the market for corporate control, and 'lifetime' employment practices, while covering a declining subset of the Japanese workforce, remained firmly in place.[1833] Milhaupt examined the pattern of change and non-change by analysing the relationship between corporate law and corporate governance and argued that corporate law has a limited relationship to corporate governance and the changes in corporate practices are brought about by dynamics external to the formal corporate governance institutions.[1834] Furthermore, he argues that the extensive change in Japanese corporate governance

[1830]Milhaupt, C.J. (2003), 'A Lost Decade for Japanese Corporate Governance Reform?: What's Changed, What Hasn't, and Why', Columbia Law and Economics Working Paper No. 234. See also Kato, K., Li, M. and Skinner, D.J. (2014), 'Is Japan Really a 'Buy'? The Corporate Governance, Cash Holdings, and Economic Performance of Japanese Companies', Chicago Booth Research Paper, 1st October 2014, (13-06).
[1831]Gilson, R.J., and Milhaupt, C.J. (2004), 'Choice as Regulatory Reform: The Case of Japanese Corporate Governance', Columbia Law and Economics Working Paper 251; Stanford Law and Economics Olin Working Paper 282, at 20. Qian, J., and Zhao, S. (2011), 'Do shareholder rights matter? Evidence from a quasi-natural experiment', Paper presented at the Third International Conference on Corporate Governance in Emerging Markets, Korea University Business School, Seoul.
[1832]Milhaupt, C.J. (2003), 'A Lost Decade for Japanese Corporate Governance Reform?: What's Changed, What Hasn't, and Why', Columbia Law and Economics Working Paper No. 234. McCahery, J.A., Sautner, Z., and Starks, L.T. (2010), 'Behind the scenes: The corporate governance preferences of institutional investors', Tilburg Law School Research Paper No. 010/2010. Kato, K., Li, M. and Skinner, D.J. (2014), 'Is Japan Really a 'Buy'? The Corporate Governance, Cash Holdings, and Economic Performance of Japanese Companies', Chicago Booth Research Paper, 1st Octber 2014, (13-06).
[1833]Milhaupt, C.J. (2003), 'A Lost Decade for Japanese Corporate Governance Reform?: What's Changed, What Hasn't, and Why', Columbia Law and Economics Working Paper No. 234. McCahery, J.A., Sautner, Z., and Starks, L.T. (2010), 'Behind the scenes: The corporate governance preferences of institutional investors', Tilburg Law School Research Paper No. 010/2010. Kato, K., Li, M. and Skinner, D.J. (2014), 'Is Japan Really a 'Buy'? The Corporate Governance, Cash Holdings, and Economic Performance of Japanese Companies', Chicago Booth Research Paper, 1st Octber 2014, (13-06).
[1834]Milhaupt, C.J. (2003), 'A Lost Decade for Japanese Corporate Governance Reform?: What's Changed, What Hasn't, and Why', Columbia Law and Economics Working Paper No. 234. McCahery, J.A., Sautner, Z., and Starks, L.T. (2010), 'Behind the scenes: The corporate governance preferences of institutional investors', Tilburg Law School Research Paper No. 010/2010. Kato, K., Li, M. and Skinner, D.J. (2014), 'Is Japan Really

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must await further changes in the distribution of shareholders, in the capital markets, and in the incentive structures for management, and the further erosion of corporate norms that promote employee and managerial interests over shareholder interests.[1835]

The classification of financial systems into bank and market centered is not an easy exercise. As discussed above, one way to classify financial systems is based on the existence of regulations restricting bank ownership of corporate equity. This approach is useful for distinguishing the US from Germany, which does not have such regulations. However, regulations restricting bank ownership of corporate equity do not assure the development of a market centred system.[1836] Styre supports the view of Fligstein and Choo[1837] that corporate governance literature in law has always considered political and social factors as fundamental to companies and economic growth and dismiss the classification of financial systems as bank or market centred because it misses the importance of investor rights.[1838] Fligstein and Choo supported the view postulated by La Porta *et al*, namely that all financiers depend on legal protection to function and that a method of financing develops when it is protected by the law that gives financiers the power to get their money back.[1839] For example Germany and certain German civil law countries have developed banking systems that afford strong legal protection of creditors, because without such rights German banks would have much less power. The same applies to the UK that also has a large banking and public debt sector, because creditors have extensive rights.[1840] However, countries such as Italy and Belgium, for example, do not have well developed debt nor equity markets because of the limited legal protection afforded to minority shareholders.[1841] Franks *et al* stated that in countries with poor shareholder protection they found that even the largest firms tend to have controlling shareholders and in most instances the controlling shareholders was a family and sometimes even the State.[1842] The controlling

a 'Buy'? The Corporate Governance, Cash Holdings, and Economic Performance of Japanese Companies', Chicago Booth Research Paper, 1st Octber 2014, (13-06).

[1835]Milhaupt, C.J. (2003), 'A Lost Decade for Japanese Corporate Governance Reform?: What's Changed, What Hasn't, and Why', Columbia Law and Economics Working Paper 234. Kato, K., Li, M. and Skinner, D.J. (2014), 'Is Japan Really a 'Buy'? The Corporate Governance, Cash Holdings, and Economic Performance of Japanese Companies', Chicago Booth Research Paper, 1st Octber 2014 (13-06).

[1836]Dam, L. and Koetter, M. (2012), 'Bank bailouts and moral hazard: Evidence from Germany', Review of Financial Studies, 25(8), at 2343-2380.

[1837]Fligstein, N. and Choo, J. (2005), 'Law and Corporate Governance', Annual Review of Law and Social Science, at pages 61-83. Kose, A., Prasad, E., Rogoff, K., and Wei, S. (2010), 'Financial globalization and economic policies', Discussion Paper 7117, Centre for Economic Policy Research.

[1838]Styhre, A. (2015), 'A managerial revolution in reverse: finance market control of the corporation and the triumph of the agency theory model', Management & Organizational History, 10(1), at 71-86.

[1839]Fligstein, N. and Choo, J. (2005), 'Law and Corporate Governance', Annual Review of Law and Social Science, at pages 61-83. See also Giroud, X., and Mueller, H. (2010), 'Does corporate governance matter in competitive industries?', Journal of Financial Economics 95: at 312–31.

[1840]Styhre, A. (2015), 'A managerial revolution in reverse: finance market control of the corporation and the triumph of the agency theory model', Management & Organizational History, 10(1), at pages 71-86.

[1841]Fligstein, N. and Choo, J. (2005), 'Law and Corporate Governance', Annual Review of Law and Social Science, at pages 61-83. For a paper on the link between law and corporate governance see Claessens, S., and Yurtoglu, B. (2012), 'Corporate Governance and Development - An Update', Global Corporate Governance Forum Publication (Focus 10), International Finance Corporation, Washington, DC., at 8-13.

[1842]Franks, J., Volpin, P. and Wagner, H.F. (2012), 'The Life Cycle of Family Ownership', Review of Financial Studies, 25(6), at 1675-1712.

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shareholders often control large firms through pyramid structures, and in part because they manage the firms they control.[1843] This has resulted in these firms having a problem of separation of ownership and control. [1844]

Despite the difficulty of classifying financial systems into bank and market centred, Burkart *et al* highlight that bank centered financial systems distract attention from the important role that stock markets play in external finance.[1845] They argue that equity financing is essential for the expansion of new companies whose main assets are growth opportunities, and are therefore in principle companies which could utilize private equity financing.[1846] However, it has many of the same problems of excessive investor power suppressing entrepreneurial initiative as does a bank centred financial system. On the other hand public equity financing, for which a well developed stock market is needed, has other advantages over private equity financing. These advantages include allowing the buyers of equity to diversify.[1847] It also offers the initial equity holders, such as the private equity fund, an attractive exit option through the public equity markets. In addition, it allows companies to time their equity issues to take advantage of favourable investor sentiment toward the market. La Porta *et al* in a subsequent article state that a legal approach is a better way to understand corporate governance and its reform, rather than the common distinction between bank centered and market centred financial systems.[1848] The aforementioned authors stated:

> '... Our analysis suggests that the objective of corporate governance reform in most countries is to protect the rights of outside investors, including both shareholders and creditors. To organize this discussion, we draw a distinction between legal and functional convergence. Legal convergence refers to the changes in the rules and in enforcement mechanisms toward some desirable standard. To achieve legal convergence to effective investor protection, most countries

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[1843]Borisova, G., Brockman, P., Salas, J.M. and Zagorchev, A. (2012), 'Government ownership and corporate governance: Evidence from the EU', Journal of Banking and Finance, 36(11), at 2917-2934.

[1844]Borisova, G., Brockman, P., Salas, J.M. and Zagorchev, A. (2012), 'Government ownership and corporate governance: Evidence from the EU', Journal of Banking and Finance, 36(11), at pages 2917-2934. See also Horn, L. (2012), 'Corporate governance in crisis? The politics of EU corporate governance regulation', European Law Journal, 18(1), at pages 83-107.

[1845]Burkart, M., Gromb, D., and Panunzi, F. (1997), 'Large shareholders, monitoring and fiduciary duty', Quarterly Journal of Economics 112, at pages 693-728. See also Claessens, S., Ueda, K., and Yafeh, Y. (2010), 'Financial frictions, investment, and institutions', Discussion Paper DP 8170, Centre for Economic Policy Research.

[1846]Burkart, M., Gromb, D., and Panunzi, F. (1997), 'Large shareholders, monitoring and fiduciary duty', Quarterly Journal of Economics 112, at pages 693-728. See also Claessens, S., Ueda, K., and Yafeh, Y. (2010), 'Financial frictions, investment, and institutions', Discussion Paper DP 8170, Centre for Economic Policy Research.

[1847]Burkart, M., Gromb, D., and Panunzi, F. (1997), 'Large shareholders, monitoring and fiduciary duty', Quarterly Journal of Economics 112, at pages 693-728. See also Bruno, V., and Claessens, S. (2010), 'Corporate governance and regulation: Can there be too much of a good thing?', Journal of Financial Intermediation, 19, at pages 461–82.

[1848]La Porta, R., Lopez-De-Silanes, F., Shleifer, A. and Vishny, R.W. (1999), 'Investor Protection: Origins, Consequences, Reform', NBER Working Paper No. 7428. Available at www.nber.org/papers/w7428, accessed in August 2012, page 25. See also Bebchuk, L.A., and Weisbach, M.S. (2010), 'The state of corporate governance research', Review of Financial Studies, 23, at pages 939–961.

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require extensive legal, regulatory, and judicial reform. Alternatively, functional convergence refers to more decentralized, market-based changes, which do not require legal reform per se, but still bring more firms and assets under the umbrella of effective legal protection of investors ...'[1849]

Fox and Heller state that the structural changes that took place in the world's political economy during the 1980s and 1990s, made it even more imperative to examine carefully how social and legal arrangements affect firms, markets and economic growth across nations.[1850] In addition, Claessens states that technological progress and opening up of financial markets have complicated the allocation and monitoring of capital within and between countries.[1851]

It is submitted that the private equity industry should strive at bettering the corporate governance practices of investee companies based on the assumption that ultimately the investors in their private equity funds will benefit. However, this should be done within a legal framework that includes effective legal contracting and improved regulation. Since good governance requires adequate transparency and an effective board, there is a better chance for the private equity firm to detect problems and engage with management to take remedial action sooner rather than later. Private equity investments usually involve large interest in often illiquid companies and the private equity firms seldom have the option of disposing of their interests relatively quickly where an investee company encounters a major crisis. Thus, disclosure and transparency enables early detection of underperformance while the promotion of best practices, maintain management's focus on the ultimate goals for the company.[1852] In addition, sound governance should improve a company's credibility. Investors would prefer dealing with a company that is transparent and properly governed. The primary objective of most private equity investments is to exit at a profit. Sullivan and Lim argue that there is a positive correlation between good governance and a company's share price, in that the market is willing to pay a premium for a well governed company.[1853]

[1849] La Porta, R., Lopez-De-Silanes, F., Shleifer, A. and Vishny, R.W. (1999), 'Investor Protection: Origins, Consequences, Reform', NBER Working Paper No. 7428. Available at www.nber.org/papers/w7428, accessed in August 2012, at page 25.

[1850] Fox, M.B, and Heller, M.A. (editors) (2006), 'Corporate Governance Lessons From Transition Economy Reforms', Princeton University Press.

[1851] Claessens, S., (2006), 'Corporate Governance and Development', The World Bank Research Observer, at page 95. See also Bruno, V., and Claessens, S. (2010), 'Corporate governance and regulation: Can there be too much of a good thing?', Journal of Financial Intermediation, 19, at pages 461–82.

[1852] Sullivan, P.H. and Lim, G. (2004), 'Corporate Governance and Private Equity: Global Corporate Governance Guide 2004', Globe White Page Ltd.

[1853] Sullivan, P.H. and Lim, G. (2004), 'Corporate Governance and Private Equity: Global Corporate Governance Guide 2004', Globe White Page Ltd. Their study shows the relationship of corporate governance and the value of equity in public companies and that there is indeed such a premium. For a related discussion see also Yafeh, Y., and Hamdani, A. (2011), 'Institutional investors as minority shareholders', Working Paper 172/2010, Fifth Annual Conference on Empirical Legal Studies, European Corporate Governance Institute, sourced from Social Science Research Network. Available at http://ssrn.com/abstract=1641138, accessed in May 2013.

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Nevertheless, it is submitted that the consistent development of well defined corporate governance practices and laws in South Africa are essential. It would be too restrictive to only focus such development in relation to the private equity business model, because corporate governance essentially involves balancing the interests of a company's many stakeholders, which may include a private equity fund as a shareholder. However, it is beyond the scope of this thesis to define an appropriate corporate governance framework, other than to submit that a company should have an adequately defined and enforced corporate governance framework, which should be based on both statutory rules and a code of principles. It is evident from the above discussion that a corporate governance framework broadly consists of a system of rules, practices and processes, or laws by which a company is directed, operated, regulated, and controlled, but which is based on the principle of investor protection.

Following on from this discussion is a legal analysis of the principles relating to the fiduciary duties of directors in corporate law. However, it is beyond the scope of this thesis to discuss each of the fundamental fiduciary duties a director of a company must be mindful of in terms of common law and related statutory provisions.[1854] Also it is beyond the scope of this thesis to discuss the statutory standards of directors, in terms of section 75 of the Companies Act 71 of 2008. The provisions in the Companies Act 71 of 2008 that regulate a director's duties are further supported by provisions, for example, sections 77 and 78 of the Companies Act 71 of 2008 which deal with the liability of directors and a director's indemnity respectively; however both sections 77 and 78 are also beyond the scope of this discussion. However, the analysis in paragraph 2(b) of this chapter will include a broad discussion of section 76 of the Companies Act 71 of 2008 because it makes provision for the codification of the fiduciary duties of directors.

As briefly mentioned in chapter one, managers from private equity firms serve as directors of the private equity funds' underlying investee companies in which the private equity firms invest. This feature has raised the importance of legal issues related to the fiduciary duties of directors, including the specific issues related to the interrelation of private equity firms and the portfolio companies in which they invest. Therefore, the next paragraph 2(b) will provide a critical analysis of the concept of fiduciary duties and will analyse the common law rules and relevant case law, as well as related statutory provisions relating to fiduciary duies.

2(b) Fiduciary Duties

[1854]Blackman, M.S., Jooste, R.D., and Everingham, G.K. (2008), 'Commentary on the Companies Act,' Juta and Company, Cape Town, volume 2, 208.

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Common Law

It is trite that the relationship between a private equity firm and the investors is that of principal and agent, in terms of which the investor (as principal) engages the private equity firm (as agent) to invest in investee companies for the benefit of the investors. In terms of the private equity business model, the investors invest in a private equity fund managed by the private equity firm who in turn invests the investor capital into numerous underlying portfolio companies on their (investors) behalf. As part of managing these underlying portfolio companies, the private equity firm typically appoints staff member(s) to the board of directors of these companies to manage the interest of the private equity fund. For this reason it is important to discuss the statutory and common law duties of a director, such as his or her fiduciary duties. According to Stevens and De Beer, directors of companies in terms of South African common law have two duties; namely fiduciary duties and the duty of skill and care.[1855] They state that the duty of skill and care is delictual in nature.[1856] Nevertheless, it is beyond the scope of this paragraph to discuss the common law duty of skill and care, but rather to focus on the fiduciary duties of a director of a company.

Black's Law Dictionary, defines a fiduciary is either 'one who owes to another the duties of good faith, trust, confidence, and candor,' or 'one who must exercise a high standard of care in managing another's money or property'.[1857] According to the Wex legal dictionary:

> 'A fiduciary duty is a legal duty to act solely in another party's interests. Parties owing this duty are called fiduciaries. The individuals to whom they owe a duty are called principals. Fiduciaries may not profit from their relationship with their principals unless they have the principals' express informed consent. They also have a duty to avoid any conflicts of interest between themselves and their principals or between their principals and the fiduciaries' other clients. A fiduciary duty is the strictest duty of care'[1858]

A more appropriate definition in the context of this discussion is the one put forward by Idensohn that states:

> 'According to the 'voluntary assumption or contractual' theory, a fiduciary relationship arises only where a person willingly undertakes or assumes a position of trust, confidence and loyalty in relation to a vulnerable beneficiary who legitimately expects and relies on the maintenance of that trust, confidence and loyalty ... The general function of the fiduciary principle is to ensure that the

[1855]Stevens, R., and De Beer, P. (2016), 'The Duty of Care and Skill, and Reckless Trading: Remedies in Flux?', South African Mercantile Law Journal, 2, at page 250.
[1856]Stevens, R., and De Beer, P. (2016), 'The Duty of Care and Skill, and Reckless Trading: Remedies in Flux?', South African Mercantile Law Journal, 2, at page 250.
[1857]Black's Law Dictionary, 9th edition (2009), 702.
[1858]Available at www.law.cornell.edu/wex/fiduciary_duty, accessed in June 2015.

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interests of the beneficiary remain paramount, and to do so prophylactically by imposing strict liability and deterring opportunistic breaches by the fiduciary.'[1859]

Frankel describes a fiduciary relationship as follows:

'As in a status relation, one party to a fiduciary relation (the entrustor) is dependent on the other (the fiduciary) … By definition, the entrustor becomes dependent because he must rely on the fiduciary for a particular service … Moreover, unless the entrustor agrees, the fiduciary cannot manipulate the terms of his performance once the relation has been established. In contrast to contract and status relations, in which both parties seek to satisfy their own needs and desires through the relation, fiduciary relations are designed not to satisfy both parties' needs, but only those of the entrustor. Thus, a fiduciary may enter into a fiduciary relation without regard to his own needs. Moreover, an entrustor does not owe the fiduciary anything by virtue of the relation except in accordance with the agreed-upon terms or legally fixed status duties. Therefore, in a fiduciary relation, the entrustor is free from domination by the fiduciary, although he may still be coerced in parallel status relation. Thus, fiduciary relations combine the bargaining freedom inherent in contract relations with a limited form of the power and dependence of status relations. Accordingly, the law of fiduciary relations should, if possible, preserve the best aspects of status and contract relations. It is desirable for the entrustor to depend on the fiduciary to satisfy certain needs. But it would not be desirable for fiduciary law to impose the relation on either law should permit the parties to enter into the relation freely and to ensure that the fiduciary will not coerce the entrustor.'[1860]

Ribstein remarks that the most famous judicial expression of fiduciary duties is Justice Cardozo's lines in the case of *Meinhard v Salmon*,[1861] where he stated:

'Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is

[1859] Idensohn, K. (2010), 'The regulation of shadow directors', 22 SA Mercantile Law Journal at 334. Furthermore, Idensohn mention that the voluntary assumption and legitimate expectation criteria have found particular favour with the English courts and quoted *Ultraframe (UK) Ltd v Fielding* (2005) EWHC 1638 (Ch), note 11 in paragraph 1285, as quoted in McGhee, J. (2005), 'Snell's Equity', 31 ed, in paragraph 7-07. Namely, '... there is growing judicial support for the view that a fiduciary is someone who have undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relation of trust and confidence. The concept encaptures a situation where one person is in a relationship with another which gives rise to a legitimate expectation, which equity will recognise, that the fiduciary will not utilise his or her position in such a way which is adverse to the interests of the principal ...'.
[1860] Frankel, T. (1983), 'Fiduciary Law', California Law Review, May 1983, 71, at pages 797-802.
[1861] *Meinhard v Salmon* 1928 (164) N.E. 545, (N.Y), at 546.

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unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions (citation omitted). Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.'[1862]

Fiduciary duties are duties that are based on the concept of good faith and are owed to the company as a result of the control that directors exercise over the assets of the company, and the power that is held by such directors to act on behalf of another.[1863] Fiduciary duties are non-negotiable and cannot be waived in any manner or form.[1864] Furthermore, a fiduciary relationship, in the context of a company and its director, emanates from the concept of trust and the director putting the interest of the company before his or her own interests.[1865] In *Aberdeen Railway Co. v Blaikie Brothers*[1866] the court accepted that a director of a company must not place himself in a position in which his duty and self-interest may conflict with each other. This duty protects the company from potential abuses by a director, for instance, where a director is faced with a situation where he or she could negatively impact the business of a company by not placing the interest of the company first.[1867] According to Blackman *et al*, a fiduciary duty in broad terms is a person who has the responsibility or is required by law to act in the best interest of another and therefore by handling a company's affairs the directors of a company owes fiduciary duties to the company.[1868] According to Cassim, all directors of companies by virtue of their positions in relation to the company have fiduciary duties that have to be adhered to at all times.[1869] Blackman *et al,* acknowledge nine fundamental fiduciary duties which directors must be mindful not to breach at any given time.[1870] According to Blackman *et al,* directors may not:

'(i) exceed their power; or (ii) exercise their power for an improper or collateral purpose; or (iii) fetter their discretion; or (iv) place themselves in a position in which their personal interest conflict,

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[1862]Ribstein, L.E. (2005), 'Are Partners Fiduciaries?', University of Illinois Law Review, Symposium Issue, Volume 2005, No. 1, February 2005; Illinois Public Law Research Paper No. 04-20 at page 210.

[1863]Delport, P. and Esser, I.M. (2011), 'The duty of care, skill and diligence: The King report and the 2008 Companies Act', Journal of Contemporary Roman-Dutch Law, 74, at 449.

[1864]Delport, P. and Esser, I.M. (2011), 'The duty of care, skill and diligence: The King report and the 2008 Companies Act', Journal of Contemporary Roman-Dutch Law, 74, at 449.

[1865]Havenga, M. (1996), 'Breach of Directors' Fiduciary Duties: Liability on What Basis?', 8 SA Mercantile Law Journal 366.

[1866]*Aberdeen Railway Co. v Blaikie Brothers*, 1854 (2) ER Rep 12 461.

[1867]*Aberdeen Railway Co. v Blaikie Brothers*, 1854 (2) ER Rep 12 461.

[1868]Blackman, M.S., Jooste, R.D., and Everingham, G.K. (2008), 'Commentary on the Companies Act,' Juta and Company, Cape Town, volume 2, 208.

[1869]Cassim, M.F. (2009), 'Da Silva v CH Chemicals (Pty) Ltd: Fiduciary Duties of Resigning Directors', 126, South African Law Journal 61. Cassim discussed *Da Silva and others v CH Chemicals (Pty) Ltd,* 2008 (6) SA 620 (SCA), where the argument was raised that a director, in certain instances, will also have a fiduciary duty to a company even after resignation.

[1870]Blackman, M.S., Jooste, R.D., and Everingham, G.K. (2008), 'Commentary on the Companies Act,' Juta and Company, Cape Town, volume 2, 208.

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> or may possibly conflict, with their duties to the company; or (v) deal with the company otherwise than openly and in good faith; or (vi) make a secret profit; or (vii) take certain economic opportunities; or (viii) compete with the company; or (ix) misuse confidential information.'[1871]

As mentioned above, one of the typical features of private equity investing is the private equity firm appointing individual(s) to serve on the board of directors of the underlying portfolio investee companies to manage the interest of the private equity fund and ultimately to act in the best interest the fund's investors. However, in the context of a private equity fund, this expectation can often be problematic because directors must exercise their duties as directors with unfettered discretion. Directors cannot, without the consent of the company, fetter their discretion in relation to the exercise of their powers, and cannot bind themselves to vote in a particular way at future board meetings.[1872] In *Fisheries Development Corporation of SA Ltd v Jorgensen*[1873] the court held that if a director is appointed to represent certain shareholders he/she is still obliged to exercise his/her discretion and must act positively to protect the interests of the company even if they conflict with those of the people who elected him. In this case, it was stated as follows:

> ' … in carrying out his duties and functions as director, he is in law obliged to serve the interests of the company to the exclusion of any such nominator, employer or principal.'[1874]

According to the International Organisation of Securities Commissions ('IOSCO'):

> 'This dual role creates an ongoing obligation for the appointed individual to consider the needs of both parties independently, and to ensure that any information received from either party is not shared inappropriately. While it is generally considered that the interests of the firm, its fund investors and the portfolio companies are well aligned, that alignment may break down in instances where, for example, the investee company may be seeking additional funding as a result of extreme financial distress. However, in such circumstances it is common for the private equity firm to instruct another member of its staff (or independent party) to monitor the investee company on behalf of the fund, leaving its board representative free to fulfil those duties owed to the investee company. This issue is already addressed under company law which often clarifies

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[1871] Blackman, M.S., Jooste, R.D., and Everingham, G.K. (2008), 'Commentary on the Companies Act,' Juta and Company, Cape Town, volume 2, 208.

[1872] Ferran, E. (1994), 'The Decision of the House of Lords in Russel v Northern Bank Development Corporation Ltd', Cambridge Law Journal, Volume 53(2), at pages 343-366.

[1873] Fisheries Development Corporation of SA Ltd v Jorgensen and Another; Fisheries Development Corporation of SA Ltd v AWF Investments (Ply) Ltd and Others 1980 (4) SA 156 (W).

[1874] Fisheries Development Corporation of SA Ltd v Jorgensen and Another; Fisheries Development Corporation of SA Ltd v AWF Investments (Ply) Ltd and Others 1980 (4) SA 156 (W) at 156.

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the requirement that as a director of the investee company such individuals have a primary responsibility to the company.'[1875]

In the case *Kregor v Hollins*[1876] the principle was established that company directors must exercise an independent and unfettered discretion. A company director cannot fetter his discretion by way of a contract with an outsider. The facts of the case were that Hollins invested £5,000 and agreed to pay remuneration to Kregor to act as his nominee director. Hollins defaulted in paying and Kregor succeeded in a suit when there was a finding of fact that the agreement did not obligate Kregor to put Hollin's interest above that of the company.[1877] Judge Avory (Court of Appeal) stated that if Kregor was to prefer the interest of Hollins to that of the shareholders and that if there is conflict that Kregor was to promote Hollin's interests rather than the interests of the whole body of shareholders (which were in conflict), then the agreement will be unlawful.[1878] Cassim *et al* makes reference to Keay[1879] when stating:

> 'Accordingly, a voting agreement under which a director binds him- or herself to vote or to exercise his or her powers in accordance with the instructions of some other person, thereby fettering the director's discretion, will not be enforced by the court. The effect of such a voting agreement, if it were to be binding, is that the directors thereby disable themselves from acting honestly in what they believe to be the best interest of the company.'[1880]

Company directors are required to act independently of control by any other person and must exercise their own judgment as to the discharge of their duties.[1881] Therefore company directors may not simply act as the proxies or nominees of other people.[1882] In practice, it will not be a good defence from liability to an action for breach of a fiduciary duty, for a director (private equity firm's appointed individual) to argue that he/she simply took instructions from another. In the private equity industry, the duty to exercise an independent judgment is critical when it comes to nominee directors (private equity firm's appointed director). In this regard the High Court judgment in *Fisheries Development*

[1875]International Organization of Securities Commissions (IOSCO), (2009), 'Private Equity Conflicts of Interest', Report by the Technical Committee of the International Organization of Securities Commissions, November 2009, at page 18.
[1876]*Kregor v Hollins*, (1913) 109 LT 225 (King's Bench Division and Court of Appeal).
[1877]*Kregor v Hollins*, (1913) 109 LT 225 (King's Bench Division and Court of Appeal).
[1878]*Kregor v Hollins*, (1913) 109 LT 225 (King's Bench Division and Court of Appeal). See also *Fulham FC Ltd v Cobra Estates Plc*, (1994) 1 BCLC 363.
[1879]Keay, A. (2008), 'The Duty of Directors to Exercise Independent Judgment', Company Lawyer, 29.10, at pages 290-296.
[1880]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', Second Edition, Juta and Co, Cape Town, at pages 528-529.
[1881]Sealy, L.S. (1971), 'Cases and Materials in Company Law', Cambridge Legal Case Books, Cambridge University Press, at page 396.
[1882]Sealy, L.S. (1971), 'Cases and Materials in Company Law', Cambridge Legal Case Books, Cambridge University Press, at page 396.

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Corporation of SA Ltd v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd[1883] is particularly important:

> 'A director is in that capacity not the servant or agent of a shareholder who votes for or otherwise procures his appointment to the board …. The director's duty is to observe the utmost good faith towards the company, and in discharging that duty he is required to exercise independent judgment and to take decisions according to the best interests of the company as his principal. He may in fact be representing the interests of the person who nominated him, and he may even be the servant or agent of that person, but, in carrying out his duties as a director, he is in law obliged to serve the best interests of the company to the exclusion of the interests of any such nominator, employer or principal. He therefore cannot fetter his vote as a director, save in so far as may be a contract for the board to vote in that way in the best interests of the company, and, as a director, he cannot be subject to the control of any employer or principal other than the company.'[1884]

It is common practice to appoint nominee directors and it is expected that any decisions made by such nominee directors, 'must be in accordance with what he genuinely and honestly considers to be in the best interests of the company'.[1885] According to Cassim *et al*:

> 'Financial institutions frequently appoint nominees to safeguard their interest. The courts have ruled that there is nothing inherently dishonest or improper about nominee directors. In most cases no harm is done to the company mainly because the interests of the nominator often coincide with, or conform to, those of the company, to the extent that they both desire the company to prosper. This enables nominee directors to comply with their duties both to the company as well as to their nominators. When, however, the interests of the company clash with those of the nominator there is a manifest conflict of interest that puts the nominee director in an invidious position. The problem is exacerbated if the nominee is also an employee of the nominator.'[1886]

In the case *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd*[1887] the plaintiff trustee of a company loan stock sought to make the employer (the employer being a bank who had made nominee appointments to the debtor company board) of the two directors who negligently prepared financial certificates for the trustee relating to the stock, liable for their negligent acts. The plaintiff

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[1883] *Fisheries Development Corporation of SA Ltd v Jorgensen and another; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd and Others* 1980 (4) SA 156 (W) 163.
[1884] *Fisheries Development Corporation of SA Ltd v Jorgensen and another; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd and Others* 1980 (4) SA 156 (W) 163.
[1885] Cassim, F.H.I. (2011), 'The Practitioners Guide to the Companies Act 71 of 2008', Chapter 8: The Fiduciary and Statutory Duties of Directors, Juta and Company Ltd, at page 85.
[1886] Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', Second Edition, Juta and Co, Cape Town, at page 530.
[1887] *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* 1990 (3) All ER 404 (PC).

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trustee had to show that the employees were acting within the scope of the defendant's employment, as distinct from their agency authority from the company of which they were directors.[1888] Lord Lowry, in delivering the judgment of the Privy Council dismissed the plaintiff trustee's claim and stated:

> 'the two directors owed three separate duties. They owed in the first place to the company the duty to perform their duties as directors without gross negligence ... they owed a duty to the plaintiff (the trustee) to use reasonable care to see that the certificates complied with the requirements of the trust deed. Finally, they owed a duty to their employer, the bank, to exercise reasonable diligence and skill in the performance of their duties as directors … but these duties were separate and distinct and different in scope and nature.'[1889]

The common law principle with regard to the duty to exercise an independent judgment is clear. Despite a nominee director representing the interests of the nominator, the nominee is required in law to serve the interest of the company to the exclusion of the interests of its nominator.[1890] According to Cassim *et al*:

> 'As directors, they cannot be subject to the control of any employer or principal other than the company. In short, a director may not serve two masters as this gives rise to conflicting loyalties. It is the interests of the company, and not that of the nominator, that are paramount.'[1891]

The case *Peoples Department Stores Inc. (Trustee of) v Wise*[1892] is a Supreme Court of Canada decision on the scope of the fiduciary duty upon directors and officers of a corporation. The court held that that there is a distinction between the interests of the corporation and those of the stakeholders and creditors. The court also placed significant heavy emphasis on the fact that a director owes a fiduciary duty to the corporation.[1893] The facts of the case were that Wise Stores Inc. was a retail store chain whose shares were primarily held by the three Wise brothers. In 1992 they acquired Peoples Department Store, a competitor. From 1994 their business interests went through a difficult time and in an attempt to reduce costs they developed a scheme where certain inventory would be purchased through Peoples and then given to Wise on credit. Soon thereafter, Wise owed in excess of $18 million to Peoples and by 1995, both Wise and Peoples declared bankruptcy. The creditors for Peoples brought an action against the Wise brothers for breach of their fiduciary duties as directors by implementing the credit scheme. The Trustees argued that the Wise

[1888] *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* 1990 (3) All ER 404 (PC).
[1889] *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* 1990 (3) All ER 404 (PC).
[1890] Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', Second Edition, Juta and Co, Cape Town, at pages 530-531.
[1891] Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', Second Edition, Juta and Co, Cape Town, at page 531.
[1892] *Peoples Department Stores Inc. (Trustee of) v Wise* 2004, 3 S.C.R. 461.
[1893] *Peoples Department Stores Inc. (Trustee of) v Wise* 2004, 3 S.C.R. 461.

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brothers favoured the interests of Wise Stores over that of Peoples. At trial the Quebec Superior Court found that the Wise brothers breached their fiduciary duty, however the decision of the trial judge was overturned by the Quebec Court of Appeal.[1894]

The Supreme Court of Canada in *Peoples Department Stores Inc. (Trustee of) v Wise*[1895] held that a director is not an agent of the shareholders or other stakeholders. The director is expected at all times to act in the best interests of the corporation as a complete entity, and not in the best interests of any of its individual parts.[1896] The court went on to state that this principle of corporate altruism becomes questionable when a director is a nominee of a specific shareholder. Furthermore, the nominee director must balance his/her overarching duty to the corporation and his/her obligation to his/her appointing shareholder.[1897] In the case *820099 Ontario Ltd v Harold E. Ballard Ltd*,[1898] the court stated that whether this balance can be achieved depends, realistically, on the degree of involvement of the appointing shareholder. In *820099 Ontario Ltd v Harold E. Ballard Ltd*,[1899] Farley J stated as follows:

> ' … the life of a nominee director who votes against the interests of his appointing shareholder is neither happy nor long.'[1900]

In the case *Hawkes v Cuddy*,[1901] Burton LJ stated that:

> 'In my judgement, the fact that a director of a company has been nominated to that office by a shareholder does not, of itself, impose any duty on the director owed to his nominator. The director may owe duties to his nominator if he is an employee or officer of the nominator, or by reason of a formal or informal agreement with his nominator, but such duties do not arise out of his nomination, but out of a separate agreement or office. Such duties cannot however, detract from his duty to the company of which he is a director when he is acting as such … an appointed director, without being in breach of his duties to the company, may take the interests of his nominator into account, provided that his decisions as a director are in what he genuinely considers to be the best interests of the company; but that is a very different thing from his being under a duty to his nominator by reason of his appointment by it.'[1902]

[1894] *Peoples Department Stores Inc. (Trustee of) v Wise* 2004, 3 S.C.R. 461.
[1895] *Peoples Department Stores Inc. (Trustee of) v Wise* 2004, 3 S.C.R. 461.
[1896] See also *Pente Investment Management Ltd v Schneider Corp* 1998, 42 O.R. (3d) 177.
[1897] *Peoples Department Stores Inc. (Trustee of) v Wise* 2004, 3 S.C.R. 461.
[1898] *820099 Ontario Ltd v Harold E. Ballard Ltd* 1991, 3 B.L.R. (2d) 113 (ON. S.C.).
[1899] *820099 Ontario Ltd v Harold E. Ballard Ltd* 1991, 3 B.L.R. (2d) 113 (ON. S.C.).
[1900] *820099 Ontario Ltd v Harold E. Ballard Ltd* 1991, 3 B.L.R. (2d) 113 (ON. S.C.).
[1901] *Hawkes v Cuddy* 2009 EWCA Civ 291.
[1902] *Hawkes v Cuddy* 2009 EWCA Civ 291.

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In an ideal scenario, the interests of the underlying portfolio company and its shareholders will be aligned with the private equity fund that wants to improve shareholder value to increase the return on its investment. However, the commercial reality is that there will be instances in which these interests will come into conflict, which will put the private equity fund appointed director in a position of conflict between his/her fiduciary duties to the portfolio company and his/her duties to the private equity fund. For instance, conflicts of interest could result from situation in which certain transactions benefit the private equity fund's short term objectives but not the long term objectives of the underlying portfolio investee company and its other shareholders. An example would be where the private equity fund wants the portfolio company to raise additional debt finance to grow the company 'quicker' in order for it to exit sooner, rather than grow at a slower rate using organic earnings to finance the company's growth.

Furthermore, it is suffice to state that board members have fiduciary duties to the companies on whose boards they serve. These duties requires directors to keep themselves informed about the affairs of the company and to use all reasonably available information when making decisions as a board member. These duties require directors to place the interests of the company and its shareholders ahead of their own personal interests and the interests of private equity fund that appointed them. On the other hand, it would be reasonable to expect that a person who serves on a portfolio company board as an appointee of his/her private equity fund also has a duty to such private equity fund. For instance, the private equity fund appointee director would typically be a member of the private equity firm, which in turn is the manager of the private equity fund in which the investors made their investments. The private equity firm owes duties to the investors in terms of the private equity fund partnership agreements, therefore the private equity fund appointee director owe duties to the private equity fund's investors to take reasonable actions to secure the investors' return on their investment in the private equity fund. It will be argued throughout this chapter that company directors must however, at all times, exercise an independent and unfettered discretion and that a company director cannot fetter his/her discretion by way of a contract with an outsider, such as with the private equity fund that appointed him/her. Particularly in those situations where there is a conflict between the interests of the underlying portfolio investee company, with those of the private equity fund, the private equity fund appointee director must always act in the interest of the company on whose board he/she serves.[1903] However, what would be the position in a practical situation where the shareholders of a company consents to a private equity fund nominee director negotiating with the company, but on behalf of the private equity fund (his/her nominator) and ultimately putting the interest of the private equity fund before that of the company?

In *Cobden Investments Ltd v RWM Langport* it was recognised that the shareholders could, by unanimous consent, agree that a nominee director could negotiate with the company on behalf of

[1903]See *Kregor v Hollins*, (1913) 109 LT 225 (King's Bench Division and Court of Appeal).

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his nominator without regard to the best interests of the company.[1904] In South Africa, the Companies Act 71 of 2008 does not specifically make reference to the duty to exercise any independent judgment, since the duty to exercise an independent judgment is an aspect of the directors' duty to act in good faith and in the best interests of the company.[1905] Nevertheless, as mentioned above, in general, a director may not fetter his discretion by contracting with other directors or with third parties to act in a certain way in the future. Therefore, a director's obligation to act in accordance with his fiduciary duties would usually take precedence over any course of conduct he may have previously agreed with co-directors or third parties.[1906] However, there is authority to the effect that a director would not be fettering his discretion where he/she has entered into a contract for the company on a *bona fide* basis which requires the director or any number of directors to act in a certain way in order to give effect to the contract. Also, provided the decision to enter the contract is made in accordance with the fiduciary duties of the director, the consequence of the manner in which he may be required to act in accordance with the contract remains as a result of the exercise of fiduciary duties.[1907] However, this would not be so in the case of a contract binding a director to exercise his discretion in a certain way, which has not been entered into for or on behalf of the company at all, or for or on behalf of the company other than in accordance with the fiduciary duties of the director.[1908] The Australian case *Thorby v Goldberg* dealt with the restructuring of the capital of a company in terms of an agreement entered into in advance with regard to certain steps which would be taken.[1909] In this case Kitto J stated as follows:

> 'The argument for illegality postulates that since the discretionary powers of directors are fiduciary, in the sense that every exercise of them is required to be in good faith for the benefit of the company as a whole, an agreement is contrary to the policy of the law and void if thereby the directors of a company purport to fetter their discretions in advance: see Gower on Modern Company Law 2nd ed (1957) p 478. It is said that the agreement in the present case does purport to bind those of the O Group who are directors to take future steps as to which it is their duty to exercise an unfettered discretion when the time comes for taking those steps. There may be more answers than one to the argument, but I content myself with one. There are many kinds of transactions in which the proper time for the exercise of the directors' discretion is the time of the negotiation of a contract, and not the time at which the contract is to be performed. A sale of land

[1904] *Cobden Investments Ltd v RWM Langport* 2008 EWHC 2810 (Ch).
[1905] Cassim, F.H.I. (2011), 'The Practitioners Guide to the Companies Act 71 of 2008', Chapter 8: The Fiduciary and Statutory Duties of Directors, Juta and Company Ltd, at page 85.
[1906] See Keay, A. (2007), 'Tackling the issue of the corporate objective: an analysis of the United Kingdom's enlightened shareholder value approach', Sydney Law Review, 29, at 577.
[1907] See Keay, A.R. (2010), 'The duty to promote the success of the company: is it fit for purpose?', University of Leeds School of Law, Centre for Business Law and Practice Working Paper. See also Ashton, P. (2013), 'How Fred the Shred Got Away with It: Loud Calls for Company Law Reform', Birkbeck Law Review, 1, at 187.
[1908] See also Parry, R. (2005), 'Directors' duties within the United Kingdom', Research Handbook on Corporate Legal Responsibility, 73. See also Siems, M.M. (2002), 'Shareholders, Stakeholders and the 'Ordoliberalism'', European Business Law Review, 13, at pages 147-159.
[1909] *Thorby v Goldberg* 1964, 112 CLR 597.

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is a familiar example. Where all the members of a company desire to enter as a group into a transaction such as that in the present case, the transaction being one which requires action by the board of directors for its effectuation, it seems to me that the proper time for the directors to decide whether their proposed action will be in the interests of the company as a whole is the time when the transaction is being entered into, and not the time when their action under it is required. If at the former time they are bona fide of opinion that it is in the interests of the company that the transaction should be entered into and carried into effect, I see no reason in law why they should not bind themselves to do whatever under the transaction is to be done by the board. In my opinion the defendants' contention that the agreement is void for illegality should be rejected.'[1910]

In *Thorby v Goldberg,* Litton J also stated:

'If, when a contract is negotiated on behalf of a company, the directors bona fide think it is the interests of the company as a whole that the transaction should be entered into and carried into effect they may bind themselves by contract to do whatever is necessary to effectuate it.'[1911]

In *Thorby v Goldberg,* Owen J also stated as follows:

'For all that appears from the plea, the directors of the Company may, before the execution of the agreement, have given proper consideration to the desirability of entering into it and decided that it was in the best interests of the Company that it should be made. If so, it would be impossible to argue that they had by executing the document, improperly fettered the future exercise of their discretion.'[1912]

The judgment in the Australian case *Thorby v Goldberg*[1913] was referred to with approval in the English decision of *Fulham Football Club v Cabra Estates Plc.*[1914] In this case, the Court of Appeal dealt with a number of arguments relating to an agreement between shareholders and directors relating to planning permission to develop certain land for residential purposes.[1915] Furthermore, *inter alia*, the directors argued that the restraints imposed by the covenants contained in the agreements were unenforceable as being illegal; and contrary to public policy; and that they could not be bound by the undertakings so far as they conflicted with their fiduciary duties to the club as directors.[1916] The judge accepted the first and second arguments, and rejected the third on the basis that the

[1910] *Thorby v Goldberg* 1964, 112 CLR 597.
[1911] *Thorby v Goldberg* 1964, 112 CLR 597.
[1912] *Thorby v Goldberg* 1964, 112 CLR 597.
[1913] *Thorby v Goldberg* 1964, 112 CLR 597.
[1914] *Fulham Football Club v Cabra Estates Plc* 1992 BCC 863.
[1915] *Fulham Football Club v Cabra Estates Plc* 1992 BCC 863.
[1916] *Fulham Football Club v Cabra Estates Plc* 1992 BCC 863.

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directors had assumed the obligations in question as the only members of the company.[1917] Neill LJ stated as follows:

> 'Before the judge it was argued by the plaintiffs that it was an implied term of the undertaking that the directors would not thereby be required to do anything that would be inconsistent with the fiduciary duties owed by them to the company. It was further argued that, whether or not any such term should be implied, as a matter of law a director of a company may not fetter the exercise of his fiduciary duties by contractual undertaking. Both these arguments were rejected by the judge but were revived before us by a respondent's notice. It is trite law that directors are under a duty to act bona fide in the interests of their company. However, it does not follow from that proposition that directors can never make a contract by which they bind themselves to the future exercise of their powers in a particular manner, even though the contract taken as a whole is manifestly for the benefit of the company. Such a rule could well prevent companies from entering into contracts which were commercially beneficial to them.'[1918]

In addition, the English cases *Rackham v Peek Foods*[1919] and *John Crowther v Carpets International*,[1920] were referred to in *Fulham Football Club v Cabra Estates Plc*,[1921] affirming the view that an undertaking given by a director of a company to act in a certain way, will remain subject to the director's fiduciary duty to act *bona fide* and in the best interests of the company at the time. Neill LJ further stated:

> 'We were referred to two English cases at first instance where in each the court held that an undertaking by directors to use their best endeavours to ensure that their shareholders should approve a particular deal by the company (in one case a purchase, in the other a sale) was unenforceable. The cases are *Rackham v Peek Foods Ltd* 1990 BCLC 895 and *John Crowther Group plc v Carpets International plc* 1990 BCLC 460. In neither case was *Thorby v Goldberg* cited. It may be that these decisions can be justified on their particular facts, but they should not be read as laying down a general proposition that directors can never bind themselves as to the future exercise of their fiduciary powers. If they could be so read then they would be wrong.'[1922]

[1917] *Fulham Football Club v Cabra Estates Plc* 1992 BCC 863.
[1918] *Fulham Football Club v Cabra Estates Plc* 1992 BCC 863.
[1919] *Rackham v Peek Foods* 1990 BCLC 895.
[1920] *John Crowther v Carpets International* 1990 BCLC 460.
[1921] *Fulham Football Club v Cabra Estates Plc* 1992 BCC 863.
[1922] *Fulham Football Club v Cabra Estates Plc* 1992 BCC 863.

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Nevertheless, the above mentioned cases affirm the position that the wording of the agreements in question are critical with regard to the director's fiduciary duty to act *bona fide* and in the best interests of the company.[1923] In the case *Rackham v Peek Foods*,[1924] Templeman J stated that:

> 'Of course, directors normally recommend a conditional agreement because otherwise they would never have allowed the company to enter into the agreement itself. But, if, after the date of the conditional agreement, the directors consider that the bargain has become unacceptable from the point of view of the shareholders, it is the duty of the directors so to advise the shareholders and that advice by the directors does not constitute a breach of the 'best endeavours' covenant by the company. Similarly, although Bates had given a 'best endeavours' covenant, they were nevertheless entitled and bound to give honest advice to Consolidated and could not be in breach of their covenant if they gave honest advice, albeit that the advice resulted in the agreement failing to become unconditional.'[1925]

It is submitted that the common law would support the view that a director may enter into a contract on a *bona fide* basis in the best interests of the company, with the result that the director is obliged by the contract to act in a certain way in the future, which may not be construed as an improper fettering of discretion.[1926] This being so, despite the general principle that a director may not fetter his discretion. Nevertheless, apart from fiduciary duties, other issues arise in the case of a director attempting to agree to act in a certain manner in the future.[1927] Odell states that where the future conduct being agreed to is uncertain in relation to the facts, it gives rise to the following contractual issues:

> 'certainty – whether an agreement requiring a director to vote in a certain manner is sufficiently certain as a matter of contract law, in particular if the manner in which he should vote, and subject matter with respect to which he will vote, remains unknown at the time he enters into the agreement; and legality – whether an agreement may be void for illegality on the basis that it is too broad and constitutes an unlawful fettering of discretion. In this regard, we anticipate that a

[1923]Copp, S.F. (2009), 'Corporate social responsibility and the Companies Act 2006', Economic Affairs, 29(4), at pages 16-21. Keay, A.R. (2010), 'The duty to promote the success of the company: is it fit for purpose?', University of Leeds School of Law, Centre for Business Law and Practice Working Paper. See also Keay, A. (2007), 'Tackling the issue of the corporate objective: an analysis of the United Kingdom's enlightened shareholder value approach', Sydney Law Review, 29, at 577.
[1924]*Rackham v Peek Foods* 1990 BCLC 895.
[1925]*Rackham v Peek Foods* 1990 BCLC 895.
[1926]Copp, S.F. (2009), 'Corporate social responsibility and the Companies Act 2006', Economic Affairs, 29(4), at 16-21.
[1927]See Stevens, R., and De Beer, P. (2016), 'The Duty of Care and Skill, and Reckless Trading: Remedies in Flux?', South African Mercantile Law Journal, 2, at 250.

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distinction may be drawn between a case where the future conduct agreed to is agreed in the absence of knowledge of the specific facts to which the agreed conduct will apply.'[1928]

As submitted at the closing of paragraph 2(a) of this chapter, it is beyond the scope of this thesis to discuss each of the fundamental fiduciary duties a director of a company must be mindful of in terms of common law. Nevertheless, it is submitted that it is important firstly to consider the fiduciary relationship that exists between directors and their respective companies. The central idea in a fiduciary relationship is service of another's interests and so fiduciaries must avoid putting themselves in a position where they will be tempted into their own interests or any interest other than their principal's. The common law principles discussed above, as developed by the courts, remains relevant to the statutory standards of directors in terms of the Companies Act 71 of 2008, which will be discussed next.

Statutory Provisions

As mentioned at the closing of paragraph 2(a) of this chapter, the discussion of the common-law fiduciaries duties will now be followed by a broad discussion of the related statutory provision, namely section 76 of the Companies Act 71 of 2008. Section 76 of the Companies Act 71 of 2008 makes provision for the codification of the fiduciary duties of directors, as well as the standards of conduct required to be performed and exercised by a director. As mentioned above in terms of the common law discussion, Blackman *et al* are of the view that in the group of companies scenario a director only owes duties to the company he works for and not for any other company in the group.[1929] In the holding-subsidiary company scenario, particularly where nominee directors are put on the board of subsidiary companies by the holding company, such directors should not dismiss their duties to the subsidiary for the sole benefit of the holding company.[1930] Section 76(2)(a)(ii) of the Companies Act 71 of 2008 clarifies the common law fiduciary duty to act in the best interest of the company and imposes a duty on directors not to misuse their positions as directors or not to use information obtained as directors to knowingly cause harm to a subsidiary of a company. According to Cassim *et al*:

'Moreover, section 76(2)(a) does not explicitly require the use of the position of director or any information obtained as director to be improper, but it is submitted that the whole tenor and

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[1928]Odell, A. (2013), 'Jersey: Appointing Nominee Directors And Fettering Of Discretion Of Directors', Institute of Chartered Secretaries and Administrators, March 2013. Available at www.icsa.org.uk/?utm_source=website&utm_medium=icsa-promotion-ad&utm_campaign=mondaq, accessed in June 2015.

[1929]Blackman, M.S., Jooste, R.D., and Everingham, G.K. (2008), 'Commentary on the Companies Act,' Juta and Company, Cape Town, volume 2, 208.

[1930]See Botha, D.H. (1983), 'Holding and subsidiary companies: fiduciary duties of directors', 16 De Jure 234, (1984), De Jure 167.

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> intention of the section is that it is improper to use the office of director, or information obtained as director to gain an advantage for him-or herself, or to knowingly cause harm to the company or its subsidiary...Section 76(2)(a)(i) encapsulates the common-law 'non-profit' rule and imposes a mandatory and positive duty on directors to avoid a conflict of interest...'[1931]

Cassim *et al* state that the statutory duty in terms of sections 76(2)(a)(i) and (ii) of the Companies Act 71 of 2008 and the common-law fiduciary duty to avoid a conflict of interest, should support each other and that the courts should be left to develop these parallel duties so that they are mutually reinforcing.[1932] This approach should be supported by the view stated by Blackman *et al*:

> '... while certain duties apply without qualification to all directors, the extent to which other duties apply to particular directors depends upon the tasks or functions assigned to or assumed by them.'[1933]

It is submitted that section 76(2) of the Companies Act 71 of 2008 places a positive obligation on a director to avoid any conflict of interests with the company. This obligation is two-fold. Firstly, in terms of section 76(2)(a) of the Companies Act 71 of 2008, as discussed above, a director must not use the position of director to gain an advantage for the director or for another person other than the company or a wholly-owned subsidiary of the company; or knowingly cause harm to the company or a subsidiary of the company. Secondly, section 76(2)(b) of the Companies Act 71 of 2008 places a mandatory duty on a director of a company to communicate to the board, at the earliest moment possible, any information that comes to the director's attention, unless he/she reasonably believes that such information is immaterial to the company or is generally available to the public or known to other directors; or unless he/she is bound not to disclose that information by a legal or ethical obligation of confidentiality. Section 76(2)(b) of the Companies Act 71 of 2008, reads as follows:

> '(b) communicate to the board at the earliest practicable opportunity any information that comes to the director's attention, unless the director –
>
> (i) reasonably believes that the information is –
>
> (aa) immaterial to the company; or
>
> (bb) generally available to the public, or known to the other directors; or
>
> (ii) is bound not to disclose that information by a legal or ethical obligation of confidentiality.'

[1931]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', Second Edition, Juta and Co, Cape Town, at page 551.
[1932]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', Second Edition, Juta and Co, Cape Town, at page 551.
[1933]Blackman, M.S., Jooste, R.D., and Everingham, G.K. (2008), 'Commentary on the Companies Act,' Juta and Company, Cape Town, volume 2, 208 at 8-40.

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However, directors are exempt from disclosing such information if he/she is bound by a legal or ethical obligation of confidentiality that prohibits them from doing.[1934] In addition, directors are also exempt from disclosing such information if he/she may have signed a non-disclosure or confidentiality agreement with a third party.[1935] Furthermore, a director may also be protected if they fail to disclose relevant information in the reasonable belief that the information is immaterial or generally known to the public or to the other directors, despite this not in fact being the case.[1936]

In addition, section 76(3) of the Companies Act 71 of 2008 states that a director of a company, when acting in that capacity, must exercise the powers and perform the functions of a director: in good faith and for a proper purpose; in the best interests of the company; and with the degree of care, skill and diligence that may reasonably be expected of a person carrying out the same functions in relation to the company as carried out by that director, and having the general knowledge, skill and experience of that director. Section 76(4) of the Companies Act 71 of 2008 states that in respect of any matter arising in the exercise of the powers or the performance of the functions of a director, a director will have satisfied the obligations in section 76(3) of the Companies Act 71 of 2008, if the director: has taken reasonably diligent steps to become informed about the matter; has made a decision, or supported the decision of a committee or the board with regard to that matter; and had a rational basis for believing, and did believe, that the decision was in the best interests of the company.[1937] In further compliance with this section, the director is required to communicate to the board, at the earliest practicable opportunity, any material information that comes to his or her attention, unless he/she: reasonably believes that the information is publicly available or known to the other directors; or is bound by a legal or ethical obligation of confidentiality.[1938]

Nevertheless, the provisions in the Companies Act 71 of 2008 that regulate a director's duties are further supported by provisions such as sections 77 and 78 of the Companies Act 71 of 2008 which deal with the liability of directors and a director's indemnity respectively; both of which are beyond the scope of this discussion. It is submitted that directors need to know what their duties are, and

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[1934]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', Second Edition, Juta and Company, Cape Town, at page 553.
[1935]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', Second Edition, Juta and Company, Cape Town, at page 553.
[1936]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', Second Edition, Juta and Company, Cape Town, at page 553. See also Delport, P.A., Kunst, J.A. and Vorster, Q. (2011), 'Henochsberg on the Companies Act 71 of 2008', LexisNexis Butterworth's Publishers.
[1937]Section 77 of the Companies Act 71 of 2008 makes provision for the liability of a director in the event that he/she breaches one or more of his statutory duties owed towards the company. Common law liability would be attracted by a director for the breach of any duty(ies) contained in sections 75, 76(2) and 76(3)(a) and (b) of the Companies Act 71 of 2008.
[1938]Section 72 of the Companies Act 71 of 2008 entitles companies to appoint board committees and delegate to any committee any authority of the board. Such committees may include people who are not directors of the company, but they may not be ineligible or disqualified to be a company director and may not vote on any matter to be decided by the committee.

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directors must be aware of what is expected of them. In an effort to create greater clarity, certain duties of directors have been partially codified in the Companies Act 71 of 2008.[1939] The provisions in the Companies Act 71 of 2008 relating to directors duties are a partial codification of the company law, and the common law principles remain, subject to the specific conditions imposed by the Companies Act 2008.[1940] In addition, all directors of a company are subject to statutory and common law fiduciary duties. However, the mere appointment as a nominee does not imply a duty to act in favour of the nominator, but in certain situations as mentioned above, a director of a company may fetter his/her discretion by agreeing to act in a particular manner in respect of decisions he/she may make in the future. Nevertheless, much of the latter will depend on the facts of each situation.[1941]

Stevens raises an ancillary question:[1942]

> ‘to what extent directors on the subsidiary board may fetter their discretion, especially in the context of the holding company subsidiary company relationship.’

Stevens, furthermore states that:[1943]

> ‘the untenable situation could arise where a director acted in the best interest of the holding company ... but to the detriment of the subsidiary of which he is also a director. When the holding company gives instructions to the subsidiary company, it effectively gives the instructions to the board of the subsidiary to decide and implement the instructions. The holding company, in terms of section 3 of the act, will naturally control the board of the subsidiary and “nominee” directors in place.’

Stevens argues that:[1944]

> ‘if one accepts that company groups are commercial realities, it could quite easily be accepted that the board of directors of the holding com[any will give instructions to the (board of the) subsidiary company which may face value be detrimental to the subsidiary company.

[1939] Companies Act 71 of 2008. See Bouwman, N. (2009), ‘An appraisal of the modification of the director's duty of care and skill’, South African Mercantile Law Journal, 21, at 509 and Cassidy, J. (2009), ‘Models for reform: the directors' duty of care in a modern commercial world’, Stellenbosch Law Review, 20, at pages 373 - 406.
[1940] Bouwman, N. (2009), ‘An appraisal of the modification of the director's duty of care and skill’, South African Mercantile Law Journal, 21, at 509.
[1941] Stevens, R. (2016), ‘Liability Within Company Groups’, Journal of South African Law (TSAR), 2016(4), at pages 709-730. See also section 76(4)(a)(iii) of the Companies Act 71 of 2008.
[1942] Stevens, R. (2016), ‘Liability Within Company Groups’, Journal of South African Law (TSAR), 2016(4), at page 717.
[1943] Stevens, R. (2016), ‘Liability Within Company Groups’, Journal of South African Law (TSAR), 2016(4), at page 717.
[1944] Stevens, R. (2016), ‘Liability Within Company Groups’, Journal of South African Law (TSAR), 2016(4), at page 707.

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> This begs the question of who will be exposed to liability to the subsidiary company where the subsidiary suffers damages due to the instructions which the holding company issued to its representatives on the board of the subsidiary. If one ignores the possibility of joint and several liability, two possible wrongdoers could be identified, and therefore, two possibilities could exist for the subsidiary to recover damages from. In the first instance, the more obvious possibility would be to hold the directors of the subsidiary company liable for breach of their fiduciary duty for not acting in the best interest of the company ... less obvious possibility in terms of current South African law would be to hold the holding company liable ... due to instructions which holding company issued to the board of directors.'

Nevertheless, our law does not readily recognise this commercial reality and the only possible defence that a director may have against the allegation that he/she did not act in the best interest of his/her company is that he/she had a rational belief that he/she did.[1945] Stevens argument suggests in theory that it would be possible for a director to argue a rational basis in defence for the belief "... in the materialisation of such benefits".[1946]

Despite the latter submission, the general position is still that the directors of a company owe fiduciary duties to the company of which they are directors, and not to the specific shareholders of such company. Therefore, in the context of a private equity fund, the primary reason for appointing the nominee director to an underlying portfolio investee company's board would generally be to protect the private equity fund's interests in the underlying portfolio investee company. However, this often leads to instances where the nominee director is conflicted between protecting the private equity fund's interest and acting in the best interest of the investee company.

The nature of the private equity business model is that conflicts of interest are a commercial reality. Board members, especially private equity fund appointed directors, have fiduciary duties to the companies on whose boards they serve and to the shareholders of such companies. These duties require directors to place the interests of the company and its shareholders ahead of their own personal interests and the interests of private equity fund that appointed them. On the other hand, it would be reasonable to expect that a person who serves on a portfolio company board as an appointee of his/her private equity fund also has a duty to such private equity fund. However, in the context of a private equity fund this expectation can often be problematic because directors must exercise his/her duties as a director with unfettered discretion and in accordance with the degree of care required of a person in his/her position. Directors cannot, without the consent of the company, fetter their discretion in relation to the exercise of their powers, and cannot bind themselves to vote

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[1945]Stevens, R. (2016), 'Liability Within Company Groups', Journal of South African Law (TSAR), 2016(4), at page 729. See also section 76(4)(a)(iii) of the Companies Act 71 of 2008.

[1946]Stevens, R. (2016), 'Liability Within Company Groups', Journal of South African Law (TSAR), 2016(4), at page 729. See also section 76(4)(a)(iii) of the Companies Act 71 of 2008.

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in a particular way at future board meetings. It is clear from the preceding case law and legislation that company directors must however, at all times, exercise an independent and unfettered discretion and that a company director cannot fetter his/her discretion by way of a contract with an outsider, such as with the private equity fund that appointed him/her. Particularly in those situations where there is a conflict between the interests of the underlying portfolio investee company, with those of the private equity fund, the private equity fund appointee director must always act in the interest of the company on whose board he/she serves.

3. Conclusion

In concluding the first part of the chapter, it is submitted that private equity fund investors have far higher expectations with respect to the corporate governance of the funds in which they invest. For example institutional investors globally are actively calling for changes in the way company boards are constituted, and the role played by directors on those boards. Aspinall and Smith stated that:

> 'The obligations that apply to directors in this regard are set out in a combination of statutory requirements (including company law), regulatory obligations and common law fiduciary and other duties of directors. Statutory obligations generally include, *inter alia*, an obligation to ensure that proper records are maintained, whereas common law duties are more general in nature, requiring directors to act with due skill, care and diligence and a duty to act in the best interests of the company. Increasingly, regulators are seeking to codify these requirements and add to them, generally in the form of corporate governance codes of conduct ... while tailoring the requirements to the investment funds industry.'[1947]

Nevertheless, it is beneficial that the interests of the underlying portfolio investee company and its shareholders be aligned with the private equity fund that wants to improve shareholder value to increase the return on its investment. In addition, despite the merits of fiduciary duties as established in law, legal duties need to be embedded in an industry structure which provides the expertise and resources for good governance and duties must be enforced by efficient regulation.[1948] This seems to be lacking in the South African private equity regulatory environment.[1949] This does not imply a call for a general reform of the law of fiduciary duties, but rather that regulation needs to be strengthened in specific areas, more notably the fundamental duties owed by the fund manager to the investors. This brings us to the second part of this chapter that will *inter alia* discuss the practical corporate governance contracting techniques employed between the private equity firm and the

[1947] Aspinall, R., and Smith, S. (2011), 'Corporate Governance in Investment Funds: Duties and Responsibilities of Directors Revisited', Deloitte's November 2011.
[1948] United Kingdom Law Commission Report (2013), 'Fiduciary Duties of Investment Intermediaries: Summary of the Consultation Paper', Consultation Paper No 215, October 2013. Paper commissioned by the United Kingdom Department for Business, Innovation and Skills and Department for Work and Pensions, at page 3.
[1949] See discussion South African regulatory environment in chapter two.

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investors. This discussion will hopefully highlight the areas of regulation that needs to be strengthened in relation to duties owed by the fund manager.

The second part of this chapter will discuss more specifically the role of corporate governance in terms of the relationship between the private equity firm and the investors that invest in the private equity fund. It is submitted that the private equity industry should strive at bettering the corporate governance practices within a legal framework that also includes effective legal contracting. Nevertheless, as mentioned in paragraphs 3.1.1 and 3.1.2 of chapter two, the relationship between partners and the relationship between the trustees and beneficiaries, respectively, must display the highest degree of good faith which is utmost good faith. Therefore, fund managers of a private equity fund, whether structured as a *bewind* trust or *en commandite* partnership; and the investors to such private equity fund; must at all times consider the duty of utmost good faith when drafting the terms of a partnership agreement and/or any dealing in relation to such private equity fund.[1950]

The second part of this chapter will consist of two sections. The first will include a discussion with regard to the practical corporate governance contracting techniques employed between the private equity firm and the investors. The second part will include recommendations for effective risk mitigation of conflicts of interest within the private equity firm itself.

4. Corporate Governance: Between Investors and Fund Manager

Several of the characteristics of the private equity business model that have already been discussed in chapter one, chapter two, and to a large part in the preceding paragraphs of this chapter, will again form part of the discussion below. These characteristics are introduced only to discuss more specifically the practical corporate governance techniques employed between the private equity firm and the investors that invest in the private equity fund. For instance, it is evident from the preceding discussion on fiduciary duties that an agency problem exists in the underlying portfolio investee company between the active private equity fund and the investee company's other shareholders and managers. According to Metrick,[1951] a second agency relationship also exists in the private equity market, in that the private equity firm act as agents for external investors, who choose to invest in underlying portfolio investee companies via an intermediary rather than directly.[1952] This agency problem stems from inevitably high degree of information asymmetry[1953] between the private equity firm, who play an active role in the portfolio companies, and the passive investors, who have no involvement in managing the underlying portfolio investee companies. The legal practice has

[1950] See paragraphs 3.1.1 and 3.1.2 of chapter two.
[1951] Metrick, A., (2007), 'Venture Capital and the Finance of Innovation', John Wiley and Sons, 2007.
[1952] Metrick, A., (2007), 'Venture Capital and the Finance of Innovation', John Wiley and Sons, 2007.
[1953] In contract theory and economics, information asymmetry deals with the study of decisions in transactions where one party have more or better information than the other.

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however developed corporate governance and risk mitigating techniques that are effective in limiting opportunism and controlling the level of risk created by the above mentioned agency problems.[1954]

As mentioned earlier, the extent of this discussion is restricted to the risks inherent to the private equity fund investors from potential conflicts of interest which may exist within the private equity firm or within the private equity fund, which emanates throughout the life cycle of a typical private equity fund. More specifically the potential conflicts of interest that may be encountered by the private equity firm that manages the private equity fund. Furthermore, the discussion will not address potential conflicts of interest which are not specific to the private equity business model or those potential conflicts of interest which are usually within the ambit of company law, such as the duties and liabilities of nominee directors appointed to an underlying portfolio investee company by the private equity firm. The latter has been extensively discussed under paragraph 3 earlier in this chapter.

Private equity funds are created following contractual negotiation between the private equity firm and the investors, who are the potential investors in the private equity fund. The private equity funds are established under a negotiated contractual agreement which will stipulate the material terms and conditions of the private equity fund, which will include *inter alia* specific terms and conditions relating to the appropriate private equity fund legal structure, its investment strategy, the allocation of fees and costs, allocation of investment opportunities, any co-investment arrangements, the allocation and distribution of profits, the content and frequency of investor reporting key-man provisions and mechanisms for conflict and dispute resolution.[1955] The chosen legal structure for a private equity fund is crucial to the governance structure of a private equity fund, whether a *bewind* trust or *en commandite* partnership. The above mentioned private equity fund structures permit the private equity firm to achieve significant control over the operation and management of their funds subject to a limited number of negotiated intrusive legal obligations afforded to the investors.[1956] As discussed in chapter two, other features, such as tax benefits, the flexibility surrounding its structure and terms and its fixed life, contribute to the private equity business model continuing its viability as the business form of choice.[1957] The nature of these models allows the participants to enter into a fund management arrangement that aligns the interests of the private equity firm to those of the outside investors. The flexibility of the model allows the investors to vote on important issues such as the amendment and dissolution of the fund agreements, the extension of the private equity fund's life and the valuation of the underlying portfolio, despite the restrictions on the investor's managerial rights.[1958]

[1954]Metrick, A., (2007), 'Venture Capital and the Finance of Innovation', John Wiley and Sons, 2007.

[1955]Talmor, E., and Vasvari, F. (2011), 'International Private Equity', Wiley and Sons. See also Meyer, T. (2014), 'Private Equity Unchained: Strategy Insights for the Institutional Investor', First Edition, MacMillan Publishers Ltd, at pages 149-160 and 259-270.

[1956]Talmor, E., and Vasvari, F. (2011), 'International Private Equity', Wiley and Sons.

[1957]Albeit structured as a *bewind* trust or *en commandite* partnership.

[1958]European Private Equity and Venture Capital Association ('EVCA') Report (2005) updated in 2010, 'EVCA

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Generally there is an alignment of interest between the private equity firm and the fund investors, but at times such an alignment is broken. For instance, a private equity firm and/or its staff may co-invest alongside the private equity fund in an underlying portfolio company. This is generally considered as an alignment of interests of the private equity firm, its staff and the private equity fund's investors. However, conflicts of interest can occur if the private equity firm is permitted to invest on a deal-by-deal basis and/or on different terms to those offered to fund investors.[1959] For instance, where the private equity firm and/or its staff and/or its affiliates are offered more favourable terms of investment to that which is offered to the private equity fund. In practice, such potential conflicts of interest are mitigated by contractual terms that will stipulate the basis upon which the fund manager and/or its staff are required to co-invest alongside the fund.[1960] For instance, such terms will require an upfront agreed *pro rata* participation by the private equity firm and/or its staff which must invest in all deals *pari passu* with the fund investors.[1961]

In practice, the mitigation of potential conflict of interest risks typically occurs by way of the contractual alignment of interest, such as contracting mutually acceptable disclosure and incentive agreements between the private equity firm and the funds' investors.[1962] Despite the alignment of interests between the private equity firm and the funds' investors, the commercial reality of the private equity business model is that the potential for material conflicts of interest always exist.[1963] The discussion to follow will outline possible mitigating measures alongside the potential conflict of interest risks. The extent to which the mitigation of conflicts of interest by private equity firms is regulated may differ from jurisdiction to jurisdiction because the mitigation of conflicts may either be required due to general or specific legal or regulatory provisions or as a consequence of general industry practice.[1964] The modest goal of this chapter is to outline principles against which both the private equity industry and regulators can assess the quality of mitigation of conflicts of interest by private equity firms.

Corporate Governance Guidelines: Guidelines and good practice in the management of privately held companies in the private equity and venture capital industry', European Private Equity and Venture Capital Association.

[1959] Frase, D., Helm, R., and Day, M. (2012), 'Practitioner's Guide to Conflicts of Interest in the Financial Services Industry', First Edition, Sweet and Maxwell Publishers, at pages 138-170.

[1960] International Organization of Securities Commissions (IOSCO), (2009), 'Private Equity Conflicts of Interest', Report by the Technical Committee of the International Organization of Securities Commissions, November 2009, at page 16.

[1961] According to the International Organization of Securities Commissions ('IOSCO'), the use of preferential co-investment terms by private equity firms have largely been removed in developed private equity markets, but still represent an issue in emerging markets. International Organization of Securities Commissions, (2009), 'Private Equity Conflicts of Interest', Report by the Technical Committee of the International Organization of Securities Commissions, November 2009, at 16.

[1962] Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies, 26(2), at pages 368-402.

[1963] Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies, 26(2), at pages 368-402.

[1964] Frase, D., Helm, R., and Day, M. (2012), 'Practitioner's Guide to Conflicts of Interest in the Financial Services Industry', First Edition, Sweet and Maxwell Publishers, at pages 138-170.

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4.1 Corporate Governance: Between Investors and Fund Manager at the Fund Raising Stage

An important area where legal practice has developed specific contractual considerations relates to the fees and services of external advisors. For instance, when raising a private equity fund, the private equity firm often retains the services of an external placement agent to market the fund to the potential outside investors.[1965] If the private equity firm intends to recover the costs incurred by the appointment of a placement agent from the private equity fund on an undisclosed basis, it would present a material conflict of interest with the fund's investors. A further material conflict would exist where the external advisor failed to disclose to potential investors that it is incentivised by or affiliated to the private equity firm that is raising the private equity fund.[1966]

In practice, an example of a corporate governance and risk mitigating technique would be that the above mentioned advisory fees are to be borne by the private equity fund, but the basis of any such cost would typically be agreed in advance with the fund investors. The private equity fund management agreements between the parties will stipulate the clear expectation that investors will receive appropriate disclosure of all actual costs as and when such costs are incurred. The private equity fund placement agents' costs are usually paid by the private equity firm directly, or paid by the private equity fund with a corresponding offset against the private equity fund firm's management fees.[1967]

Another area where contractual techniques intend to create an alignment between the interests of the private equity firm and the outside investors, relates to remuneration arrangements. As discussed in chapter one, the remuneration arrangement between the private equity firm and the outside investors is usually comprised of two main sources. Firstly, the private equity firm will receive a fund management fee for managing the private equity fund. Secondly, the private equity firm will usually also be entitled to a percentage of the profits (carried interest) generated by the private equity fund. Contractually, the private equity firm will typically only be entitled to the carried interest after the fund investors have received a full return on their investment (hurdle rate) plus having taken into account all fund costs and fees.[1968]

[1965]Barret, R., Butler, M., and Bartlett, J.W., (2011), 'Advanced Private Equity Term Sheets and Series A Document: Business Structure and Operations', Release 19, Law Journal Press, New York, 2011, ISBN No. 978-1-58852-120-0.
[1966]See Meyer, T. (2014), 'Private Equity Unchained: Strategy Insights for the Institutional Investor', First Edition, MacMillan Publishers Ltd, at pages 149-160 and 259-270.
[1967]Barret, R., Butler, M., and Bartlett, J.W., (2011), 'Advanced Private Equity Term Sheets and Series A Document: Business Structure and Operations', Release 19, Law Journal Press, New York, 2011, ISBN No. 978-1-58852-120-0.
[1968]See paragraph four of chapter one hereof.

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A further area of potential conflict of interest between the private equity firm and investors relate to the final size of the private equity fund. This is usually determined and agreed upon during the fund raising process by means of contractual negotiation between the private equity firm and potential fund investors.[1969] There remains a potential conflict of interest between the private equity firm's ambitions to raise increasingly larger size private equity funds, whereas the potential investors' goal is to ensure that whatever capital is raised can be effectively deployed towards suitably attractive investment opportunities within the fund's proposed investment period. This conflict of interest stems from the way that the private equity firm's management fee is calculated.[1970] Typically, the private equity firm receives an annual fund management fee determined as a percentage of the total size of the private equity fund. Therefore, the larger the size of the private equity fund, the more fees the private equity firm would earn. This serves the interests of the private equity firm without any real increased investment benefit to the prospective investors.[1971]

In addition, the amount of capital raised by the private equity firm for the private equity fund could result in a fund size that is greater than what can be reasonable invested by the private equity firm. In practice, a method used by investors and private equity firms to show an alignment of interest, is for the private equity fund that is to be raised, to be subject to the condition that the private equity firm commit to co-invest a set percentage of their own capital on a co-investment basis alongside the private equity fund.[1972] The set percentage would be determined in relation to the total amount of investor committed capital. It is submitted that a private equity firm is strongly motivated to protect their reputation and to maintain a healthy relationship with its investors because of future fund raising.[1973] Despite the latter, the main mitigating factor against the potential conflicts of interests is that the fund-raising process is subject to contractually binding negotiations between the private equity firm and the investors, where investors are able to negotiate definitive terms and conditions relating to the management fees and performance based fees to be earned by the private equity firm.[1974] In addition, during the fund-raising process the investors are able to negotiate definitive

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[1969]Barret, R., Butler, M., and Bartlett, J.W., (2011), 'Advanced Private Equity Term Sheets and Series A Document: Business Structure and Operations', Release 19, Law Journal Press, New York, 2011, ISBN No. 978-1-58852-120-0.

[1970]See International Organization of Securities Commissions (IOSCO), (2009), 'Private Equity Conflicts of Interest', Report by the Technical Committee of the International Organization of Securities Commissions, November 2009, at pages 13-14.

[1971]Barret, R., Butler, M., and Bartlett, J.W., (2011), 'Advanced Private Equity Term Sheets and Series A Document: Business Structure and Operations', Release 19, Law Journal Press, New York, 2011, ISBN No. 978-1-58852-120-0. See also Bartlett, J.W. (1995), 'Organising the Pooled Investment Vehicle (PIC), Equity Finance: Venture Capital, Buy-outs, Restructuring and Reorganisations', Second Edition, Aspen, Volume 3.

[1972]Frase, D., Helm, R., and Day, M. (2012), 'Practitioner's Guide to Conflicts of Interest in the Financial Services Industry', First Edition, Sweet and Maxwell Publishers, at pages 138-170.

[1973]European Private Equity and Venture Capital Association ('EVCA') Report (2005) updated in 2010, 'EVCA Corporate Governance Guidelines: Guidelines and good practice in the management of privately held companies in the private equity and venture capital industry', European Private Equity and Venture Capital Association.

[1974]Frase, D., Helm, R., and Day, M. (2012), 'Practitioner's Guide to Conflicts of Interest in the Financial Services Industry', First Edition, Sweet and Maxwell Publishers, at pages 138-170.

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terms and conditions relating to a maximum fund size that will not be exceeded at the final closing of the private equity fund. During the fund-raising process, the investors would also be able to negotiate the terms and manner of information disclosure to be made by the private equity firm relating to the private equity fund. In the developed private equity markets the provisions and content of investor reporting and disclosure requirements are well established.[1975] Despite the above common risk mitigation strategies being in place to address potential conflicts of interest, they do not represent all possible risk mitigation methods at the fund raising stage of a private equity fund.[1976]

The above mentioned contractually binding negotiations during the fund-raising stage would typically result in the establishment of an investor advisory committee of the private equity fund. This committee is usually established subject to a contractual requirement that the private equity fund has to maintain an investor advisory committee, comprising of the private equity funds' investors.[1977] The investor advisory committee offers the fund investors a forum in which to examine and comment on the operation and management of the private equity fund.[1978] The exact role of an investor advisory committee would invariably differ from one private equity fund to another. An investor advisory committee could simplistically be described as having a board-like character.[1979] The investor advisory committee's primary responsibility is to address and resolve all material conflicts of interest relating to the private equity fund; and review the private equity firm's approach towards resolving all material fund-related conflicts of interest.[1980] In practice, this should be done before the private equity firm decides upon a particular proposed course of action.[1981] The committee is not an investment decision making body, but rather a body for sound corporate governance adherence.[1982]

4.2 Corporate Governance: Between Investors and Fund Manager at the Investment and Management Stage

Another area where the legal practice has developed practical contracting techniques is in terms of the private equity fund's investment allocations. In terms of the private equity business model, a

[1975]European Private Equity and Venture Capital Association ('EVCA') Report (2005) updated in 2010, 'EVCA Corporate Governance Guidelines: Guidelines and good practice in the management of privately held companies in the private equity and venture capital industry', European Private Equity and Venture Capital Association.
[1976]See Bassi, I. And Grant, J. (2006), 'Structuring European Private Equity', Euromoney Books Publishers, at pages 35-84.
[1977]Stowell, D. (2012), 'Investment Banks, Hedge Funds, and Private Equity', Academic Press Publishers, at pages 389-408.
[1978]Bassi, I. And Grant, J. (2006), 'Structuring European Private Equity', Euromoney Publishers, at page 40.
[1979]See Povaly, S. (2007), 'Private Equity Exits: Divestment Process Management for Leveraged Buyouts', Springer Science and Business Media Publishers, at pages 36-41.
[1980]International Organization of Securities Commissions (IOSCO), (2009), 'Private Equity Conflicts of Interest', Report by the Technical Committee of the International Organization of Securities Commissions, November 2009, at page 12.
[1981]Bassi, I. And Grant, J. (2006), 'Structuring European Private Equity', Euromoney Publishers, at 35-84.
[1982]Also mentioned under paragraph 4.4 of this chapter.

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private equity firm would typically be subject to a contractual stipulation which prevents it from raising a successive fund with a similar investment strategy until such time that the preceding private equity fund has, for instance, invested a predetermined amount of its committed capital.[1983] For instance, the preceding private equity fund should be eighty percent invested before a successive private equity fund with a similar investment strategy could be raised by the same private equity firm.[1984] The objective of the latter principle is to protect the interests of investors in the preceding private equity fund, while at the same time providing the private equity firm with access to sufficient capital to complete investment opportunities during the successive private equity fund's fund raising process.[1985] The downside of this risk mitigation technique is that it could result in a situation where for a period of time the private equity firm may have a discretion over how to allocate its investment opportunities between the two funds (preceding and successive) until such time as the preceding fund is fully invested.[1986]

In practice, another common occurrence is when the private equity firm would typically charge the underlying portfolio investee company fees for its time and expertise as part of completing a transaction. For instance, these fees would include *inter alia*, advisory fees, underwriting fees and arrangement fees.[1987] The argument against the latter practice is that the fees paid by the underlying portfolio investee company has a negative financial effect on the investee company and dilutes the investment value of the private equity fund's investment. The contractual terms that regulate the conditions under which such fees are payable to the private equity firm are usually agreed in advance with the investors during the fund raising process.[1988] Despite the latter, it is difficult to determine in advance what the amount of such fees would be because the resulting transactions have not yet been completed. In practice, an example of a corporate governance and risk mitigating technique would be for the investors to negotiate the contractual terms with the private equity firm to either set

[1983]Barret, R., Butler, M., and Bartlett, J.W., (2011), 'Advanced Private Equity Term Sheets and Series A Document: Business Structure and Operations', Release 19, Law Journal Press, New York, 2011, ISBN No. 978-1-58852-120-0. See also Bartlett, J.W. (1995), 'Organising the Pooled Investment Vehicle (PIC), Equity Finance: Venture Capital, Buy-outs, Restructuring and Reorganisations', Second Edition, Vol. 3. Aspen.
[1984]Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies, 26(2), at pages 368-402. See also Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', Second Edition, John Wiley and Sons.
[1985]International Organization of Securities Commissions (IOSCO), (2009), 'Private Equity Conflicts of Interest', Report by the Technical Committee of the International Organization of Securities Commissions, November 2009, at pages 15-16.
[1986]Frase, D., Helm, R., and Day, M. (2012), 'Practitioner's Guide to Conflicts of Interest in the Financial Services Industry', First Edition, Sweet and Maxwell Publishers, at pages 138-170. See also Asset Alternatives Inc. Report (1999), 'Private Equity Partnership Terms and Conditions', Asset Alternatives Inc.
[1987]International Organization of Securities Commissions (IOSCO), (2009), 'Private Equity Conflicts of Interest', Report by the Technical Committee of the International Organization of Securities Commissions, November 2009, at pages 11-18.
[1988]Cooke, D. (2011), 'Private Equity: Law and Practice', Sweet and Maxwell Publishers at 17-40; 185-260.

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off all or part of any transaction fees received against its management fee.[1989] Another practical example would be for the investors to negotiate the contractual terms by which the private equity firm is allowed to charge and retain such fees. In addition, investors can require the private equity firm to provide disclosure of every transaction fee received by the fund management company.[1990]

In the same manner, a material conflict of interest may also occur where a private fund operates two or more funds with a very similar investment strategy. In practice this area of potential material conflict of interest is mitigated by stipulating that the private equity firm give priority towards allocating all appropriate investment opportunities to the preceding private equity fund.[1991] Alternatively, through negotiation between the private equity firm and the investors, the private equity fund terms could stipulate that investment opportunities are to be allocated between the relevant funds on a *pro rata* basis, or provide the flexibility to allocate larger investments directly to the successor fund to circumvent practical problems associated with joint ownership.[1992] To this end, it is important for the contractual negotiation between the private equity firm and the investors to take into account the full extent, *inter alia*, of the size and investment strategy of the current private equity funds under management of the private equity firm, as well as the future private equity funds the firm intends to raise, particular private equity funds with overlapping investment strategies.[1993] However, where such funds have been raised, it is standard practice for the private equity firm to provide disclosure upfront to all the investors.[1994]

As stated above, the co-investment by the private equity firm alongside the private equity fund which it is managing can be viewed as an alignment of interests of the private equity firm with those of the private equity fund's investors.[1995] However, a material conflict of interest will arise if the private equity firm selectively participates in certain of the private equity fund's investments or is permitted to invest on preferential terms and conditions to those applicable to the private equity fund in which the investors have committed capital.[1996] In practice, the private equity fund's contractual terms and

[1989]International Organization of Securities Commissions (IOSCO), (2009), 'Private Equity Conflicts of Interest', Report by the Technical Committee of the International Organization of Securities Commissions, November 2009, at pages 11- 18.
[1990]See Gompers, P.A and Lerner, J. (1996), 'The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements', Journal of Law and Economics, 39, at pages 463-98.
[1991]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc., at pages 145-174.
[1992]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc., at pages 145-174.
[1993]Moloney, N. (2014), 'EU Securities and Financial Markets Regulation', Oxford University Press at 194-319; 366-378.
[1994]Both investors in the preceding and successive/'new' funds.
[1995]Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies, 26(2), at pages 368-402.
[1996]See Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', Second Edition, John Wiley and Sons.

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conditions should stipulate the basis upon which the private equity firm will be required to co-invest alongside the private equity fund to eliminate preferential co-investment terms and conditions.[1997]

Nevertheless, as mentioned earlier in the chapter, the private equity firm will typically appoint a member of its staff to the board of directors of an underlying portfolio investee company. The rationale behind the appointment is twofold. Firstly, the staff member is appointed to the board of the investee company to monitor performance; and secondly to foster the growth and development of the underlying portfolio company.[1998] The role of the above mentioned appointed director creates an ongoing duty to consider the requirements of both the private equity fund and the underlying portfolio company separately. In addition, the duly appointed director needs to ensure that any information received from either party is not shared inappropriately.[1999] In theory, it would commonly be accepted that the interests of the private equity fund investors, the underlying portfolio investee companies and the private equity firm are all well aligned. However, such an alignment of interest can easily be undone in practice. For instance, an underlying portfolio investee company may be in desperate need of additional funding and this can create a material conflict of interest between the above mentioned parties, particularly in relation to the private equity firm's appointed director. However, in practice it is common for the private equity firm to rely on an independent third party/director to monitor the underlying portfolio investee company, instead of one of its own staff members to avert any material conflicts of interest.[2000] To this end, the private equity firm would have to rely on the principle that the independent director would be able to fulfil his/her duties owed to the underlying portfolio investee company as fully described in paragraph 2(b) of this chapter.[2001]

It is submitted that the enforcement of corporate governance at the investment and management stage, specifically with regard to the private equity firm in relation to the investee company, falls broadly into two categories, namely formal and informal enforcement measures.[2002] The formal measures, for instance, could be that the private equity firm contractually binds the investee company's executive management to specific behaviour. Such specific provisions would typically be contained in the shareholder agreements and would be conditional upon the private equity fund's

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[1997]Frase, D., Helm, R., and Day, M. (2012), 'Practitioner's Guide to Conflicts of Interest in the Financial Services Industry', First Edition, Sweet and Maxwell Publishers, at pages 138-170.

[1998]See Aspinall, R., and Smith, S. (2011), 'Corporate Governance in Investment Funds: Duties and Responsibilities of Directors Revisited', Deloitte's November 2011.

[1999]Cassim, F.H.I., Cassim, M.F., Cassim, R., Jooste, R.D., Shev, J., and Yeats, J. (2012), 'Contemporary Company Law', Second Edition, Juta and Co, Cape Town, at pages 528-531.

[2000]International Organization of Securities Commissions (IOSCO), (2009), 'Private Equity Conflicts of Interest', Report by the Technical Committee of the International Organization of Securities Commissions, November 2009, at page 18.

[2001]This principle was discussed earlier in the chapter under paragraph 2.2 which discussed statutory and common law duties of a director, clarifying the requirement that as a director of the investee company, such individuals have a primary responsibility to the company and not its nominator.

[2002]Du Plessis, J.J., Hargovan, A., and Bargic, M. (2011), 'Principles of Contemporary Corporate Governance', Second Edition, Cambridge University Press, at 51.

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investment in the underlying portfolio investee company.[2003] Further examples of such specific provisions would be the relative quantum of voting rights which the private equity fund would acquire, whether or not the private equity fund has taken a controlling stake in the investee company and provisions that relate to the private equity firms representation on the board of investee companies.[2004] In contrast, informal measures could include the extent and level of active involvement by the fund manager in the investee companies, the appointment of expert independent directors on the board of investee companies and the development of professional relationships with the executive management of the investee companies.[2005] The appointing of non-executive directors to the boards of investee companies who are industry experts within the industry of the investee company holds several benefits. For instance, it is aimed at stimulating investment for the investee company, brings prominent individuals onto the board of the investee company that will not only contribute to the running of the business as a result of the individual's expert skills and knowledge, but could also increase the performance amongst the fellow board members.[2006]

In practice, both the formal and informal enforcement measures are determined, agreed upon and legislated in the shareholders agreement of the investee company. This is typically concluded during the investment process by means of contractual negotiation between the private equity firm and portfolio investee company.[2007] To this end, detailed shareholders' agreements which would *inter alia* contain provisions dealing with approvals frameworks, board representation, number of executive and non-executive directors, and the establishment of subcommittees, are crucial to the enforcement of corporate governance at the investment and management stage of the private equity life cycle. The above mentioned formal and informal corporate governance enforcement measures are aimed at aligning the interests of private equity firms with those of investee companies and are often the most effective method of promoting good corporate governance and performance in their investee companies. In practice it is difficult to legislate corporate governance practices but it is essential that a culture of corporate governance be developed within portfolio investee companies.

A related corporate governance issue, pertains to the situation where the private equity firm itself and/or staff and/or its nominee director(s) have an interest in an underlying portfolio investee company, into which the private equity fund (which they are managing), makes an investment. It is assumed for the purposes of this discussion that the private equity firm (nominator) is aware of the

[2003]See Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', Second Edition, John Wiley and Sons.
[2004]Bassi, I. And Grant, J. (2006), 'Structuring European Private Equity', Euromoney Publishers, at 35-84.
[2005]See Hudson, M. (2014), 'Funds: Private Equity, Hedge and All Core Structures', John Wiley and Sons. See Moloney, N. (2014), 'EU Securities and Financial Markets Regulation', Oxford University Press, at pages 194-319; 366-378.
[2006]See Aspinall, R., and Smith, S. (2011), 'Corporate Governance in Investment Funds: Duties and Responsibilities of Directors Revisited', Deloitte's November 2011.
[2007]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc., at pages 145-174.

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nominee director's interest in an investee company; and that such nominee director's interest has been dealt with in adherence with his/her fiduciary duties under the common-law and the statutory requirements of such investee company, as discussed in paragraph 3 of this chapter. This related issue pertains to the fiduciary duties owed by the private equity firm to the investors of the private equity fund.[2008] Nevertheless, irrespective of whether the private equity fund is structured as a *bewind* trust or *en commandite* partnership, the private equity firm and its staff owe the investors and the fund itself, the duties of avoiding conflict of interest and proper disclosure.[2009] Furthermore, statutory law, judicial precedent, and the terms of the private equity fund and fund management agreements will further determine what fiduciary duties, if any, the private equity firm and its staff will owe to the investors.[2010] For example, in chapter two it was argued that one of the advantages of the *bewind* trust and *en commandite* partnership structures is that both these legal vehicles are generally very flexible business entities. For example, they both allow many of the statutory provisions that would otherwise apply to a company to be overridden, modified or supplemented by the specific terms of the trust or partnership agreements. This flexibility allows the private equity firm and investors in a private equity fund to structure a wide variety of economic and governing arrangements. It was also argued in chapter two that the nature and structure of each individual private equity fund is largely dependent on the operating agreement.[2011]

In operating a private equity fund, the general rule must be that the investors in a private equity fund must be able to trust and rely upon the private equity firm managing the fund to promote the best interests and success of the fund.[2012] As mentioned in paragraphs 2 and 3 of chapter two, the private equity firm participate in the daily operation and management of the private equity fund and because of their role in managing the fund; they are usually viewed as having fiduciary duties towards the investors in the fund. In contrast, the investors provide the capital and are not involved in managing

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[2008]See Cumming, D. and Walz, U. (2010), 'Private equity returns and disclosure around the world', Journal of International Business Studies, 41(4), at pages 727-754.

[2009]See Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies, 26(2), at pages 368-402.

[2010]Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', Second Edition, Volume 792, John Wiley and Sons. This is even more relevant in the case of an *en commandite* partnership because it is established by way of a contract between the parties expressly reflecting the intention of establishing an *en commandite* partnership. There are no specific registration requirements and legislation for establishing and regulating *en commandite* partnerships.

[2011]See paragraph 3.2 of chapter two and particular *Gatz Properties LLC v Auriga Capital Corporation* 2012, 59 A. 3d 1206, Delaware Supreme Court which deals with the application of the operating agreement and fiduciary duties. In this case, the court stated that members of limited liability companies should clearly state in the limited liability company agreement whether and to what extent the company managers or controlling persons is should have any fiduciary duties to the members. The court upheld the Chancery Court's decision regarding Gatz's liability for breach of fiduciary duty; however, it based its decision solely on contractual grounds and not on the existence of any default fiduciary duties under Delaware's limited liability company statute.

[2012]See Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, Second Edition, March 2010.

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the private equity fund, leaving operational duties to the private equity firm instead.[2013] It was also discussed paragraph 3 of chapter two that the investors typically do not owe fiduciary duties to the private equity firm. Nevertheless, the private equity firm is expected to comply with a duty of disclosure and as such must make informed decisions and should make full disclosures about reasonably known risks and potential benefits of a particular action.[2014] These disclosures relate to all the private equity fund's activities, including the fund's assets, investments in underlying portfolio investee companies, operations, finances, debt, potential and real conflicts of interest and contracts.[2015] Disclosure is particularly important in instances involving potential conflicts of interests in business dealings related to the private equity fund, such as where the private equity firm itself and/or its nominee director(s) having an interest in an underlying portfolio investee company, in which the private equity fund has or intends making an investment. Therefore, as part of their duty of disclosure, the private equity firm should disclose any conflict of interest they may have relative to any fund investments and decisions.[2016]

In practice, an example of a corporate governance and risk mitigating technique would be for the investors to negotiate the contractual terms with the private equity firm relating to investor reporting and disclosure requirements. The private equity fund management agreements between the parties will stipulate the clear expectation that investors will receive appropriate disclosure of all such related material conflicts of interest. In addition, investors should be able to negotiate definitive terms and conditions relating to the proper disclosure by the private equity firm to the investors relating to interest held in underlying investee companies by the private equity firm and/or its staff and/or nominee directors appointed to the board of investee companies by the private equity firm. Furthermore, the investors should also be able to negotiate the terms and manner of information disclosure to be made by the private equity firm relating to interest held in underlying investee companies by the private equity firm and/or its staff and/or nominee directors appointed to the board of investee companies by the private equity firm. In the developed private equity markets the provisions and content of investor reporting and disclosure requirements are well established.

This duty of disclosure, is a continuing duty that arises starting with the formation of the fund and continues through the fund's ongoing daily operations and ultimately through the fund's ultimate

[2013]Vestal, A.W. (1994), 'Disclosure Obligations of Partners Inter Se under the Revised Uniform Partnership Act of 1994: Is the Contractarian Revolution Failing', William and Mary Law School Law Review, 36, at 1559.

[2014]Lewis, W.A. (2013), 'Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies', Fordham Law Review, Volume 82, Issue 2, Article 20, 1017, at pages 1017-1051. See also discussion had in paragraph 3 of chapter two and the discussion had in paragraph 2 of chapter three. See also *Gatz Properties, LLC v Auriga Capital Corp*. 2012, 59 A. 3d 1206, Delaware Supreme Court.

[2015]Healy, P.M. and Palepu, K.G. (2001), 'Information asymmetry, corporate disclosure, and the capital markets: A review of the empirical disclosure literature', Journal of accounting and economics, 31(1), at pages 405-440.

[2016]See Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, Second Edition, March 2010.

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dissolution.[2017] One notable development in this regard was the amendment of Regulation 28 of the Pension Funds Act 24 of 1956, which was discussed in paragraphs 3 and 4 of chapter two. In terms of the aforementioned amendment, the Registrar of Pension Funds published conditions for investment by pension funds in private equity funds. One of the conditions imposed by the Registrar pertained to the management of conflicts of interest. According to this condition stated that any responsible person, manager, administrator, or advisor of a private equity fund must disclose to the fund any possible conflicts of interests that may arise or any direct or indirect benefit which such person may obtain as a consequence of any transaction concluded by the private equity fund or in the acquisition or disposal of assets in the execution of the business of the private equity fund.[2018]

Nevertheless, it is submitted, that similar to a nominee director having to place the company's interest above those of its nominator; so to should a private equity firm and their staff's place the success and interests of the private equity fund above their own personal or other business interests. Therefore, where the private equity firm itself and/or its nominee director(s) have an interest in an underlying portfolio investee company, such impacted parties should avoid any conflicts of interest between their duties to the fund and its investors, and their other personal and business activities.[2019] Furthermore, it is submitted that the private equity firm must properly hold the private equity fund's investments for the benefit of the investors and not use it for its own personal advantage. For example, a private equity firm and/or its staff personally may own shares in a particular company, but the private equity firm, on behalf of the private equity fund, should not subsequently acquire shares in the same company for their own economic gain to the detriment of the private equity fund and its investors. In practice, the private equity firm and/or its staff may be allowed to obtain an individual benefit from the private equity fund's investments, such as in the aforementioned scenario, but only after full disclosure to and prior approval from the investors.[2020] Nevertheless, as mentioned in chapter two, the private equity fund agreements, largely contracted between the private equity firm and the investors may limit, expand, or eliminate fiduciary duties by agreement, which would include the duty of disclosure, provided that these changes are reasonable under the circumstances, subject to those fiduciary duties that cannot be eliminated by agreement because they are required by statutory law.[2021] As mentioned in chapters two and the first part of chapter three, fiduciary duties

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[2017]Vestal, A.W. (1994), 'Disclosure Obligations of Partners Inter Se under the Revised Uniform Partnership Act of 1994: Is the Contractarian Revolution Failing', William and Mary Law School Law Review, 36, at 1559.

[2018]'March 2012 Regulations' means the regulations dated 15 March 2012 entitled 'Pensions Fund Act, 1956: Amended Regulation 28 of the Regulations made under Section 36 of the Act: Conditions for Investment in Private Equity Funds Approval in terms of Section 5(2)(e) of the Act' (GN 1 of 15 March 2012).

[2019]See Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc.

[2020]Lewis, W.A. (2013), 'Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies', Fordham Law Review, Volume 82, Issue 2, Article 20, 1017, at pages 1017-1051. See also discussion had in paragraph 3 of chapter two and the discussion had in paragraph 2 of chapter three. See also *Gatz Properties, LLC v Auriga Capital Corp*. 2012, 59 A. 3d 1206, Delaware Supreme Court.

[2021]For example, section 9(2) of the Trust Property Control Act 57 of 1988 states: 'Any provision contained in a trust instrument shall be void in so far as it would have the effect of exempting a trustee from or indemnifying

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are spelled out in statutory law or through judicial precedents. However, it is submitted that it should also be spelled out in the private equity fund operating agreements in order to better mitigate conflicts of interest.

It is important that private equity firms address the above mentioned corporate governance issues from the time that a decision was made to raise a private equity fund and when they engage with potential investors, right up to the point when the private equity fund is ultimately dissolved. The next part of this chapter will discuss several key practical recommendations that could be applied within the private equity firm itself to improve its own internal corporate governance framework. It will be submitted that corporate governance mechanisms should be put in place by the private equity firm in order to mitigate the conflicts of interest that may arise within the firm itself.

4.3 Corporate Governance: Within the Fund Management Firm

It is submitted that the ability of a private equity firm to demonstrate to its prospective investors and portfolio companies that it adheres to the principles of sound corporate governance; in terms of common law, statutorily and voluntary; will only enhance its reputation as a well structured and managed company.[2022] This will ultimately increase investor confidence and facilitate greater interest from prospective portfolio investee companies. To this end, corporate governance mechanisms must be put in place in order to mitigate the conflicts of interest that may arise in private equity firms.[2023] One such recommended mechanism would be for the private equity firm to implement a sound corporate governance framework that aims to manage conflicts of interest in a manner that serves the interests of all the private equity funds' under its management, but that ultimately is in the best interests of the private equity funds' investors.[2024]

The clients of a private equity firm are the investors into the private equity fund(s) under its management. The mere nature of the private equity business model creates the need for the private equity firm to enter into binding contractual relationships with a wide range of stakeholders, *inter alia*, fund investors, underlying portfolio investee companies, banks, affiliated companies, finance

him against liability for breach of trust where he fails to show the degree of care, diligence and skill as required in subsection (1)'.

[2022]Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', Second Edition, John Wiley and Sons, at pages 163-234.

[2023]Walker, D. (2007), 'Walker Guidelines for Disclosure and Transparency in Private Equity', in association with British Private Equity and Venture Capital Association ('BVCA'), November 2007, at pages 16-32. In February 2007 the British Private Equity and Venture Capital Association ('BVCA') asked Sir David Walker to undertake an independent review of the adequacy of disclosure and transparency in private equity with a view to recommending a set of guidelines for conformity by the industry on a voluntary basis. This review culminated in November 2007 with the publication of the Guidelines for Disclosure and Transparency in Private Equity.

[2024]Walker, D. (2007), 'Walker Guidelines for Disclosure and Transparency in Private Equity', in association with British Private Equity and Venture Capital Association ('BVCA'), November 2007, at pages 16-32.

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providers and third-party advisors.[2025] Many of these contractual relationships could and will give rise to material conflicts of interest. For instance, the contractual relationships could be in conflict with the duties and responsibilities owed by the private equity firm to the private equity funds' under its management and the private equity funds' investors. Despite the latter, the private equity firm's ultimate duty and responsibility is to the private equity funds' investors.[2026] It is therefore important for a private equity firm to structure its business in a manner that allows it to manage all relevant conflicts of interest, underpinned by the firm placing emphasis on those duties and responsibilities owed to the private equity funds under its management.[2027] As stated above, the private equity firm should seek to manage conflicts in a way that serves the interests of all the private equity funds' under its management, but that ultimately is in the best interests of the private equity funds' investors.[2028]

Secondly, private equity firms should draft and implement written policies and procedures that are readily accessible and that are aimed at identifying, monitoring and effectively mitigating conflicts of interest that may arise (or that are unavoidable) in the normal cause of it conducting business as a private equity fund management company.[2029] These policies and procedures should clearly set out the private equity firm's governance framework in relation to the roles and responsibilities of parties involved in implementing the policies and procedures.[2030] In addition, the policies and procedures should also be consistent with any legislation and regulation applicable in any of the jurisdictions in which the private equity firm operates and should be applied uniformly to all the private equity funds' under its management, as well as all the geographical locations that the firm operates in.[2031] Such policies and procedures should allow for the adequate consideration of issues such as, *inter alia*, the specific processes through which conflicts of interest will be identified, the mechanisms the private

[2025]Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', Second Edition, John Wiley and Sons, at pages 163-234.

[2026]See Cumming, D. and Walz, U. (2010), 'Private equity returns and disclosure around the world', Journal of International Business Studies, 41(4), at pages 727-754.

[2027]Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', Second Edition, John Wiley and Sons, at pages 163-234.

[2028]See Guidelines Monitoring Group (2014), 'Private Equity Monitoring Group on Transparency and Disclosure', 7th Report, December 2014, at pages 30-42. Available at http://walker-gmg.co.uk/sites/10051/files/141204_gmg_guidelines_final.pdf, accessed in December 2015. This is the seventh report of the Guidelines Monitoring Group established to review the private equity industry's conformity with the Walker Guidelines as well as keeping the Guidelines under review and making recommendations for changes when necessary. The Group's aim is to guide and assist the industry in evolving to a position of best practice over a period of time through annual reviews of conformity. This report summarises the actions of the Guidelines Monitoring Group to achieve such and the performance of the industry under the Guidelines. The Guidelines Monitoring Group makes periodic recommendations for changes to the Guidelines to be implemented by the British Private Equity and Venture Capital Association (the 'BVCA') after due consultation.

[2029]See Gilligan, J. and Wright, M. (2010), 'Private Equity Demystified: An Explanatory Guide', ICAEW Corporate Finance Faculty, Second Edition, March 2010.

[2030]International Organization of Securities Commissions (IOSCO), (2009), 'Private Equity Conflicts of Interest', Report by the Technical Committee of the International Organization of Securities Commissions, November 2009, at pages 23-26.

[2031]International Organization of Securities Commissions (IOSCO), (2009), 'Private Equity Conflicts of Interest', Report by the Technical Committee of the International Organization of Securities Commissions, November 2009, at pages 23-26.

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equity firm will apply to mitigate conflicts of interest, for instance, the process through which identified conflicts will be disclosed to the investors.[2032] For example, in paragraph 4.2 of this chapter, it was submitted that a private equity firm should place the interests of the private equity fund and its investors above its own business interests. Therefore, where the private equity firm itself and/or its nominee director(s) have an interest in an underlying portfolio investee company, such impacted parties should avoid any conflicts of interest between their duties to the fund and its investors, and their other personal interest; however (as submitted in paragraph 4.2 of this chapter) in practice, the private equity firm and/or its staff may be allowed to obtain an individual benefit from the private equity fund's investments, but only after full disclosure to and prior approval from the investors.[2033]

To this end, private equity firms should establish a well documented and defined process which facilitates investor consultation regarding matters relating to conflicts of interest. Potential conflicts of interest can effectively be eliminated via constructive discussion and collaboration between the private equity firm and with the investors who may be negatively affected if the conflict of interest had materialised. To facilitate this process, a firm should establish a clearly defined process for engaging in investor consultation.[2034] This process should be appropriate for the size and scale of the private equity firm's activities and the range of investors in its funds.[2035] In practice, an effective forum used for facilitating investor consultation has been through the use of investor advisory committees (as mentioned earlier). However, for such a committee to be effective there has to be clearly documented terms of reference. For instance, terms of reference should include *inter alia*, the selection and appointment of committee members, the spectrum of issues on which the committee should be consulted, the method and timeframes within which consultation will occur and the nature of decisions taken by the committee.[2036] The private equity firm should disclose the decisions taken through the investor consultation process to all the fund investors within reasonable time periods. It is important to recognise that the investors in all probability will have an interest in the outcome of the investor consultation process, albeit via the of investor advisory committee. It is therefore important that the process is transparent to all the investors.[2037] The outcome of

[2032]European Private Equity and Venture Capital Association Report (2009), 'Private Equity and Venture Capital in the European Economy: An Industry Response to the European Parliament and European Commission', February 2009. See also European Private Equity and Venture Capital Association ('EVCA') Report (2005) updated in 2010, 'EVCA Corporate Governance Guidelines: Guidelines and good practice in the management of privately held companies in the private equity and venture capital industry', European Private Equity and Venture Capital Association.
[2033]Lewis, W.A. (2013), 'Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies', Fordham Law Review, Volume 82, Issue 2, Article 20, 1017, at pages 1017-1051. See also discussion had in paragraph 3 of chapter two and the discussion had in paragraph 2 of chapter three. See also *Gatz Properties, LLC v Auriga Capital Corp*. 2012, 59 A. 3d 1206, Delaware Supreme Court.
[2034]Such as in the scenario discussed in paragraph 4.2 of this chapter.
[2035]Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies, 26(2), at pages 368-402.
[2036]Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies, 26(2), at pages 368-402.
[2037]Scharfman, J.A. (2012), 'Private Equity Operational Due Diligence: Tools to Evaluate Liquidity, Valuation, and Documentation', John Wiley and Sons, at pages 301-314.

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discussions taken forward through this process should therefore be consistently disclosed to all relevant investors as soon as is appropriate.[2038] In practice, this will be done via regular investor reporting compliance procedures that the private equity firm has established, which would have been contractually agreed upon with its investors during the fund raising process.[2039]

A private equity firm should make the policies and procedures available to all investors in the private equity fund(s) under its management. This should be done as soon as the private equity firm and the investors established their relationship and should continue to be periodically made available. The periodic review and updated versions of such policies and procedures should also be made available to all investors on an equal basis.[2040] The periodic review and the application thereof should be done on a regular basis to ensure the continued relevance of such policies and procedures.[2041] In addition, the private equity firm should establish and document the policies and procedures before the formation of a private equity fund.[2042] The policies and procedures should be made available at the outset of the negotiations with prospective investors, to afford all the potential investors adequate opportunity to incorporate such policies and procedures into the investor's decision making process.[2043] Private equity firms operate in an environment that is constantly changing. To this end, a private equity firm's policies and procedures could easily become ineffective in managing conflicts of conflicts of interest that may arise.[2044] It is therefore important that private equity firms establish a well defined approach to reviewing its policies and procedures to ensure they remain relevant and appropriate.[2045] The review should be conducted as and when change to the business environment occurs. The periodic review of the policies and procedures should also include analysis as to the appropriateness of their application.[2046]

[2038]See Cumming, D. and Walz, U. (2010), 'Private equity returns and disclosure around the world', Journal of International Business Studies, 41(4), at pages 727-754.
[2039]Scharfman, J.A. (2012), 'Private Equity Operational Due Diligence: Tools to Evaluate Liquidity, Valuation, and Documentation', John Wiley and Sons, at pages 301-314.
[2040]Tricker, B. And Tricker, R.I. (2012), 'Corporate Governance: Principles, Policies and Practices', Oxford University Press, at pages 110-172.
[2041]Tricker, B. And Tricker, R.I. (2012), 'Corporate Governance: Principles, Policies and Practices', Oxford University Press, at pages 110-172.
[2042]Frase, D., Helm, R., and Day, M. (2012), 'Practitioner's Guide to Conflicts of Interest in the Financial Services Industry', First Edition, Sweet and Maxwell Publishers, at pages 1-130.
[2043]European Private Equity and Venture Capital Association Report (2009), 'Private Equity and Venture Capital in the European Economy: Industry Response to the European Parliament and European Commission', February 2009. See European Private Equity and Venture Capital Association Report (2005) updated in 2010, 'EVCA Corporate Governance Guidelines: Guidelines and good practice in the management of privately held companies in the private equity and venture capital industry', European Private Equity and Venture Capital Association.
[2044]Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies, 26(2), at pages 368-402.
[2045]See Cumming, D. and Walz, U. (2010), 'Private equity returns and disclosure around the world', Journal of International Business Studies, 41(4), at pages 727-754.
[2046]European Private Equity and Venture Capital Association Report (2009), 'Private Equity and Venture Capital in the European Economy: Industry Response to the European Parliament and European Commission', February 2009. See also European Private Equity and Venture Capital Association Report (2005) updated in 2010, 'EVCA Corporate Governance Guidelines: Guidelines and good practice in the management of privately

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It is submitted, that the corporate governance compliance framework of a private equity firm should at all times ensure that the disclosure provided to investors is clear, complete, fair and not misleading.[2047] The application of effective disclosure procedures is a vital method of mitigating conflicts of interest in any business. Despite the method of individual disclosure situations varying depending on the precise requirements of the issue at hand, it still remains imperative that the private equity firm does everything reasonable possible to ensure that disclosures are clear, complete, fair and not misleading.[2048] In addition, the private equity firm should implement a sound corporate governance framework that aims to manage conflicts of interest in a manner that serves the interests of all the private equity funds' under its management, but that ultimately is in the best interests of the private equity funds' investors.[2049]

5. Conclusion

It is evident from the above discussion that the application of effective corporate governance systems is an important risk management tool available to investors in safeguarding their investment in a private equity fund. In addition, it was also highlighted that investor protection via legal rules and regulations is more effective in developing countries financial markets than the traditional law and economics perspective of financial contracting. However, as a result of the often-widening gap between ownership and control of companies it is important for policy makers to pay attention to legal rules and regulations protecting investors and corporate governance. This is because despite the statutory inefficiencies at times, it generally seems to have had a positive impact in several (English) common-law countries.

Corporate governance is a topic of considerable interest following events, such as the Enron scandal and other corporate governance failures. In particular, it has highlighted the important role that corporate governance plays in a modern economy. It has strengthened the incentives for directors and policymakers alike to reassess the structures needed to produce high quality corporate governance. In this chapter, a number of corporate governance issues were discussed. In particular,

held companies in the private equity and venture capital industry', European Private Equity and Venture Capital Association.

[2047] Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies, 26(2), at pages 368-402.

[2048] Acharya, V.V., Gottschalg, O.F., Hahn, M. and Kehoe, C. (2013), 'Corporate governance and value creation: Evidence from private equity', Review of Financial Studies, 26(2), at pages 368-402.

[2049] Walker, D. (2007), 'Walker Guidelines for Disclosure and Transparency in Private Equity', in association with British Private Equity and Venture Capital Association ('BVCA'), November 2007, at pages 16-32. See Guidelines Monitoring Group (2014), 'Private Equity Monitoring Group on Transparency and Disclosure', 7th Report, December 2014, at pages 30-42. Available at http://walker-gmg.co.uk/sites/10051/files/141204_gmg_guidelines_final.pdf, accessed in December 2015.

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the chapter commented on the role that corporate governance plays in the financial system and wider economy, and why it is important for economic growth and financial stability as evidenced in various jurisdictions. Although corporate governance involves many systems and structures, the heart of it lies in affording efficient investor protection, together with the common law principles of fiduciary duties owed to investors. Sound corporate governance is essential to the well being of an individual company and its stakeholders, particularly its shareholders and creditors. It is also a critical ingredient in maintaining a sound financial system and a robust economy. That is why governments have taken such an interest in corporate governance failures. In the financial system, corporate governance is one of the key factors that determine the health of the system and its ability to survive economic shocks, as evidenced by the Japanese experience. Furthermore, understanding the statutory and common law rules of fiduciary duties and the interpretation thereof by the courts, helps in understanding its function in modern corporate governance.

In addition, the importance of the relationships between corporate governance and economic development is self explanatory. Following on from the discussions set out in chapter one, two and three, it is evident that well governed corporate frameworks benefit companies through greater access to financing, lower cost of capital, better company performance and more favourable treatment of all stakeholders.[2050] Throughout the first three chapters, there is sufficient evidence to show that if a country's overall corporate governance and property rights systems are weak, voluntary and market corporate governance mechanisms have more limited effectiveness. Claessens and Yurtoglu, appropriately state that:

> 'It is evident that, although corporate governance may not be the sole driver for sound economic performance, it is a significant contributor, and we have only to see the devastating consequences of poor corporate governance practices to appreciate the importance of corporate governance to economic development and its benefits for jobs and wealth creation.'[2051]

It was discussed above that the structure and operation of private equity funds in practice raises two agency problems. Firstly, an agency problem exists in the underlying portfolio investee company between the active private equity fund and investee company's other shareholders[2052] and managers. The second is where a private equity firm acts as an agent for external investors, who choose to invest in underlying portfolio investee companies via an intermediary rather than directly. However, legal practice has developed corporate governance and risk mitigating techniques via effective legal contracting aimed at controlling the level of risk created by the above mentioned

[2050]Claessens, S., and Yurtoglu, B. (2012), 'Corporate Governance and Development - An Update', Global Corporate Governance Forum Publication (Focus 10), International Finance Corporation, Washington, DC.
[2051]Claessens, S., and Yurtoglu, B. (2012), 'Corporate Governance and Development: An Update', Global Corporate Governance Forum Publication (Focus 10), International Finance Corporation, US, at page vii.
[2052]A company typically have several shareholders and a private equity fund will typically not be the sole shareholder of a company's shares.

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agency problems. In addition, a corporate governance structure with private equity involvement provides incentives to reduce agency problems.

Despite legal practice having developed effective risk mitigating techniques, the legal duties of the private equity firm still needs to be embedded in an industry structure for private equity which provides the expertise and resources for good governance; and these duties must be enforced by efficient regulation. In South Africa there are no specific case law precedents nor legislation with regard to fiduciary duties, that are directly applicable to private equity firms. Private equity will in terms of the vehicles for investment used be subject to general fiduciary duties. On the other hand, there is a widely accepted view that the starting point for understanding the obligations on investment market participants is the contract agreed by the parties; and where market participants are sophisticated commercial parties, the courts will be reluctant to interfere with their commercial arrangements. So while the private equity firm owes the investors certain fiduciary duties, it is clear that if the duties are not spelled out in the private equity fund agreement by way of covenants, the fund managers will be bound by the fiduciary duties under common law and statutory law. Therefore the private equity industry should strive at bettering the corporate governance practices within a legal framework that also includes effective legal contracting.

Nevertheless, it is clear from the introductory paragraph 1 of this chapter, that there is a strong investment case for driving corporate governance in the private equity fund management industry. This chapter highlighted that there are two levels of corporate governance involved in private equity investing. The first level of corporate governance relates to the private equity fund's underlying portfolio investee companies. The second level relates to the private equity fund itself which focuses on the relationship between the private equity firm and the investors that invest in the private equity fund. The first part of this chapter discussed the broader corporate governance compliance framework, more notable the common law and legislated grounds for corporate governance adherence. In addition, this chapter discussed the relationship between corporate governance principles and law, more notable investor protection and fiduciary duties owed by the private equity firm and its staff to the investors as part of the broader corporate governance compliance framework.

The second part of this chapter also discussed the practical considerations with regard to the role of corporate governance in terms of the relationship between the private equity firm and the investors that invest in the private equity fund. This included a discussion with regard to the practical corporate governance contracting techniques employed between the private equity firm and investors. In addition, the second part of this chapter submitted several key practical recommendations that could be applied within the private equity firm itself to improve its own internal corporate governance framework. It is submitted that private equity investment in South Africa is a positive feature of the corporate landscape. Policymakers and regulators need to be aware of all the systematic evidence

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discussed throughout the first three chapters of this thesis when they set out in designing policy and mechanisms aimed at regulating the private equity industry.

The next chapter will examine *inter alia* the regulatory, policy and tax reforms in the US, UK, Canada and Australia aimed at promoting private equity investing. The modest objective of chapter four is to establish a set of key lessons that could assist South African policymakers in creating the framework which will enhance the human and financial resources needed for a dynamic private equity sector. Chapter four intends to achieve the latter by reviewing the reforms in the above mentioned countries. The framework mentioned above, must improve the potential for capital formation via private equity funding from both local and international investors; encourage the development of entrepreneurship; and remove practical impediments to private equity investing.

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Chapter Four: Legal Considerations in the Private Equity Market

1. Introduction

This chapter will critically analyse the tax and regulatory environment within which the private equity industry operates and to which extent this environment stimulates or hinders private equity. A comparative analysis will be done with the US, UK, Canada, Australia and South Africa. Furthermore, this chapter will consider and analyse two key impediments; namely tax legislation and exit alternatives; and show how legislation could effectively address the former and how the lack of exit routes is an impediment to the growth of the local private equity industry. Two further key impediments have already been extensively discussed in the preceding three chapters, namely appropriate pension fund legislation that encourages private equity investments by pension funds and the importance of advancing higher standards of corporate governance to the private equity business model.[2053] Therefore, chapter four will not discuss again the important role corporate governance and pension fund legislation plays in shaping the private equity industry. This chapter is a comparative analysis of the extent to which the law impacts the private equity market. The applicable regulatory developments and legislation of the US, UK, Canada and Australia are analysed and compared to the South African position in order to determine whether the South African law can learn anything from these jurisdictions. The real issue for South African policy makers should be how to enhance the South African private equity markets development and role as a catalyst for economic growth. One way is to strengthen private equity regulation in South Africa, and, if so, in what ways.

Firstly, chapter four will discuss that an appropriate tax regime is critical to the private equity industry. Tax incentives have been widely used worldwide to stimulate private equity investments, and most established private equity markets provide some form of tax incentives.[2054] For instance in the US investment vehicles that are not subject to double taxation, such as the limited partnership and limited liability company, are the norm for structuring private equity funds.[2055] Cumming and Johan,

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[2053]For example, it was highlighted in chapter one that the US have encouraged private equity investments by pension funds which had a significant impact on the US private equity industry. The change in regulatory interpretation by federal pension authorities in the 1970s led pension funds to become the single most important source of US private equity funds. See also Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', Fifth Edition, Wiley and Sons. According to SAVCA, one of the main drivers for the increase in private equity investments by South African pension funds have been the greater clarity on pension fund regulation in South Africa. Available at www.bdlive.co.za/business/financial/2013/07/09/sa-private-equity-industry-on-growth-path, accessed in August 2014.

[2054]See Bedu, N. and Montalban, M. (2014), 'Analysing the uneven development of private equity in Europe: legal origins and diversity of capitalism', Socio-Economic Review, 12(1), at pages 33-70.

[2055]As discussed in paragraph 3.2 of chapter two.

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discuss related empirical evidence on the effect of regulation on the development of private equity markets.[2056] They state:

> 'Most notably, the most recent empirical evidence indicates low capital gains taxation stimulates the supply of entrepreneurial capital.'[2057]

They argue that for instance in the US, the reduction of capital gains taxes as an incentive is viewed as having made a significant contribution to the growth of private equity investments.[2058] Low capital gains taxation in a private equity market gives investors a greater incentive to invest in long-term private equity funds which increases the flow of capital into the industry.[2059]

Secondly, chapter four will discuss that for a private equity market to develop, one of the key characteristics of the market is that private equity firms must have solid exit alternatives that enable them to realise the gains on their investments. As mentioned in chapter one, when the private equity firm invests in a transaction, the goal is to exit its investment at a profit when the portfolio company's value has been maximized.

2. Tax Considerations Impacting Private Equity

Foreign investors have earmarked several jurisdictions as emerging markets stable enough to attract offshore private equity investment.[2060] For South Africa to compete as such a jurisdiction, the rate of return on funds invested must be competitive with those offered in other markets.[2061] Thus it would be fair to assume that investment proceeds should be returned to investors free of tax or taxed at a beneficial rate. Therefore it is imperative for South Africa to provide for a beneficial tax regime applicable to private equity investment and returns.[2062] The fact that the South African private equity industry is not separately regulated to ensure the capital treatment of returns from investments, negatively impacts on South Africa as a suitable jurisdiction to attract both local and foreign investors. This chapter will next discuss, amongst others:

[2056] Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc., at pages 267-301.
[2057] Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc., at pages 267-301.
[2058] Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc., at pages 267-301.
[2059] See paragraph 2.1(a) of this chapter below.
[2060] Modise, L., Makola, M., and Drake, H. (2012), 'Fund Formation: South Africa', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut. C., published by Getting the Deal Through, at 278-288.
[2061] Modise, L., Makola, M., and Drake, H. (2012), 'Fund Formation: South Africa', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut. C., published by Getting the Deal Through, at 278-288.
[2062] The taxation of investment proceeds in the private equity context in South Africa is regulated in terms of the provisions of the Income Tax Act 58 of 1962.

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- Private equity tax incentives in the US, Canada, Australia, UK and South Africa;
- Taxation of carried interest in the US, Canada, Australia, UK and South Africa; and
- Taxation of share options in the US, Canada, Australia, UK and South Africa when used as an incentive mechanism in underlying portfolio investee companies.

The above mentioned tax considerations are important to the private equity industry and the discussion to follow is aimed at analysing how these jurisdictions have addressed taxation with regard to their respective private equity industries in a manner which could be beneficial to South African law. As mentioned earlier, this chapter is a comparative analysis of the extent to which the law impacts the private equity market. The applicable regulatory developments and legislation of the US, UK, Canada and Australia will first be analysed and then compared to the South African position in order to determine whether the South African law can learn anything from these jurisdictions.

2.1 Tax Incentives

(a) United States ('US')

An important event that contributed to the success of the private equity industry in the US was the substantial reduction of capital gains tax.[2063] The Revenue Act of 1978 in the US reduced the prevailing capital gains tax rate from 49.5 percent to 28 percent in the US, giving investors a greater incentive to long-term equity investments.[2064] Another important event that contributed to the success of the private equity industry in the US was the Stock Options Law of 1981.[2065] It provided that taxes on share options are to be paid when shares are sold, instead of when the options were exercised. Ironically, there is no direct tax incentive scheme available under current US law aimed at encouraging investment in unlisted companies, unlike in the UK, Canada and Australia.[2066] For instance in Canada, numerous tax incentive schemes have been introduced, such as the labour-sponsored venture capital corporation ('LSVCC') which provide tax credits to individuals who are Canadian residents in specific Canadian provinces.[2067] However, it is submitted that the most important tax incentive that has been widely used to stimulate private equity investments in the US is that US private equity vehicles are not subject to double taxation. Therefore the limited partnership

[2063]See Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', Fifth Edition, Wiley and Sons. See also Demaria, C. (2013), 'Introduction to Private Equity: Venture, Growth, LBO and Turn-Around Capital', Second Edition, John Wiley and Sons.

[2064]See Barry, F., O'Mahony, C. and Sax, B. (2012), 'Venture capital in Ireland in comparative perspective', The Irish Journal of Management, 32(1), at pages 1-26.

[2065]In terms of the Economic Recovery Tax Act of 1981. The Economic Recovery Tax Act of 1981 provides special tax treatment for certain employee options with the introduction of 'incentive stock options' into the US Internal Revenue Code.

[2066]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', 2nd Edition, Elsevier Inc. at paragraph 9.6.3. Osborne, D., and Sandler, D. (1998), 'Tax Expenditure Analysis of Labour-Sponsored Venture Capital Corporations', Canadian Tax Journal 46(3) at pages 499-574.

[2067]The various tax incentive schemes introduced in the UK, Canada and Australia, aimed at encouraging investment in unlisted companies, will be discussed in detail hereinafter.

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and limited liability company are the norm for structuring private equity funds in the US.[2068] Almost all studies on US private equity activity conclude that the lack of double taxation was (and still is) instrumental in increasing the flow of capital into the industry.[2069] Therefore, double taxation can be viewed as a barrier to an increase in flow of capital into a private equity market. Taken together, these changes had the simultaneous effect of increasing both the supply of and demand for private equity. However, in the US there is a strong drive by opponents to the private equity model to introduce a new entity level tax on private equity partnerships and other flow-through entities.[2070]

As discussed in paragraph 3.2 of chapter two, the most commonly used vehicle for private equity funds in the US is the Delaware limited partnership, which gives limited liability to the investors who are limited partners in the limited partnership and these investors are often a mix of domestic and foreign, and taxable and tax-exempt investors (for example pension funds).[2071] Private equity funds are structured as limited partnerships in the US due to the lack of an entity-level tax on partnerships and other flow-through entities under the US tax system.[2072] Private equity funds in the US are treated as partnerships for US tax purposes. The fund itself is then not taxed in the US, but instead the fund's income flows through to each investor and is taxable at the investor level.[2073] The character of the income also flows through to the investors so that capital gains realised by the fund maintain that character in the investors' hands. The flow-through tax treatment applies to both US and non-US investors.[2074]

According to the Private Equity Growth Capital Council ('PEGCC'), businesses that are structured as corporations, on the other hand, are taxed separately from their owners.[2075] These businesses are referred to as 'C' corporations in the US and they pay an entity level corporate tax.[2076] In the US during 2013, Ways and Means Committee in the House of Representatives had solicited industry

[2068]As discussed in paragraph 3.2 of chapter two.
[2069]See Harris, R.S., Jenkinson, T. and Kaplan, S.N. (2014), 'Private equity performance: What do we know?', The Journal of Finance, 69(5), at pages 1851-1882.
[2070]According to the Private Equity Growth Capital Council (PEGCC). Available at www.pegcc.org/issues/private-equity-and-tax-policy/., accessed in April 2015.
[2071]See Lewis, W.A. (2013), 'Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies', Fordham Law Review, Volume 82, Issue 2, Article 20, 1017, at pages 1017-1051.
[2072]See subchapter K of chapter 1 of the Internal Revenue Code, Title 26 of the US Code.
[2073]Marples, D. (2014), 'Taxation of Hedge Fund and Private Equity Managers', Congressional Research Service, RS22689, 7th March 2014. Available at www.crs.gov, accessed in June 2015.
[2074]Marples, D. (2014), 'Taxation of Hedge Fund and Private Equity Managers', Congressional Research Service, RS22689, 7th March 2014. Available at www.crs.gov, accessed in June 2015.
[2075]The Private Equity Growth Capital Council is an advocacy, communications and research organization and resource center established to develop, analyze and distribute information about the private equity and growth capital investment industry and its contributions to the national and global economy. Established in 2007 and formerly known as the Private Equity Council, the PEGCC is based in Washington, D.C. The members of the PEGCC are 34 of the world's leading private equity and growth capital firms united by their commitment to growing and strengthening the businesses in which they invest. More information about the PEGCC can be found at www.pegcc.org. Available at www.pegcc.org/issues/private-equity-and-tax-policy/private-equity-partnership-taxation/#sthash.Oui9L34j.dpuf., accessed in April 2015.
[2076]Income that is distributed to the owners of the corporation (commonly referred to as shareholders), is then taxed at the individual level.

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comments on various aspects of tax policy that the Committee and its Working Groups were considering as part of the comprehensive tax reform that took place in the US.[2077] One such consideration that would have a negative impact on the private equity industry is for the introduction of a new entity level tax that should be imposed on partnerships and other flow-through entities in order to reduce tax rates on 'C' corporations.[2078] In a letter by the PEGCC to Dave Camp, the Chairman of the Committee on Ways and Means of the US House of Representatives, the PEGCC set forth sound reasons opposing a proposal for the introduction of a new entity level tax that it was considering to be imposed on partnerships and other flow-through entities in order to reduce tax rates on 'C' corporations.[2079] In the letter, the PEGCC argued that:

> 'Changes to the current flow-through (pass-through) tax structure for private equity firms organized as partnerships would diminish competition and capital formation in the industry by effectively subjecting these entities to triple taxation. Since most of the companies owned by private equity partnerships (i.e. portfolio companies) are typically organized as C Corporations, they are already subject to double taxation. A policy adopting C Corporation treatment for private equity partnerships would create a third level of taxation, increasing the overall tax rate for private equity investments by at least 10%. This new entity-level tax on flow-through (pass-through) entities would make these businesses less competitive in the global economy and create new barriers to entry for emerging funds.'[2080]

The principle policy consideration according to the PEGCC, when it comes to the taxation of private equity at the fund level, is that:

> 'If there is a flaw with the current corporate tax model, it is not that partnerships pay one level of tax but that C Corporations pay two levels of tax. The solution is not to extend a defect in the current system to more taxpayers by requiring flow-through entities to pay two levels of tax, it is to revise the law so all forms of business are subject to one level of taxation.'[2081]

A Delaware limited liability company may also be used instead of a Delaware limited partnership to structure a private equity fund in the US. The Delaware limited liability company is less popular and there are disadvantages to using a Delaware limited liability company. For instance, private equity funds that invest outside of the US or which have non-US investors, the main disadvantages are that

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[2077]See Graetz, M.J. (2014), 'The Tax Reform Road Not Taken – Yet', National Tax Journal, 67(2).
[2078]Available at www.pegcc.org/issues/comment-letters/pegcc-comment-letter-on-flow-through-pass-through-taxation/#sthash.BQQlUci1.dpuf., accessed in April 2015.
[2079]Dated 15th April 2013.
[2080]Available at www.pegcc.org/issues/comment-letters/pegcc-comment-letter-on-flow-through-pass-through-taxation/#sthash.BQQlUci1.dpuf., accessed in April 2015.
[2081]Available at www.pegcc.org/issues/private-equity-and-tax-policy/private-equity-partnership-taxation/#sthash.Oui9L34j.dpuf., accessed in April 2015.

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Delaware limited liability companies are not recognised as tax transparent in certain jurisdictions; and in some jurisdictions investors and Delaware limited liability companies may have difficulty accessing the benefits of tax treaties.[2082] Nonetheless, both limited partnerships and Delaware limited liability companies are commonly treated as tax transparent for US tax purposes. However, the Delaware limited partnership is generally considered the most suitable legal vehicle because of its better developed statutory regime and body of case law.[2083] It is the uniqueness of the 'flow-through' nature of these vehicles and tax treatment thereof that has contributed to the success of the US private equity model.[2084] It is submitted that introducing an entity level tax on the private equity partnerships model would have catastrophic consequences on the private equity business model. It would be imperative for South African policy makers to take note and not introduce a similar policy consideration of introducing an entity level tax (at private equity fund level), albeit structured as a *bewind* trust or *en commandite* partnership.

(b) Canada

The limited partnership is the predominant legal structure used in Canada as a vehicle for private equity funds.[2085] Limited partnerships are subject to Canadian provincial law and are formed under the laws of the relevant Canadian province. Similar to limited partnerships discussed throughout the previous chapters, investors in a Canadian limited partnership are also afforded limited liability provided such investors do not actively participate in the conduct of the business.[2086] In addition, Canadian limited partnerships are fiscally transparent in terms of the Canadian Income Tax Act.[2087] A limited partnership with any non-resident limited partners is deemed to be non-Canadian and all limited partners are subject to a 25 percent withholding tax on dividend or interest income (subject to reduction under any applicable treaties).[2088] It is for this reason that parallel vehicles are commonly created for non-Canadian investors otherwise there is no difference in treatment for domestic investors and foreign investors under Canadian law.[2089] Furthermore, limited liability corporations

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[2082]See Hopson, J.F. and Hopson, P.D. (2014), 'Making the Right Choice of Business Entity', The CPA Journal, 84(10), 42.
[2083]Lewis, W.A. (2013), 'Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies', Fordham Law Review, Volume 82, Issue 2, Article 20, 1017, at pages 1017-1051.
[2084]See Sensoy, B.A., Wang, Y. and Weisbach, M.S. (2014), 'Limited partner performance and the maturing of the private equity industry', Journal of Financial Economics, 112(3), at pages 320-343.
[2085]See Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc. See also Cumming, D.J. (2010), 'Private Equity: Fund Types, Risks and Returns, and Regulation', Kolb Series in Finance, Essential Perspectives, published by John Wiley and Sons, Inc., Hoboken, New Jersey, 2010.
[2086]See paragraph 3.5 of chapter two.
[2087]R.S.C., 1985, (5th Suppl).
[2088]See Steenkamp, L.A. (2014), 'The Permanent Establishment Concept In Double Tax Agreements Between Developed And Developing Countries: Canada/South Africa As A Case In Point', International Business and Economics Research Journal (IBER), 13(3), at pages 539-552. See also Brander, J.A., Du, Q. and Hellmann, T.F. (2010b), 'The Effects of Government-Sponsored Venture Capital: International Evidence', NBER Working Paper No. 16521, November 2010.
[2089]Cumming, D.J. (2011), 'Public policy and the creation of active venture capital markets', Venture Capital: An International Journal of Entrepreneurial Finance, 13:1, at pages 75-94.

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formed in the US[2090] are not fiscally transparent in terms of the Canadian Income Tax Act and are taxed as corporations in terms of the Canadian Income Tax Act.[2091] According to Cumming, limited liability corporations are not typically used for investment purposes in Canada instead a limited partnership will be used as the investment vehicle.[2092]

In Canada numerous tax incentive schemes have been introduced, but they are aimed primarily at small businesses or individual investors who are Canadian taxpayers.[2093] For instance, Canadian-controlled private corporations are entitled to a lower rate of tax deduction on operating income up to a specific threshold; they are also entitled to enhanced investment tax credits for qualified expenditures on scientific research and experimental development; as well as the deferral of an employee's taxable benefit arising from the exercise of share options.[2094] In addition, shareholders of Canadian-controlled private corporations are entitled to a capital gains exemption on a disposition of qualified small business corporation shares.[2095] A Canadian-controlled private corporation is a Canadian corporation that is not listed on a stock exchange and that is not controlled, directly or indirectly, by one or more non-residents of Canada.[2096]

Furthermore, the Canadian federal government as well as specific Canadian provincial governments provides tax credits to individuals who are Canadian residents in specific provinces and who have invested in what is called a labour-sponsored venture capital corporation ('LSVCC').[2097] As mentioned in chapters one and two, the most important provision that grants a significant tax benefit in Canada for underlying private equity portfolio companies are the LSVCC credit.[2098] In terms of a Canadian Venture Capital Association ('CVCA') report, investors can claim a federal credit of 15 percent for up to $5000 invested in LSVCC shares, while federal credits on qualifying research and

[2090]As mentioned in paragraph 2.1(a) of this chapter above, the Delaware limited liability company ('LLC') may also be used to structure a private equity fund in the US. The LLC is less popular because private equity funds that invest outside of the US are often not recognised as tax transparent.
[2091]R.S.C., 1985, (5th Suppl).
[2092]Cumming, D.J. (2011), 'Public policy and the creation of active venture capital markets', Venture Capital: An International Journal of Entrepreneurial Finance, 13(1), at pages 75-94.
[2093]Cumming, D. (2014), 'Public economics gone wild: Lessons from venture capital', International Review of Financial Analysis, 36, at pages 251-260. See also Cumming, D.J. (2007), 'Government policy towards entrepreneurial finance: Innovation investment funds', Journal of Business Venturing, 22(2), at 193-235.
[2094]Cumming, D. (2014), 'Public economics gone wild: Lessons from venture capital', International Review of Financial Analysis, 36, at pages 251-260. See also Cumming, D.J. (2011), 'Public policy and the creation of active venture capital markets', Venture Capital: An International Journal of Entrepreneurial Finance, 13(1), at pages 75-94.
[2095]Cumming, D. (2014), 'Public economics gone wild: Lessons from venture capital', International Review of Financial Analysis, 36, at pages 251-260.
[2096]Cumming, D. (2014), 'Public economics gone wild: Lessons from venture capital', International Review of Financial Analysis, 36, at pages 251-260. See also Cumming, D.J. (2011), 'Public policy and the creation of active venture capital markets', Venture Capital: An International Journal of Entrepreneurial Finance, 13(1), at pages 75-94.
[2097]Johan, S., Schweizer, D. and Zhan, F. (2014), 'The Changing Latitude: Labor-Sponsored Venture Capital Corporations in Canada', Corporate Governance: An International Review, Volume 22(2), at pages 145-161.
[2098]Johan, S., Schweizer, D. and Zhan, F. (2014), 'The Changing Latitude: Labor-Sponsored Venture Capital Corporations in Canada', Corporate Governance: An International Review, Volume 22(2), at pages 145-161.

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development is generally 20 percent with an enhanced credit of 35 percent for small Canadian controlled private corporations.[2099] On the other hand provincial credits in the region of 40 percent to 50 percent of the cost of research and development are covered by tax support. In the case of the enhanced credit, up to 40 percent of the credit is paid to the corporation if the company has no taxes at which to claim the credit.[2100] To this end, both the LSVCC credit and enhanced research and development credit can provide significant resources to the company at the time when it starts.[2101]

According to Cumming and MacIntosh,[2102] LSVCCs are tax-subsidized investment funds that attract contributions from individual investors via tax incentives and invest the funds in entrepreneurial businesses. The reason why they are referred to as 'labour sponsored' is because a trade union must initially create the corporation and such sponsoring union receives a special class of shares in the LSVCC which, while not entitled to dividends or assets, can appoint a majority of directors.[2103] In essence, a LSVCC is a form of private equity fund that depends on small amounts of capital from a large pool of individual investors.[2104] A LSVCC is different to a typically private equity fund which would typically depend on institutional investors such as pension funds and large corporations. According to Cumming and MacIntosh, a typical private equity fund also attracts investor capital from individuals, however such individuals tend to be few in number and contribute much larger amounts of money.[2105] There are several shortcomings of the Canadian LSVCC structure and most of the reasons relate to the way the Canadian Federal Government and specific provinces regulate the structure of LSVCCs and their investment activity.[2106] For instance, LSVCCs are subject to restrictions on the companies in which they can invest and are more regulated than other forms of

[2099] Canadian Venture Capital Association Submission, (2001), 'Tax Submission to the Senate Committee on Banking, Trade and Commerce on Equity Financing', Canadian Venture Capital Association. See also Wonglimpiyarat, J. (2014), 'Technology Financing and Commercialization: Exploring the Challenges and How Nations Can Build Innovative Capacity', First Edition, Palgrave Macmillan, at pages 132-152.
[2100] Canadian Venture Capital Association Submission, (2001), 'Tax Submission to the Senate Committee on Banking, Trade and Commerce on Equity Financing', Canadian Venture Capital Association. See Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', 2nd Edition, Elsevier Inc., at 292-293.
[2101] Osborne, D., and Sandler, D. (1998), 'Tax Expenditure Analysis of Labour-Sponsored Venture Capital Corporations', Canadian Tax Journal, 46(3), at pages 499-574. Wonglimpiyarat, J. (2014), 'Technology Financing and Commercialization: Exploring the Challenges and How Nations Can Build Innovative Capacity', 1st Edition, Palgrave Macmillan, at 132-152.
[2102] Cumming, D.J. and MacIntosh, J.G. (2006), 'Crowding Out Private Equity: Canadian Evidence', Journal of Business Venturing, 21(5), at pages 569-609.
[2103] Cumming, D.J. and MacIntosh, J.G. (2006), 'Crowding Out Private Equity: Canadian Evidence', Journal of Business Venturing, 21(5), at pages 569-609.
[2104] See Dzulynsky, M.B., Imerti, V.F. and Kraeker, B.A. (2012), 'Fund Formation: Canada', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages 28-33. See also Sandler, D. (2004), 'Venture Capital and Tax Incentives: A Comparative Study of Canada and the United States', Toronto: Canadian Tax Foundation.
[2105] Cumming, D.J. and MacIntosh, J.G. (2006), 'Crowding Out Private Equity: Canadian Evidence', Journal of Business Venturing, 21(5), at pages 569-609.
[2106] Berube, C. and Mohnen, P. (2009), 'Are Firms that Receive R&D Subsidies More Innovative?', Canadian Journal of Economics, 42(1), at pages 206-225.

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private equity funds.[2107] In addition, LSVCCs are only active in the Canadian domestic venture capital market segment.[2108] For example, LSVCCs can only invest in businesses in the province in which they were incorporated, regardless of market conditions and despite the fact that businesses in other regions that may offer investors superior rates of return.[2109]

LSVCCs are also constrained as to the size and nature of their investments in any given entrepreneurial business.[2110] Furthermore, they must invest a set percentage of the funds they raise typically within one to three years regardless of the prevailing economic conditions. [2111] According to Cumming and MacIntosh, the latter is further exacerbated by the fact that the governments predetermine the number of LSVCCs in each region in Canada.[2112] These authors state:

> 'effectively stifling competition among such funds, and in turn, reducing the incentives to provide high rates of return. These geographical and financial restrictions, as well as investment time limits, can lead to pressure on LSVCC managers to invest in businesses regardless of market conditions, and can result in investments in inferior firms.'[2113]

Since only individuals are permitted to invest in LSVCCs, they differ from typical private equity funds that receive capital from institutional investors such as pension funds and corporations. In addition, LSVCC managers would typically contract out investment management services to professional managers as opposed to operating the fund themselves.[2114] Johan *et al*, argues that this combination of a large number of small investors making small investments, coupled with the distant relationship between investors and fund managers implies that investors will not have the proper means to discipline fund managers for poor performance.[2115] Cumming and MacIntosh further state:

[2107]Berube, C. and Mohnen, P. (2009), 'Are Firms that Receive R&D Subsidies More Innovative?', Canadian Journal of Economics, 42(1), at pages 206-225.
[2108]Berube, C. and Mohnen, P. (2009), 'Are Firms that Receive R&D Subsidies More Innovative?', Canadian Journal of Economics, 42(1), at pages 206-225.
[2109]Berube, C. and Mohnen, P. (2009), 'Are Firms that Receive R&D Subsidies More Innovative?', Canadian Journal of Economics, 42(1), at pages 206-225.
[2110]Johan, S., Schweizer, D. and Zhan, F. (2014), 'The Changing Latitude: Labor-Sponsored Venture Capital Corporations in Canada', Corporate Governance: An International Review, 22(2), at pages 145-161.
[2111]Cumming, D.J. and MacIntosh, J.G. (2006), 'Crowding Out Private Equity: Canadian Evidence', Journal of Business Venturing, 21(5), at pages 569-609.
[2112]Cumming, D.J. and MacIntosh, J.G. (2006), 'Crowding Out Private Equity: Canadian Evidence', Journal of Business Venturing, 21(5), at pages 569-609.
[2113]Cumming, D.J. and MacIntosh, J.G. (2006), 'Crowding Out Private Equity: Canadian Evidence', Journal of Business Venturing, 21(5), at 569-609. Johan, S., Schweizer, D. and Zhan, F. (2014), 'The Changing Latitude: Labor-Sponsored Venture Capital Corporations in Canada', Corporate Governance: An International Review, 22(2), at 145-161.
[2114]Johan, S., Schweizer, D. and Zhan, F. (2014), 'The Changing Latitude: Labor-Sponsored Venture Capital Corporations in Canada', Corporate Governance: An International Review, 22(2), at pages 145-161.
[2115]Johan, S., Schweizer, D. and Zhan, F. (2014), 'The Changing Latitude: Labor-Sponsored Venture Capital Corporations in Canada', Corporate Governance: An International Review, 22(2), at pages 145-161.

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> 'the atomization of share ownership sacrifices most if not all of these benefits, since collective action and free rider problems ensure that few if any shareholders have the appropriate incentives to monitor or discipline fund managers.'[2116]

What this implies is that individual investors that invest a small amount in an LSVCC will be less likely to effectively express dissatisfaction with fund managers than an investor in a private limited partnership who invests a relatively larger amount of money and has a more direct relationship with fund managers.[2117] Cumming and MacIntosh state that as a result, 'LSVCC fund managers have less incentive to perform well than do managers of private funds'.[2118] According to Cumming and Johan, the Canadian tax system inadvertently imposes barriers to equity investments in private equity.[2119] They argue that Canadian policy should favour polices that reduce high, inefficient taxes on winners and obstacles to the growth of businesses. For instance, US policymakers reduced by half capital gains taxes on stock market listings by small businesses as long as the investor shareholder(s) hold the shares for at least five years.[2120] This encourages the growth of businesses to become a publicly listed company. On the other hand, Canada's favourable incentive regime for small private companies encourages businesses to stay small rather than pay high taxes, if they grow or become public.[2121] Policies legislated in Canada aimed at encouraging greater growth and increasing the incentive to undertake risks include the reductions in personal tax rates on capital income, including dividends, capital gains and interest. Also put forward has been the reductions in corporate tax rates on income earned by large companies.[2122] These policy changes can be expected to positively affect the private equity industry. For instance, the reduction in tax rates on dividends and capital gains will increase the after-tax return on an investment. The prospect of higher returns on investment should increase investor appetite for riskier private equity investments.[2123]

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[2116]Cumming, D.J. and MacIntosh, J.G. (2006), 'Crowding Out Private Equity: Canadian Evidence', Journal of Business Venturing, 21(5), at page 582.
[2117]Johan, S., Schweizer, D. and Zhan, F. (2014), 'The Changing Latitude: Labor-Sponsored Venture Capital Corporations in Canada', Corporate Governance: An International Review, 22(2), at pages 145-161.
[2118]Cumming, D.J. and MacIntosh, J.G. (2006), 'Crowding Out Private Equity: Canadian Evidence', Journal of Business Venturing, 21(5), at page 582.
[2119]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc., at paragraph 9.6.3.
[2120]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc., at paragraph 9.6.3.
[2121]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc., at paragraph 9.6.3.
[2122]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc., at paragraph 9.6.3.
[2123]See also Marples, D. (2014), 'Taxation of Hedge Fund and Private Equity Managers', Congressional Research Service, RS22689, 7th March 2014. Available at www.crs.gov, accessed in June 2015.

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As mentioned in paragraph 3 of chapter two, the most common legal structure used in Australia to structure private equity funds is the closed-ended Collective Investment Vehicles ('CIVs') or more commonly referred to as a unit trust.[2124] This is used by funds targeting buyouts of companies or businesses with assets exceeding A$250 million. Alternatively, either a Venture Capital Limited Partnership ('VCLP') structure or Early Stage Venture Capital Limited Partnership ('ESVCLP') structure may be used. A VCLP is used by private equity funds targeting smaller investments with assets of up to A$250 million whereas a ESVCLP is used by private equity funds targeting smaller investments with assets of up to A$50 million.[2125] The VCLP regime was introduced in 2002 under the Venture Capital Act 2002 and Taxation Laws Amendment (Venture Capital) Act 2002. The ESVCLP regime was introduced in 2007 under the Tax Laws Amendment (2007 Measures No. 2) Act 2007.[2126] Therefore, in Australia either of the above structures may be used for private equity funds, which are aimed at both larger and smaller private equity transactions.

The Australian laws that regulate fund structures in Australia are complex and it is beyond the scope of this thesis to comprehensively detail all material aspects of the relevant laws. This discussion will provide a broad analysis of the available fund structures, but more importantly highlight the key legislated tax concessions that are available to investors and fund managers of each of these fund structure types. For instance, certain of the key legislated tax concessions that are available to investors and the fund manager of an ESVCLP or a VCLP are not available in respect of a CIV. [2127] Furthermore, on 11th May 2010 the Australian Tax Authority ('ATO') released rulings indicating it will treat income from the disposal of assets by private equity funds on revenue account, namely taxing it as ordinary income. However, the ATO ruled that if the CIV qualifies as a Managed Investment Trust ('MIT') then it can elect to treat qualifying assets on capital account, namely taxing it as capital gains.[2128] The introduction of the MIT tax framework was part of the ATO's review of the tax treatment of CIVs and to consider whether including a broader range of tax flow-through vehicles should be permitted, consistent with the Government's objective of developing Australia as a leading financial centre.[2129] A CIV may qualify as a MIT if the trust meets all of the required criteria. The criteria being

[2124]Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', in Private Equity in 29 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at 6-12.
[2125]As discussed in paragraph 3.4 of chapter two. See also Australian Government: The Board of Taxation (2011), 'Review of Taxation Arrangements under the Venture Capital Limited Partnership Regime: A Report to the Assistant Treasurer', The Board of Taxation, June 2011.
[2126]As discussed in paragraph 3.4 of chapter two.
[2127]Australian Private Equity and Venture Capital Association Limited, (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014. See also Maarbani, S. (2011), 'Establishing a new Venture Capital or Private Equity Fund', PricewaterhouseCoopers, 1st September 2011.
[2128]The MIT rules were introduced in June 2010 and defined under section 9 of the Corporations Act, 2001. See Chapter 5C of the Corporations Act of 2001. See also Australian Private Equity and Venture Capital Association Limited (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014.
[2129]Australian Private Equity and Venture Capital Association Limited (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014.

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that the CIV has a manager which is an Australian resident with an Australian financial services license; the trust must not control a trading business; is listed or widely held; and invests in passive investments, such as rent, debt or equity.[2130]

Collective Investment Vehicles ('CIVs') are fiscally transparent if they do not constitute public CIVs that control or are able to control a trading business.[2131] One method used in practice to overcome this, is by structuring the private equity fund as multiple CIVs, co-investing in parallel so that the trustee of any one CIV/unit trust does not effectively control the trading business.[2132] A CIV is not fiscally transparent in relation to tax losses that cannot be used by its investors and these losses remain in the trust and can be offset against the trust's future income if certain criteria are met.[2133] Furthermore, in certain circumstances trustees may be required to withhold from certain returns paid to, or at the direction of non-resident beneficiaries.[2134] In addition, a lower rate applies to distributions from a CIV that qualifies as a MIT.[2135] In this regard they allow the trustee of a qualifying MIT to make an irrevocable election to apply only the Australian capital gains tax provisions to gains and losses on disposal of qualifying assets.[2136] However, the capital gains treatment does not apply to carried interests acquired by the manager of the MIT.[2137] If a trust is eligible to be a MIT and does not make the capital election, then the gains and losses are applied to income.[2138]

During 2014 the Australian Private Equity and Venture Capital Association Limited ('AVCAL') met with the Secretariat to the Financial System Inquiry ('FSI') to discuss a range of specific issues relevant to the private equity market in Australia.[2139] The AVCAL highlighted several policy and regulatory factors that act as impediments on the capacity of the Australian private equity industry to

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[2130] Chapter 5C of the Corporations Act of 2001. Australian Government: The Board of Taxation (2011), 'Review of Taxation Arrangements under the Venture Capital Limited Partnership Regime: A Report to the Assistant Treasurer', The Board of Taxation, June 2011. Available at www.taxboard.gov.au., accessed in May 2015.
[2131] Chapter 5C of the Corporations Act of 2001. As defined in the public trading trust rules.
[2132] Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', in Private Equity in 29 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 6-12.
[2133] Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', in Private Equity in 29 Jurisdictions Worldwide', editor Cogut, C., published by Getting the Deal Through, at pages 6-12.
[2134] At 30 percent for a corporate beneficiary. See also Laura, A., Johns, D., and Feros, P. (2012), 'Fund Formation: Australia', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut. C., published by Getting the Deal Through, at pages 6-154.
[2135] At 15 percent for a corporate beneficiary.
[2136] Australian Private Equity and Venture Capital Association Limited (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014. This election should both result in greater certainty for foreign investors concerning the Australian tax consequences of their investment; and in certain circumstances, ensure that the foreign resident CGT exemption applies.
[2137] Australian Private Equity and Venture Capital Association Limited (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014.
[2138] Australian Private Equity and Venture Capital Association Limited (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014.
[2139] Stated in a letter addressed to the Chairman, David Murray, of the Financial System Inquiry ('FSI') by the Chief Executive Officer, Yasser El-Ansary, of the Australian Private Equity and Venture Capital Association Limited ('AVCAL') dated 28 April 2014. Sourced in Australian Private Equity and Venture Capital Association Limited (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014.

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increase its contribution to the future growth and expansion of Australian businesses within its economy. The AVCAL made specific reference to the findings of the Johnson Report of 2010.[2140] The Johnson Report recommended that the Treasurer request the Board of Taxation to review the scope for providing a broader range of tax flow-through collective investment vehicles.[2141] The subsequent Board of Taxation review of the tax arrangements applying to CIVs was completed in December 2011 but the report, and the Government's response, has to date not yet been released.[2142] As part of the AVCAL supplementary submission to the FSI on 28th April 2014, they argue that:

> 'AVCAL believes that the outcomes of this review are important because the CIV of choice domestically, apart from VCLPs, remains a managed investment scheme taking the legal form of a trust. Some features of Managed Investment Trust (MIT) tax framework put Australia's funds management sector at a competitive disadvantage in terms of managing funds for offshore clients who have greater certainty of flow-through tax treatment through other international CIVs of choice such as limited partnerships and limited liability companies. These shortcomings and uncertainties should be addressed, in consultation with industry, as part of the Government's ongoing review of the MIT tax framework. These reforms are also important to Australia's future capacity to attract foreign investment into our economy. In view of this, AVCAL recommends that the FSI encourage the Government to: release the Board of Taxation's review of CIVs, together with its response to the report; provide legislative certainty for the retention of character and source for investors in MITs, and address other areas of the MIT tax framework to allow these vehicles to operate in as similar a fashion as possible to how international CIVs are taxed in other jurisdictions; and prioritise, as part of the proposed Tax White Paper which will be prepared in the course of the next two years, the implementation of policies that will support Australia's capacity to attract capital from domestic and international investors through a globally competitive environment for collective investment management activities.'[2143]

[2140] Johnson Report (2010), 'Australia as a Financial Centre: Building on our Strengths', Report by the Australian Financial Centre Forum. On 26 September 2008, Minister Bowen established the Australian Financial Centre Forum (AFCF) to progress the Government's initiative to position Australia as a leading financial services centre in the region. The AFCF is a Government and industry partnership comprising: a Chairman, Mr Mark Johnson; a Panel of Experts, consisting of six senior financial sector representatives; the Treasury Taskforce; and a Reference Group, which will be the main consultative body and includes representatives from the peak financial sector industry associations, the State Governments and Austrade.

[2141] Australian Government: The Board of Taxation (2011), 'Review of Taxation Arrangements under the Venture Capital Limited Partnership Regime: A Report to the Assistant Treasurer', The Board of Taxation, June 2011. Available at www.taxboard.gov.au., accessed in June 2015.

[2142] Australian Private Equity and Venture Capital Association Limited (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014. The delay between reporting and public release is a concern pointed to in Parliament by the current Government (when in Opposition), in March 2013. Senate Notice Paper No.143 – 14/5/2013; Orders of the Senate, Senator Mathias Cormann.

[2143] Australian Private Equity and Venture Capital Association Limited (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014, at page 5.

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Subsequent to the AVCAL supplementary submission, the Financial Services Council ('FSC') [2144] also commented on the Board of Taxation's review of the tax arrangements applying to CIVs.[2145] The FSC, like the AVCAL argued that Australian policy makers should be more cognisant of the preferences of international private equity investors. The FSC submission argued that most foreign investors[2146] do not come from a common-law jurisdiction and thus are not familiar with trusts and often prefer to invest in a CIV which possess either a contractual basis[2147] or is a corporate entity.[2148] Therefore, to allow Australian based fund managers to service these clients from Australia, as opposed to them establishing an offshore CIV in a competing jurisdiction, the FSC proposes the establishment of alternative flow through vehicles, particularly for non-resident investors.[2149] In addition, the FSC suggested that the elective provisions that apply to MITs should not be limited to unit trusts, but to any legal entity that meets the prescribed prerequisite conditions.[2150] The FSC submission states that:

> 'Once such an entity has elected into the regime the features normally associated with MITs such as transparency, flow through, deemed capital status would apply, regardless of how that type of entity might normally be treated for tax purposes. By allowing such flexibility, Australian managers would be able to develop products that suited particular overseas jurisdictions … the preferred style of CIV may differ from country to country and, indeed, may even vary within a country depending upon the type of investment. Such flexibility provides a degree of protection against future developments that may result in unit trusts falling out of favour with investors.'[2151]

According to the FSC, the proposed new CIV flow through vehicle will be an Australia domiciled onshore vehicle, primarily intended for investment by non-resident investors.[2152] The definition of a CIV in terms of the FSC proposal should encompass corporate vehicles, limited partnership vehicles and any future vehicle which meets the criteria. The existing definition of 'managed investment

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[2144] The Financial Services Council ('FSC') is the peak body representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advisory networks. Collectively the FSC have 128 members who are responsible for investing over $1.7 trillion on behalf of more than ten million Australians.
[2145] Financial Services Council (FSC) Submission Report (2011), 'Commentary on the outcomes of the Review of the Tax Arrangements applying to Collective Investment Vehicles by the Board of Taxation, 1st March 2011.
[2146] Despite foreign investors residing in a double tax treaty country.
[2147] For instance an Irish common contractual fund.
[2148] For instance a Luxembourg SICAV.
[2149] Financial Services Council (FSC) Submission Report (2011), 'Commentary on the outcomes of the Review of the Tax Arrangements applying to Collective Investment Vehicles by the Board of Taxation, 1st March 2011.
[2150] Financial Services Council (FSC) Submission Report (2011), 'Commentary on the outcomes of the Review of the Tax Arrangements applying to Collective Investment Vehicles by the Board of Taxation, 1st March 2011.
[2151] Financial Services Council (FSC) Submission Report (2011), 'Commentary on the outcomes of the Review of the Tax Arrangements applying to Collective Investment Vehicles by the Board of Taxation, 1st March 2011, at page 1.
[2152] Financial Services Council Submission Report (2011), 'Commentary on the outcomes of the Review of the Tax Arrangements applying to Collective Investment Vehicles by the Board of Taxation, 1 March 2011, at page 5.

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scheme' as contained in section 9 of the Corporations Act of 2001 applies to cover all forms of CIV legal structures except that for a corporate CIV vehicle and the definition will need to be amended so that the corporate CIV vehicle is not exempted from being a managed investment scheme simply because it is a body corporate, otherwise an alternative regulatory regime would need to be enacted.[2153] As mentioned above, the Board of Taxation review of the tax arrangements applying to CIVs was completed in December 2011 but the report (despite compelling supplementary submissions from the likes of the AVCAL and FSC), and the Government's response, has to date not yet been released.[2154]

The other available legal vehicles used in Australia to structure a private equity fund are the previously mentioned VCLP[2155] and ESVCLP[2156] regimes.[2157] VCLPs and ESVCLPs are both fiscally transparent for tax purposes for both domestic and foreign investors. Foreign investors may be exempt from Australian income tax and capital gains tax on capital gains made on the disposal of qualifying investments held for at least twelve months.[2158] The origins to VCLPs and ESVCLPs date back to 1999 in Australia. In Australia the support for private equity through tax concessions was highlighted as the correct policy response in the Ralph Report of 1999.[2159] The Ralph Report broadly supported the introduction of tax measures that would increase Australia's international competitiveness. The Ralph Report recommended that targeted tax relief be provided by way of a capital gains tax exemption for private equity investment:

> 'A major motivation for reform of the capital gains tax arrangements was the desire to increase the international competitiveness of Australian business and to encourage greater investment by Australians. The Review believes lower capital gains tax will improve the workings of Australian capital markets and encourage a greater level of investment and innovation. The constraint on lowering capital gains tax to maximise investment is that imposed by the need to maintain revenue neutrality. The measures recommended in this report are also designed to encourage greater

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[2153]Financial Services Council Submission Report (2011), 'Commentary on the outcomes of the Review of the Tax Arrangements applying to Collective Investment Vehicles by the Board of Taxation, 1 March 2011, at page 5.

[2154]Australian Private Equity and Venture Capital Association Limited (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014. The delay between reporting and public release is a concern pointed to in Parliament by the current Government (when in Opposition), in March 2013. Senate Notice Paper No.143 – 14/5/2013; Orders of the Senate, Senator Mathias Cormann.

[2155]Introduced in 2002: Venture Capital Act 2002 and Taxation Laws Amendment (Venture Capital) Act 2002.

[2156]Introduced in 2007 under Tax Laws Amendment (2007 Measures No. 2) Act 2007.

[2157]As discussed in paragraph 3.4 of chapter two.

[2158]As discussed in paragraph 3.4 of chapter two.

[2159]Ralph Report (1999), 'A Tax System Redesigned, More Certain, Equitable and Durable', Review of Business Taxation, July 1999. Available at www.rbt.treasury.gov.au/., accessed in June 2015. In 1999, the Australian government received and basically adopted the Ralph Report which recommended sweeping changes to the basis of business taxation, including the international taxation regime.

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investment in venture capital and so support new high growth businesses in Australia based on innovation and development of new markets.'[2160]

The VCLP regime was introduced to encourage foreign investment in Australian private equity and provided an exemption from income tax on profits, both capital and revenue, from the disposal of qualifying investments by certain foreign partners of a VCLP.[2161] As a result of the introduction of Division 855 of the Income Tax Assessment Act 1997, which exempts non-residents from Australian income tax in relation to capital gains from the sale of investee companies in defined circumstances, this benefit is now largely obsolete for non-resident limited partners of VCLPs.[2162] The VCLP structure provides no such tax advantages for Australian resident investors. Funds structured as VCLPs are either managed by the general partner of the limited partnership, or have the investment management functions outsourced to a special purpose investment management entity.[2163] Investors in a VCLP obtain limited partnership interests and have rights and obligations governed by the limited partnership deed and must have a minimum fund size of AUD$10 million.[2164] However, there is no limitation on the maximum fund size of a VCLP. The VCLP is a tax flow-through vehicle allowing distributions to be taxed in the hands of the investors and the right to claim losses will depend on an individual investor's circumstances.[2165] In terms of the VCLP regime, one restriction is that the VCLP may only invest in qualifying private equity investments, which broadly excludes investing in entities which activities primarily include property development, land ownership, banking, providing capital to others, leasing, factoring, securitisation, insurance, construction or the acquisition of infrastructure facilities and/or making passive investments.[2166]

As part of the same above mentioned review by the Australian Board of Taxation of CIVs, the Board of Taxation also undertook a review into the current taxation arrangements under the VCLP regime.[2167] The starting point of the aforementioned review was to determine whether the current rules of the VCLP regime were delivering on the original policy objectives. The policy objectives of the VCLP regime are explicitly stated in the explanatory memorandum:

[2160]Ralph Report (1999), 'A Tax System Redesigned, More Certain, Equitable and Durable', Review of Business Taxation, July 1999. Available at www.rbt.treasury.gov.au/, accessed in June 2015.
[2161]Introduced in 2002: Venture Capital Act 2002 and Taxation Laws Amendment (Venture Capital) Act 2002.
[2162]Australian Government: The Board of Taxation (2011), 'Review of Taxation Arrangements under the Venture Capital Limited Partnership Regime: A Report to the Assistant Treasurer', The Board of Taxation, June 2011. Available at www.taxboard.gov.au., accessed in June 2015.
[2163]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc., at pages 267-301.
[2164]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc., at pages 267-301.
[2165]See Maarbani, S. (2011), 'Establishing a new Venture Capital or Private Equity Fund', PricewaterhouseCoopers, 1st September 2011.
[2166]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc., at pages 267-301.
[2167]Australian Government: The Board of Taxation (2011), 'Review of Taxation Arrangements under the Venture Capital Limited Partnership Regime: A Report to the Assistant Treasurer', The Board of Taxation, June 2011. Available at www.taxboard.gov.au., accessed in June 2015.

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'To facilitate non-resident investment in the Australian venture capital industry by providing incentives for increased investment which will support patient equity capital investments in relatively high-risk start-up and expanding businesses that would otherwise have difficulty in attracting investment through normal commercial means.'[2168]

The Board of Taxation recommended that that deemed capital account treatment should apply to qualifying domestic partners on gains or profits made by a VCLP on the disposal of eligible investments.[2169] According to the AVCAL, this recommendation by the Board of Taxation was made on the basis of the Board of Taxation's assessment of how the current VCLP regime could be amended in order to facilitate more direct investment into Australian businesses by private equity.[2170] The AVCAL stated that the previous government had made a decision to proceed with amendments that would introduce consistency as between the tax treatment of different classes of domestic and offshore investors into VCLPs,[2171] but the current Government reversed this decision in December 2013, and decided not to proceed with this reform, which was stated as follows:

'AVCAL's view at that time, and still at this point, is that the Government had missed an opportunity to implement reforms that would assist in facilitating greater investment into mid-market Australian businesses through PE and VC funds. AVCAL believes that the Government should continue the implementation of the BoT's recommended reforms, which will improve the capacity of the current VCLP regime to deliver on the original policy objectives that were set by the Coalition Government when this structure was first introduced back in 2002. To the best of our understanding, AVCAL does not believe that the implementation of these reforms would carry a significant revenue cost to the federal budget position.[2172] In AVCAL's assessment, further investment into mid-market businesses is being held back as a direct result of the current inconsistency in the tax rules that apply to different classes of domestic investors in VCLPs. As the legislation currently stands, foreign investors have certainty in respect of capital account tax treatment, but a similar level of certainty does not exist for all domestic investors. Feedback from AVCAL members over many years has consistently highlighted that the present capital/revenue account tax uncertainty is the issue of greatest concern within the VCLP regime, and a significant

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[2168]Explanatory Memorandum, Taxation Laws Amendment (Venture Capital) Act 2002.

[2169]Australian Government: The Board of Taxation (2011), 'Review of Taxation Arrangements under the Venture Capital Limited Partnership Regime: A Report to the Assistant Treasurer', The Board of Taxation, June 2011, at page 45-47. Available at www.taxboard.gov.au., accessed in June 2015.

[2170]Australian Private Equity and Venture Capital Association Limited (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014.

[2171]After accepting the Board of Taxation's recommendation.

[2172]Any perceived risk to the revenue associated with AVCAL's recommendations should be more than offset by increased taxation receipts from bigger and more profitable portfolio companies, and more productive workforces. The assessment of the Deputy Governor of the RBA, Mr Battellino, noted in the Senate Report on the review of private equity in 2007, was that: "[the] conclusion would be that really on a macro scale shifts in the patterns of financing probably do not have a big overall impact on the tax base."

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impediment to domestic fundraising. These conclusions were largely echoed by the BoT in their 2011 report.'[2173]

As mentioned above, the ESVCLP is used by private equity funds targeting smaller investments with assets of up to A$50 million. The ESVCLP regime was introduced in 2007 under the Tax Laws Amendment Act 2007. In terms of an ESVCLP, income and capital gains derived from, or from the disposal of, qualifying investments are exempt from tax in Australia in the hands of both domestic and foreign investors.[2174] The tax-free treatment serves as a legislative incentive aimed at mitigating the risk of early stage venture capital investments.[2175] As with VCLPs, losses do not flow through to the limited partners and private equity funds structured as ESVCLPs are typically managed by the general partner of the limited partnership.[2176] The fund must be structured as a limited partnership and have committed capital of at least AUD$10 million and not more than AUD$100 million.[2177] Similar to VCLPs, one of the restrictions of ESVCLPs is that they may only invest in qualifying investments. In addition, an ESVCLP must have an approved investment plan which demonstrates a focus on early stage private equity. [2178] In terms of the Tax Laws Amendment Act of 2007, the gross assets of an investee company at the time an ESVCLP makes its first investment in it must not exceed AUD$50 million. The limited partnership structures adopted by the VCLP and ESVCLP regimes are recognised internationally as the preferred vehicle for start-up and early stage private equity investment. Barkoczy *et al* stated that:

> 'If Australia wants to attract foreign investment, it is important that it allows such investment to be made through vehicles that are both suitable and familiar to foreign investors. The use of flow-through vehicles should also produce a much 'cleaner' delivery of tax concessions than using the more complicated corporate structure, which is coupled with dividend and capital gains tax exemptions and is superimposed upon a complex imputation system.'[2179]

[2173]Stated in a letter addressed to the Chairman, David Murray, of the Financial System Inquiry ('FSI') by the Chief Executive Officer, Yasser El-Ansary, of the Australian Private Equity and Venture Capital Association Limited ('AVCAL') dated 28 April 2014, at page 3. Sourced in Australian Private Equity and Venture Capital Association Limited (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014.

[2174]Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', in Private Equity in 29 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at 6-12.

[2175]Laura, A., Johns, D. and Feros, P. (2014), 'Fund Formation: Australia', in Private Equity in 29 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at 6-12.

[2176]Laura, A., Johns, D., and Feros, P. (2012), 'Fund Formation: Australia', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut. C., published by Getting the Deal Through, pages 6-154.

[2177]Laura, A., Johns, D., and Feros, P. (2012), 'Fund Formation: Australia', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut. C., published by Getting the Deal Through, pages 6-154.

[2178]Laura, A., Johns, D., and Feros, P. (2012), 'Fund Formation: Australia', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut. C., published by Getting the Deal Through, pages 6-154.

[2179]Barkoczy, S., Sandler, D., Glover, J. and Kowalski, J. (2007), 'Venture Capital Tax Expenditure Programs, An International Comparative Analysis of Legal Structures and Benefits', A Report Prepared for the Department of Industry Tourism and Resources Commonwealth of Australia Government Venture Capital Incentives: A Multi-Jurisdictional Comparative Analysis Australian Tax Research Foundation, Research Study No. 46 pages 191-74193-5.

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VCLP and ESVCLPs are generally used for funds that are broadly aimed to develop Australia's start-up, early stage and expansion private equity industry by providing a vehicle of choice to pool private equity investment and to develop skills and experience in private equity fund management in Australia.[2180] It is evident that there has been significant reform with regard to the Australian private equity market, most notable being with regard to tax concessions. Nonetheless, the CIV still remains the most commonly used legal structure in Australia to structure private equity funds. In addition, it would be interesting to see whether policy makers adopt a new Australia domiciled onshore flow through CIV vehicle, primarily intended for investment by non-resident investors.

(d) United Kingdom ('UK')

As discussed in paragraph 3.3 of chapter two, there are three types of partnership available in terms of UK law; namely the general partnership;[2181] the limited partnership;[2182] and the limited liability partnership.[2183] However, the limited partnership registered in terms of the Limited Partnerships Act of 1907 is the most commonly used legal vehicle for private equity funds.[2184] It was also mentioned in paragraph 3.3 of chapter two, that a limited partnership established in terms of the Limited Partnerships Act of 1907 in the UK does not have legal personality separate from its partners.[2185] Limited partnerships established in terms of the Limited Partnerships Act of 1907, should not be confused with limited liability partnerships, which are established in terms of the Limited Liability Partnership Act of 2000.[2186] Such limited liability partnerships are not typically used to structure private equity funds in the UK because one key disadvantage is that income and capital gains derived from the underlying partnership investments are not tax exempt and do not possess the tax pass-through feature of the limited partnership registered in terms of the Limited Partnerships Act of 1907.[2187] Nevertheless, the limited partnership is the predominant legal vehicle used by private equity firms to structure private equity funds because it affords investors' limited liability; it is tax

[2180]See Maarbani, S. (2011), 'Establishing a new Venture Capital or Private Equity Fund', PricewaterhouseCoopers, 1st September 2011, at page 1. See also Hudson, M. (2014), 'Funds: Private Equity, Hedge and All Core Structures', First Edition, The Wiley Finance Series, John Wiley and Sons.
[2181]See Partnership Act of 1890.
[2182]See Limited Partnerships Act of 1907.
[2183]See Limited Liability Partnership Act 2000.
[2184]Barry, B. (2011), 'England and Wales', in Private Equity in 33 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages, at page 67.
[2185]Barry, B. (2011), 'England and Wales', in Private Equity in 33 Jurisdictions Worldwide', contributing editor Cogut, C., published by Getting the Deal Through, at pages, at page 67.
[2186]Burdett, J., Kumar, P. and Pople, Z. (2013), 'The Limited Partnership: A Fresh Look at a Trusted Model', Practical Law Publishing Limited, July 2013, at pages 1-7. A 'partnership' in terms of section 11 of the Limited Liability Partnerships Act of 2000 is now considered a separate legal person and is deemed to have legal personality. It allows limited liability for general trading debts, but individual partners cannot limit personal liability for negligence. It was introduced to allow some protection against large negligence actions, where the risks were felt to be excessive.
[2187]Burdett, J., Kumar, P. and Pople, Z. (2013), 'The Limited Partnership: A Fresh Look at a Trusted Model', Practical Law Publishing Limited, July 2013, at pages 1-7.

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transparent; and it offers a great deal of organisational flexibility so that the specific requirements of individual investors can be accommodated.[2188]

The UK private equity market has strongly followed the developments in the US.[2189] Despite this trend, UK investment institutions have not benefited from investments in the private equity market to the same degree as US investors. This has not only been a result of relative performances of the UK, as opposed to the US private equity market, but is also due to the extent UK institutions have generally been private equity averse.[2190] According to Myners' report to the British Treasury,[2191] the primary reasons for the aversion relate to the UK's regulatory and fiscal system, coupled with the broader issues in UK institutional investment.[2192] Nevertheless, as submitted in chapter two, the limited partnership is the dominant investment vehicle used in the UK and US private equity markets.[2193]

As mentioned above, the limited partnership in the UK is governed by the Limited Partnership Act of 1907, which imposes strict constraints on the number of partners and on the limited partners' involvement in the fund's activities.[2194] An initial drawback of the UK limited partnership was the twenty partner limit. In the past, it had been possible to structure funds to avoid the law, for example by using different structures or setting up separate partnerships, in order to take investments from more than twenty investors.[2195] The law restricting the number of partners in a business had been in place since 1907. In 2002 the British Government changed legislation, in that private equity firms structured as limited partnerships governed under the Limited Partnership Act of 1907 became exempt from the twenty partner limit on 22nd March 2002.[2196] Only partnerships authorised by the UK Financial Services and Market Act 2000 qualify, so partnerships managed from abroad will not be affected.[2197] The UK government department of Business, Enterprise and Regulatory Reform consulted in 2008 on proposals to modify and merge the Limited Partnership Act of 1907 with the

[2188]Burdett, J., Kumar, P. and Pople, Z. (2013), 'The Limited Partnership: A Fresh Look at a Trusted Model', Practical Law Publishing Limited, July 2013, at pages 1-2.
[2189]Faber, D. (2013), 'Legal Structures for Small Businesses', in Part Two of 'Reform of UK Company Law', edited by De Lac, J., Cavendish Publishing.
[2190]Faber, D. (2013), 'Legal Structures for Small Businesses', in Part Two of 'Reform of UK Company Law', edited by De Lac, J., Cavendish Publishing, at pages 82-95.
[2191]Myners, P. (2001), 'Institutional Investment in the United Kingdom: A Review', presented to Rt. Hon Gordon Brown, MP, Chancellor of the Exchequer, His Majesty's Treasury.
[2192]Faber, D. (2013), 'Legal Structures for Small Businesses', in Part Two of 'Reform of UK Company Law', edited by De Lac, J., Cavendish Publishing, at pages 82-95.
[2193]Cumming, D.J. (2010), 'Private Equity: Fund Types, Risks and Returns, and Regulation', John Wiley & Sons.
[2194]Limited Partnership Act of 1907, Chapter 24 7 Edw 7.
[2195]See Burdett, J., Kumar, P. and Pople, Z. (2013), 'The Limited Partnership: A Fresh Look at a Trusted Model', Practical Law Publishing Limited, July 2013, at pages 1-7.
[2196]Davies, P.L. (2008), 'Gower and Davies: Principles of Modern Company Law', 8th Edition, Sweet Maxwell Publishers.
[2197]Davies, P.L. (2008), 'Gower and Davies: Principles of Modern Company Law', 8th Edition, Sweet Maxwell Publishers.

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Partnership Act 1890, but the proposals did not go ahead and the 1907 Act remains the governing Act.[2198]

Nevertheless, the other investment vehicle available in the UK is the stock exchange listed investment trust. This investment vehicle is not as commonly used as the limited partnership, but it can be regarded as the second most used investment vehicle in the UK private equity market after the partnership structure.[2199] In the UK, the major difference between the two investment vehicles is the time-restricted nature of the limited partnership. In terms of the aforementioned trust structure, capital gains are reinvested rather than returned to investors, who received their investment returns through dividends and capital gains on trust shareholdings.[2200] The basic shortcoming of the investment trust structure in the UK is that the timing difference between the raising of capital and its investment diminishes the private equity returns from the trust and often results in the fund manager of the trust being pressured into making early investments to compensate for this return dilution.[2201] In addition, the control by investors of the fund managers is much weaker due to the dispersed shareholdings and with regard to the reinvestment of the investor's capital, enabling the fund managers to avoid the effort of systematic fund raising.[2202] The advantage of the investment trust is the trust's transparent nature to end-investors, in that no corporation tax is levied on income or gains from the trust's investments, provided that the trust meets the tax rules for distributing income to investors.[2203] Furthermore, the UK investment trust structure is listed on a stock exchange and offers a degree of liquidity and market valuation.[2204]

In another UK private equity incentive scheme, an individual subscribing for up to £100,000 of shares in a tax year in unlisted companies carrying on qualifying trades will get income tax relief at twenty percent on his or her investment, subject to a five year holding period.[2205] This scheme is referred to

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[2198] Faber, D. (2013), 'Legal Structures for Small Businesses', in Part Two of 'Reform of UK Company Law', edited by De Lac, J., Cavendish Publishing at pages 82-95. See Department of Trade and Industry (2004), 'Reform of Partnership Law: A Consultation Paper on the Economic Impact of the Law Commissions' Proposals', Report presented to Parliament by the UK Secretary of the Department of Trade and Industry, April 2004.

[2199] Sinclair, W. and Lipkin, E.B. (2013), 'St. James's Place Tax Guide 2013-2014', 42nd Edition.

[2200] See generally Morse, G. (2010), 'Partnership Law', Seventh Edition, Oxford University Press.

[2201] Listed investment trusts do not have a set 'life-limit', they are open-ended with the capital gains reinvested rather than returned to shareholders. The listed investment trust access capital from a very wide range of institutional and individual investors through public offering and the only direct linkage between the trust share prices and their net asset values are due to fluctuating supply and demand in the market for trust shares. Because the trust is listed the 'committed capital' is received by the trust / fund manager as and when the trust is raised, whereas in the case on the unlisted trust the committed capital is drawn down from investors as and when the fund manager wants to make an investment. In the case of the listed investment trust, the longer the fund manager takes to make an investment after having raised the fund, the greater the negative impact on the return / performance of the trust.

[2202] See Talmor, E., and Vasvari, F. (2011), 'International Private Equity', Wiley and Sons.

[2203] McLaughlin, M. (2013), 'Tax Planning 2013/14', Bloomsbury Publishing Plc.

[2204] Talmor, E., and Vasvari, F. (2011), 'International Private Equity', Wiley and Sons. See also Myners, P. (2001), 'Institutional Investment in the United Kingdom: A Review', presented to Rt. Hon Gordon Brown, MP, Chancellor of the Exchequer, His Majesty's Treasury.

[2205] McLaughlin, M. (2013), 'Tax Planning 2013/14', Bloomsbury Publishing Plc.

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as the Enterprise Investment Scheme ('EIS'), and exempts capital gains on the sale of such investments from capital gains tax.[2206] Similar to the venture capital trusts mentioned above, the EIS allows individuals to roll over up to £100,000 of capital gains made on disposals of any assets into shares subscribed in venture capital trusts, where the reinvestment in the trust occurs within one year before or one year after the disposal.[2207] Primarily, the EIS allows certain individual investors to invest in small companies directly rather than through a venture capital trust. However, the conditions are similar to those for venture capital trusts.[2208] For an investee company to qualify under the EIS the investor must not be connected with the company at any time between two years before and three years after the issue of the shares.[2209] In terms of the EIS, investors are connected if they hold or are entitled to acquire more than thirty percent of the share capital, the loan capital and issued share capital of the company or the voting power in the company; control the company; and are employees, partners or directors of the company, unless they are unpaid directors or business angels.[2210] According to Mason, business angels are high net worth individuals who invest their own money, often along with their time and expertise, directly in unlisted companies with the goal of making a financial gain.[2211]

The shares acquired by the investor must be ordinary shares with no preferential or redemption rights, and be fully paid up in cash on issue.[2212] The issuing arrangements for the shares must not include any arrangements for a pre-arranged exit and that protect investors against the risks of making the investment.[2213] Provided the shares are held for at least three years, the tax reliefs available are (i) an income tax reduction calculated at thirty percent of the amount invested in shares on or after 6th April 2011, coupled with an investment limit of £500,000 for the tax year and with a minimum investment of £500 in any one company in any one tax year; (ii) the deferral or rollover relief from capital gains tax gains realised on disposal of any asset, if the proceeds are reinvested in a qualifying EIS investment; (iii) capital gains on the sale of EIS investments are exempt from capital gains tax, but loss relief[2214] can be claimed on a disposal of shares at a loss.[2215] Subject to Parliamentary and state-aid approval, changes to EIS and Venture Capital Trust Schemes are proposed in the Finance Act 2012.[2216] Several changes will apply to shares in investee companies

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[2206] The Enterprise Investment Scheme ('EIS') is a series of UK tax reliefs launched in 1994 to encourage investments in small unlisted companies carrying on a qualifying trade in the UK. The EIS offers both income tax and capital gains tax reliefs to investors who subscribe for shares in qualifying companies.
[2207] McLaughlin, M. (2013), 'Tax Planning 2013/14', Bloomsbury Publishing Plc.
[2208] McLaughlin, M. (2013), 'Tax Planning 2013/14', Bloomsbury Publishing Plc.
[2209] Sinclair, W. and Lipkin, E.B. (2013), 'St. James's Place Tax Guide 2013-2014', 42nd Edition.
[2210] Sinclair, W. And Lipkin, E.B. (2013), 'St. James's Place Tax Guide 2013-2014', 42nd Edition.
[2211] Mason, C.M. (2011), 'Business Angels', in World Encyclopaedia of Entrepreneurship, edited by Dana, L.D., published by Edward Elgar Publishing Limited, at page 1.
[2212] Sinclair, W. and Lipkin, E.B. (2013), 'St. James's Place Tax Guide 2013-2014', 42nd Edition.
[2213] McLaughlin, M. (2013), 'Tax Planning 2013/14', Bloomsbury Publishing Plc.
[2214] Against income or capital gains.
[2215] Less any income tax relief given.
[2216] Sinclair, W. and Lipkin, E.B. (2013), 'St. James's Place Tax Guide 2013-2014', 42nd Edition.

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issued on or after 6th April 2012.[2217] Firstly, the annual amount which an individual can invest under the EIS is to be increased from £500,000 to £1 million. Secondly, the maximum amount which a company can raise under EIS and venture capital trust is to be increased from £2 million to £10 million. [2218] Lastly, the size of eligible companies under EIS and venture capital trust is to be increased so that they can have fewer than two hundred and fifty employees (rather than the current fifty) and the gross assets of the company can be up to £15 million before the investment (rather than the current £7 million).[2219]

A further UK private equity incentive scheme is a general relief where capital gains without value limit are reinvested within three years in unlisted companies carrying on trade, which is very similar to the tests of qualifying trade for venture capital trusts and the enterprise investment scheme.[2220] Furthermore, under the UK Venture Capital Trust Scheme, an individual can offset the amount of any capital loss made by him on disposing of shares which he has subscribed for certain unlisted trading companies against his liability for income tax in the current or preceding tax year.[2221] UK tax reforms can be characterised as following a measured approach designed to encourage investment and economic growth. While the limited partnership remains the predominant legal vehicle to structure private equity funds in the UK, both the EIS and Venture Capital Trust Schemes are alternatives, highly tax efficient closed-end collective investment schemes that are used to provide capital finance for small expanding companies and that provide beneficial capital gains for its investors.[2222]

(e) South Africa

A few key lessons emerged from reviewing the reforms in the above jurisdictions. Firstly, it is evident that an appropriate tax regime is critical to the private equity industry. For instance, investment vehicles that are not subject to double taxation, such as the limited partnership and limited liability companies in the US, are the norm. Secondly, tax incentives have been widely used to stimulate

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[2217] Sinclair, W. and Lipkin, E.B. (2013), 'St. James's Place Tax Guide 2013-2014', 42nd Edition.
[2218] Sinclair, W. and Lipkin, E.B. (2013), 'St. James's Place Tax Guide 2013-2014', 42nd Edition.
[2219] Sinclair, W. and Lipkin, E.B. (2013), 'St. James's Place Tax Guide 2013-2014', 42nd Edition.
[2220] See Hudson, M. (2014), 'Funds: Private Equity, Hedge and All Core Structures', 1st Edition, The Wiley Finance Series, John Wiley and Sons, at paragraph 2.2.4. See also Caselli, S. (2009), 'Private Equity and Venture Capital in Europe: Markets, Techniques, and Deals', Elsevier Publishing, at pages 41-66.
[2221] See Hudson, M. (2014), 'Funds: Private Equity, Hedge and All Core Structures', First Edition, The Wiley Finance Series, John Wiley and Sons, at paragraph 2.2.4. See also Caselli, S. (2009), 'Private Equity and Venture Capital in Europe: Markets, Techniques, and Deals', Elsevier Publishing, at pages 41-66. See also British Venture Capital Association Report (2003), 'The Economic Impact of VCTs in the UK,' London: British Venture Capital Association. These schemes form part of a group of schemes and reliefs that aim to encourage investment in small unlisted trading companies. These UK schemes are the Enterprise Investment Scheme, Seed Investment Scheme, Venture Capital Trust scheme, Share Loss Relief and Corporate Venturing Scheme.
[2222] See Brookes, D. and Ward, M. (2011), 'Venture Capital Tax Reliefs: The VCT Scheme, the EIS and the CVS', Second Edition, Bloomsbury Professional.

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private equity investments, and most of the jurisdictions discussed above offer some form of tax incentives. For instance in the US, the reduction of capital gains taxes as an incentive is viewed as having made a significant contribution to the growth of private equity investments. At this point it would be important to note that the discussion to follow will not be a discussion on the taxation of a *bewind* trust or *en commandite* partnership in terms of South African tax law.[2223] This has already been discussed in chapter two. Firstly, the discussion to follow will consider the South African tax regimes treatment of capital gains tax. The aim is to provide greater clarity as to the approach adopted by South African courts in determining whether share disposals are on capital or revenue account. In the private equity context, the accurate taxation of share disposals is crucial because it bears a direct impact on the ultimate returns to be earned by investors. Despite an existing body of case law in South Africa on the subject, there are limited precedents relating to the Eighth Schedule[2224] of the Income Tax Act 58 of 1962, which can provide any sort of interpretation for capital gains purposes. This is important because as Armour and Cumming's states:

> 'legislators may successfully stimulate private equity markets by reducing direct taxation, particularly capital gains taxation'.[2225]

Secondly, the discussion will consider the Venture Capital Company initiative which is the only specific tax incentive scheme in South Africa that encourages investment in unlisted companies.

As mentioned throughout the preceding chapters, the principal structures that are used in South Africa as vehicle to structure a private equity fund are (a) *en commandite* partnerships; and (b) *bewind* trusts. Both *bewind* trusts and *en commandite* partnerships are tax transparent for South African tax purposes. In the case of an *en commandite* partnership, each partner is deemed to carry on a trade and the partners are taxed in their personal capacities on their attributable partnership interests.[2226] Foreign partners are only taxed on South African-sourced, or deemed sourced, income and are subject to capital gains tax on the disposal of immovable property or any interest or right in immovable property in South Africa; and assets of a South African permanent establishment.[2227] The ownership of the assets of a private equity fund, structured as a *bewind* trust, resides in the hands

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[2223]See paragraph 3.1 of chapter two.
[2224]In terms of the Eighth Schedule to the Income Tax Act 58 of 1962, capital gains tax is levied in respect of the 'disposal' of any 'asset' by a person. The definition of 'disposal' in paragraph 11 of the Eighth Schedule to the Act includes any act which results in the creation of an asset.
[2225]Armour, J. and Cumming, D.J. (2007), 'Bankruptcy Law and Entrepreneurship', ECGI - Law Working Paper No. 105/2008, American Law and Economics Review, Forthcoming; University of Cambridge Centre for Business Research Working Paper No. 300. Available at SSRN: http://ssrn.com/abstract=762144, accessed in June 2014.
[2226]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.
[2227]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.

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of the investors, with the trustees merely administering such assets on their behalf. *Bewind* trusts are treated on the same basis as partnerships for tax purposes.[2228]

That having been said, it is not within the scope of this thesis to argue whether South African private equity funds should pay higher taxes or lower taxes. Rather, it is clear from the preceding discussion that it would be more attractive for the local industry if a private equity fund is treated as a long term investor, rather than an operating business because then the returns to the private equity firm could be taxed at lower capital gains rates, rather than as ordinary income. Therefore, the compensation of private equity firms (carried interest) and profits generated from underlying investments by the private equity fund should be taxed at lower rates under current South African tax legislation, without the need for new legislation. It is submitted that this thesis does not argue for altering the tax treatment of a single industry because it raises tax policy concerns which are beyond the scope of this thesis. However, whether or not the current tax treatment of the private equity industry can be viewed as creating a distortion in the South African economy, by encouraging taxpayers to convert otherwise taxable income into tax-free capital gains is beyond the scope of this thesis. The South African Revenue Service (SARS) has observed that sophisticated taxpayers such as private equity funds have engaged in the conversion transactions mentioned above, which in theory erodes the corporate and individual income tax bases. Therefore, capital gains tax ('CGT') was introduced in South Africa in the first place (albeit not specifically for the private equity industry), as a critical element of any income tax system as it protects the integrity of the personal and corporate income tax bases.[2229] Nevertheless, changing the way private equity firms, *bewind* trusts and *en commandite* partnerships in general are taxed is a subject that should only be undertaken after very careful consideration of the real and potential consequences.

Capital Gains Tax

Capital gains tax ('CGT') was introduced in South Africa with effect from 1st October 2001, by the insertion of section 26A and an Eighth Schedule into the Income Tax Act 58 of 1962, by the Taxation Laws Amendment Act 5 of 2001.[2230] In terms of the South African tax regime (at the time of writing this thesis),[2231] whether a gain is subject to capital gains tax or normal income tax will ultimately depend upon the intention of the investor participant concerned (in a private equity fund context), namely whether it held the investment on capital account or on revenue account.[2232] In simple terms,

[2228] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.
[2229] Available at www.treasury.gov.za/documents/national%20budget/2000/cgt/cgt.pdf, accessed in April 2016.
[2230] Olivier, L. and Honiball, M. (2011), 'International Tax: A South African Perspective', Blue Weaver Marketing.
[2231] Specifically in terms of the provisions of the Income Tax Act, 58 of 1962.
[2232] See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.

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a taxpayer who holds a share as a capital asset will have a capital profit or loss on disposal which must be dealt with in terms of the Eighth Schedule to the Income Tax Act 58 of 1962. The capital gain or loss on disposal is determined as the difference between proceeds on the disposal and the base cost of the asset.[2233] The determination of the base cost of shares can be complex, especially if the shares were purchased before the 1st October 2001, as the application of so-called ‘kink tests’ must be considered.[2234] For example, if the shares were purchased before the 1st October 2001 and the proceeds on disposal fall below the market value of the shares on that date, it is likely that no capital loss will be recognised on disposal because of the base cost is deemed to equal the proceeds in terms of paragraph 26 of the Eight Schedule to the Income Tax Act 58 of 1962.[2235]

Other complications occur if the taxpayer received any capital distributions in respect of the shares, and the rules in this regard differ depending on when the capital distribution was made.[2236] Furthermore, special valuation rules apply for the determination of capital gains or losses on disposal of foreign-listed shares in terms of paragraph 43(4) of the Eight Schedule to the Income Tax Act 58 of 1962. For the purposes of this thesis the focus will only be the treatment of a capital loss once it has been determined. It is important to highlight that capital losses cannot be set off against other income.[2237] Capital losses may be set off against other capital gains arising during the same tax year, and any remaining capital gain or loss after this set-off is then dealt with according to specific rules which vary depending on the type of taxpayer concerned.[2238] In the case of companies and trusts, the annual exclusion does not apply, and fifty percent of the capital gain is included in taxable income.[2239] Nevertheless, any capital loss must be carried forward to the following tax year as an ‘assessed capital loss’. An assessed capital loss may only be set off against current or future capital gains, and never against ordinary income. In certain circumstances, ‘anti-loss’ rules in the Eighth Schedule to the Income Tax Act 58 of 1962, restrict the set-off or carry forward of a capital loss.[2240] For example, if a taxpayer disposes of his or her shares at a capital loss within two years of having received ‘extraordinary dividends’, the capital loss is disregarded up to the amount of those

[2233]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), ‘Silke: South African Income Tax’, LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.
[2234]Olivier, L. and Honiball, M. (2011), ‘International Tax: A South African Perspective’, Blue Weaver Marketing.
[2235]South African Revenue Service (SARS) (2010), ‘The ABC of Capital Gains Tax For Individuals’, Legal and Policy Division of SARS. Available at www.marwick.co.za/docs/ABCofCGTforIndividuals.pdf, accessed in June 2015.
[2236]See Olivier, L. (2012), ‘Capital Versus Revenue: Some Guidance’, De Jure, 2012, pages 172-178. Available at www.dejure.up.ac.za/index.php/volumes/45-vol-1-2012/notes/olivier-l., accessed in June 2015.
[2237]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), ‘Silke: South African Income Tax’, LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.
[2238]In the case of individuals, the first R16 000 of the capital gain or loss is disregarded and if the individual have a remaining capital gain, 25% of that remaining amount is included in taxable income and taxed at his or her marginal tax rate. If there is a capital loss remaining that capital loss must be carried forward to the following tax year as an ‘assessed capital loss’.
[2239]De Koker, A.P., Williams, R.C., Silke, J.M. and Silke, A.S. (2013), ‘Silke tax yearbook 2012-2013’, Butterworth Publishers, Durban.
[2240]De Koker, A.P., Williams, R.C., Silke, J.M. and Silke, A.S. (2013), ‘Silke tax yearbook 2012-2013’, Butterworth Publishers, Durban.

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extraordinary dividends in terms of paragraph 19 of the Eighth Schedule to the Income Tax Act 58 of 1962.[2241]

Furthermore, 'extraordinary dividends' are those received during the two years before the disposal which exceed fifteen percent of the proceeds on disposal of the shares. Another example is the disregarding of capital losses on short-term 'wash-sales'[2242] in terms of paragraph 42 of the Eighth Schedule to the Income Tax Act 58 of 1962.[2243] This rule applies where a taxpayer disposes of shares at a loss and buys back the same type and the quantity of shares within a forty five day period on either side of the disposal. In this case, the disregarded capital loss is added to the base cost of the replacement shares and is, therefore, effectively deferred until the replacement shares are sold.[2244] It should be appreciated that, with the exception of one provision, there are no specific provisions in South African tax law dealing with the scenario where proceeds from the disposal of an asset are of a capital or revenue nature.[2245] In other words, there are a number of general tests applied by the courts over the years to determine the nature of the proceeds arising from the disposal of an asset.[2246] Generally, proceeds will be of a capital nature if they are fortuitous and not deliberately sought for and worked for.[2247] In other words, the proceeds should not form part of a business in carrying out a profit making scheme.[2248]

The test to be applied in determining whether the profit made by a taxpayer is of revenue or of a capital nature has been formulated in many ways by the courts. The fundamental inquiry in the context of the sale of shares (and other property) is whether, in buying and selling the shares, the taxpayer engaged in a scheme of profit-making or whether the sale merely constituted the realisation of a capital asset acquired for purposes other than such a profit-making scheme.[2249] The principle has been confirmed by our courts that the mere realisation of an asset, albeit at a profit, does not result in a profit-making scheme.[2250] In fact, in *CIR v Paul* the Appellate Division[2251] held that a disposal of a capital asset does not become a profit-making scheme merely because the owner

[2241]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.
[2242]'Wash-sale' refers to anti-avoidance rule in paragraph 42 of the 8th Schedule of Income Tax Act 58 of 1962.
[2243]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023. See also Haupt, P. (2012), 'Notes on South African Income Tax', 31st Edition, H and H Publications, at 925.
[2244]Croome, B.J. and Olivier, L. (2010), 'Tax Administration', Juta and Company. See also Croome, B.J. (2010), 'Taxpayers' Rights in South Africa', Juta and Company.
[2245]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.
[2246]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.
[2247]See Emslie, T. and Davis, D. (2012), 'Income Tax Cases and Materials', The Taxpayer.
[2248]See Emslie, T. and Davis, D. (2012), 'Income Tax Cases and Materials', The Taxpayer.
[2249]*Commissioner for Inland Revenue v Strathmore Consolidated Investments Ltd,* 1959 (1) SA 469 (A).
[2250]*Elandsheuwel Farming (Edms) Bpk v SBI,* 1978 (1) SA 101 (A).
[2251]Then Appellate Division and now Supreme Court of Appeal.

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seeks to realise it to the best possible advantage.[2252] Something more is required to take the taxpayer from the category of an investor to a speculator. The facts of the case were that the taxpayer wanted to purchase a portion of a parcel of land on which he wished to erect a dwelling for himself. The owner of the land was, however, not prepared to sell the desired portion, but insisted that the taxpayer purchase the whole parcel of land, which the taxpayer was accordingly obliged to do. His intention was, however, immediately to dispose of the surplus portion of the land not needed by him, and he did so, at a profit.[2253] The court held that the sale of that surplus portion was, in the circumstances, not part of a profit-making scheme.[2254]

According to Olivier, South African courts apply at least three different tests to determine the nature of an amount.[2255] One such principle was applied in the leading dictum *CIR v Pick-n-Pay Employee Share Purchase Trust*, where the Appellate Division[2256] established the principle that things acquired otherwise than in a scheme of profit-making, are capital.[2257] The facts of the case were that a trust was formed to provide shares to company employees. The trust acquired shares at the market value from the company and on-sold them to the employees continuously. The intention of the trust was not to make a profit. However, it had to sell the shares to the employees at a specific price which resulted in the trust making a profit. The question the court had to decide was whether the profit was of a capital nature.[2258] The majority decision of the court was that the profits were of a capital nature.[2259] The court reached its decision by firstly having to establish whether the taxpayer objectively conducted a business and secondly whether it was the objective of the taxpayer to conduct a business.[2260] Judge Smalberger held:

> 'The appropriate test in a matter such as the present is a well established one. The receipts accruing to the Trust will be revenue if they constitute "a gain made by an operation of business in carrying out a scheme for profit-making" in the words of the eminent Scottish judge in the *California Copper Syndicate* case quoted with approval in the passage from *Overseas Trust Corporation Ltd v Commissioner for Inland Revenue* 1926 AD 444 at 452-3 referred to in my colleague's judgement ... The corollary is that they will be non-revenue if they do not derive from "an operation of business in carrying out a scheme for profit-making". The phrase from the *California Copper Syndicate* case has undergone some measure of refinement in the cases of

[2252] *CIR v Paul* 1956 (3) SA 335 (A).
[2253] *CIR v Paul* 1956 (3) SA 335 (A).
[2254] *CIR v Paul* 1956 (3) SA 335 (A).
[2255] Olivier, L. (2012), 'Capital Versus Revenue: Some Guidance', De Jure, 2012, pages 172-178. Available at www.dejure.up.ac.za/index.php/volumes/45-vol-1-2012/notes/olivier-l., accessed in June 2015. For income tax purposes, the nature of an amount refers to the distinction between whether an amount or expenditure is of a capital nature or not.
[2256] Then Appellate Division and now Supreme Court of Appeal.
[2257] *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271.
[2258] *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271.
[2259] *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271.
[2260] *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271.

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> *Natal Estates Ltd v SIR* 1975 (4) SA 177 (a) at 198E-G and *Elandsheuwel Farming (Edms) Bpk v SBI* 1978 (1) SA 101 (a) at 118A-B to the extent that a distinction is drawn between the carrying on of a business and the pursuance of a profit-making scheme.'[2261]

This dictum has created a legal principle which eases the burden of proof placed on taxpayers and a taxpayer can discharge the onus of proving that an asset is of a capital nature by satisfying the court that it has not engaged in a scheme of profit making.[2262] This test was also applied by the court in *CSARS v Wyner,*[2263] where the Supreme Court of Appeal held that the profit made by a taxpayer when she sold her house, was taxable as it was a scheme of profit-making.[2264] The facts of the case were that the taxpayer sold her house twelve months after buying it and that the bridging finance she obtained was only for a limited period of twelve months and her intention from the start was to sell the property after acquisition.[2265] Although the transaction did not have the character of a normal business transaction, the court held that the profit was still taxable.[2266]

A second test applied by the courts to determine the nature of an amount was applied in *CIR v Visser,* where it was held that 'income' is what 'capital' produces, or is something in the nature of interest or fruit as opposed to principal or tree.[2267] This test is fairly straightforward in that income (or fruit) is produced by an income-producing asset (or tree) and that such income is of a revenue nature, while the income-producing asset is of a capital nature.[2268] In *CIR v Visser*[2269] the court held that:

> 'Income' is what 'capital' produces, or is something in the nature of interest or fruit as opposed to principal or tree. This economic distinction is a useful guide in matters of income tax, but its application is very often a matter of great difficulty, for what is principle or tree in the hands of one man may be interest or fruit in the hands of another. Law books in the hands of a lawyer are a capital asset; in the hands of a bookseller they are a trade asset'.[2270]

[2261] *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), 54 SATC 271.
[2262] See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.
[2263] See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023. See also Haupt, P. (2012), 'Notes on South African Income Tax', 31st Edition, H and H Publications, at page 47.
[2264] *CSARS v Wyner* 2003(4) SA 541 (SCA), 66 SATC 1.
[2265] *CSARS v Wyner* 2003(4) SA 541 (SCA), 66 SATC 1.
[2266] *CSARS v Wyner* 2003(4) SA 541 (SCA), 66 SATC 1.
[2267] *CIR v Visser* 1978 8 SATC 271 (TPD).
[2268] See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023. See also Haupt, P. (2013), 'Notes on South African Income Tax', 32nd Edition, H and H Publications, at page 43.
[2269] *CIR v Visser* 1978 8 SATC 271 (TPD).
[2270] *CIR v Visser* 1978 8 SATC 271 (TPD), at 276.

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According to Olivier, it is often difficult to determine when an amount represents the tree and when it represents the fruit.[2271] For instance, in *BP Southern Africa (Pty) Ltd v CSARS*[2272] which dealt with the nature of expenditure, the lower court held that a payment for the right to operate under a certain name was of a capital nature. On appeal, the Supreme Court of Appeal held that the amount was not of a capital nature because it was more closely connected to the taxpayer's income earning activities, namely the fruit, than it was to its income earning structure, namely the tree.[2273]

A third approach adopted by the courts is that where an amount is received from the disposal of fixed capital (as opposed to floating capital) the court treats such an amount as being of a capital nature.[2274] However, if it is received from the disposal of floating capital, is not of a capital nature.[2275] In *SBI v Aveling*[2276] the court held that fixed capital is described as something held with an element of permanency and which will produce income for the holder. In *CIR v George Forest Timber Co Ltd*,[2277] the court stated:

> 'Capital, it should be remembered, may be either fixed or floating. I take the substantial difference to be that floating capital is consumed or disappears in the very process of production, while fixed capital does not; though it produces fresh wealth, it remains intact. The distinction is relative, for even fixed capital, such as machinery, gradually wears away and needs to be renewed. But as pointed out by Mason J in *Stephan v CIR* (1919 WLD at 5) the two phrases have an ascertained meaning in accountancy as well as in economics. Ordinary merchandise in the hands of a trader would be floating capital. Its use involves its disappearance; and the money obtained for it is received as part of the ordinary revenue of the business. It could never have been intended that money received by a merchant in the course, and as the result of his trading, should not form part of his gross income.'[2278]

Despite numerous tests being applied by the courts, the starting point is generally to determine the intention of the taxpayer at the time of acquisition and whether there has been a change of intention prior to the disposal of the asset.[2279] Where the taxpayer has mixed intentions, it is the dominant intention that prevails. The factors that would generally be taken into account are the taxpayer's *ipse dixit*;[2280] the duration that the asset has been held; the frequency of transactions; the nature of the

[2271] Olivier, L. (2012), 'Capital Versus Revenue: Some Guidance', De Jure, at pages 173-174.
[2272] *BP Southern Africa (Pty) Ltd v CSARS* 2007, SCA 7 (RSA) 69 SATC 79.
[2273] *BP Southern Africa (Pty) Ltd v CSARS* 2007, SCA 7 (RSA) 69 SATC 79.
[2274] Olivier, L. (2012), 'Capital Versus Revenue: Some Guidance', De Jure, at pages 173-174.
[2275] Olivier, L. (2012), 'Capital Versus Revenue: Some Guidance', De Jure, at pages 173-174.
[2276] *SBI v Aveling* 1978 (1) SA 862 at 880.
[2277] *CIR v George Forest Timber Co Ltd* 1924 AD 516 1 SATC 20.
[2278] *CIR v George Forest Timber Co Ltd* 1924 AD 516 1 SATC 20 at 23-24.
[2279] Emslie, T. and Davis, D. (2012), 'Income Tax Cases and Materials', The Taxpayer.
[2280] A Latin phrase meaning 'he himself said it'.

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taxpayer's business; the existence of an income flow from the holding of the asset (namely dividends as opposed to the sale of the asset itself); and the reason for the disposal of the asset.[2281]

In determining whether a scheme of profit-making has been engaged in, the court in *SIR v The Trust Bank of Africa Ltd* stated that this is 'fundamentally a question of intention'.[2282] In other words, the intention with which the shares were acquired is of the utmost importance, but not necessarily decisive.[2283] In order to show that a receipt is of a capital nature, the taxpayer would have to prove that his or her dominant purpose in holding the shares was to hold them more or less permanently so as to produce income.[2284] In *ITC 1185* the Special Court held that, where the taxpayer did not have one clear purpose or intention in acquiring the property but was alive to more than one use, to which he or she might put it, the inquiry will be to determine, if possible, whether one particular purpose was dominant in his mind.[2285] If the court is able to find that there was a dominant purpose, which operated decisively or very substantially in the process which led to the decision to acquire the property, the court will give effect to that dominant purpose or intention.[2286] The court went on to say that the difficulty in these cases lays not so much in the formulation of an approach but in the application of the principles that must necessarily guide the court.[2287] In other words, it is not a difficult matter to say that an important factor is: what was the taxpayer's intention when he bought the property? The court held that it is often very difficult, however, to discover what the taxpayer's true intention was.[2288]

In trying to ascertain the intention of the taxpayer, it is necessary to bear in mind in that the *ipse dixit* of the taxpayer as to his or her intention and purpose should not lightly be regarded as decisive, as it is the function of the court to determine on an objective review of all the relevant facts and circumstances what the motive, purpose and intention of the taxpayer was.[2289] In order to determine the motive, purpose and intention of the taxpayer, the court will consider, *inter alia*, the conduct of the taxpayer in relation to the transactions in issue, the nature of his or her business or occupation and the frequency or otherwise of his or her past involvement or participation in similar transactions.[2290] The facts in regard to those matters will form an important part of the material from

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[2281] Emslie, T. and Davis, D. (2012), 'Income Tax Cases and Materials', The Taxpayer.
[2282] *SIR v The Trust Bank of Africa Ltd* 1975 (2) SA 652 (A), 37 SATC 87.
[2283] *SIR v The Trust Bank of Africa Ltd* 1975 (2) SA 652 (A), 37 SATC 87.
[2284] *SIR v The Trust Bank of Africa Ltd* 1975 (2) SA 652 (A), 37 SATC 87.
[2285] *ITC 1185*, (1972) 35 SATC 122.
[2286] *Commissioner of Taxes v Levy* 1952 (2) SA 413 (AD) 421; and *Commissioner of Taxes v Glass* 1962 (1) SA 872 (FC) 880-881.
[2287] *ITC 1185*, (1972) 35 SATC 122.
[2288] *ITC 1185*, (1972) 35 SATC 122.
[2289] De Koker, A.P., Williams, R.C., Silke, J.M. and Silke, A.S. (2013), 'Silke tax yearbook 2012-2013', Butterworth Publishers, Durban.
[2290] *ITC 1185*, (1972) 35 SATC 122 at pages 123-124. See Croome, B.J. and Olivier, L. (2010), 'Tax Administration', Juta and Company. See also Olivier, L. (2012), 'Capital Versus Revenue: Some Guidance', De Jure, 2012, at pages 172-178. Available at www.dejure.up.ac.za/index.php/volumes/45-vol-1-2012/notes/olivier-l., accessed in June 2015.

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which the court will draw its own inferences against the background of the general human and business probabilities.[2291] This is not to say that the court will give little or no weight to what the taxpayer says his or her intention was, as it sometimes contended in argument on behalf of the Commissioner in cases of this nature.[2292] The taxpayer's evidence under oath and that of his or her witnesses must necessarily be given full consideration and the credibility of the witnesses must be assessed as in any other case that comes before the court. But direct evidence of intent and purpose must be weighed and tested against the probabilities and the inferences normally to be drawn from the established facts.[2293]

The court in *ITC 1185,* further stated that it would certainly be more difficult for one whose business it is to buy and sell properties for profit to persuade the court that, in the particular instance which was in issue, his or her intention was to make a capital investment, than it would be for one whose occupation was in no way concerned with dealing in properties and had never before bought or sold property.[2294] However, the court cautioned that just as proof that the taxpayer is normally a dealer in property is no absolute bar to establishing that a particular acquisition was made as an investment, so proof that a transaction was isolated and far removed from the taxpayer's normal business activities will not necessarily cause the court to accept that the profits of that isolated transaction must therefore be a receipt of a capital nature.[2295]

In *Barnato Holdings Ltd v Secretary for Inland Revenue* the court held that the factors which would tend to indicate that the shares in question were acquired for better or for worse, or, 'relatively speaking, for keeps' would include whether the shares were only disposed of due to some unusual, unexpected, or special circumstance, warranting or inducing the disposal.[2296] In such circumstances, the proceeds would bear the usual badge of a fixed, capital investment. The essence of fixed capital, as distinct from floating capital, is '… 'n element van permanentheid, in die sin dat daar 'n bedoeling is om dié betrokke bate min of meer permanent te hou met dié doel dat dit inkomste moet voortbring.'[2297] The purpose with which a taxpayer acquires or holds an asset is a question of fact.

In *SIR v The Trust Bank of Africa Ltd*[2298] the court held that:

[2291] *ITC 1185*, (1972) 35 SATC 122 at pages 123-124.
[2292] *ITC 1185*, (1972) 35 SATC 122 at pages 123-124.
[2293] *ITC 1185*, (1972) 35 SATC 122 at pages 123-124.
[2294] *ITC 1185*, (1972) 35 SATC 122. See Emslie, T. and Davis, D. (2012), 'Income Tax Cases and Materials', The Taxpayer.
[2295] *ITC 1185*, (1972) 35 SATC 122 at page 124.
[2296] *Barnato Holdings Ltd v SIR,* 1978 (2) SA 440 (A), 40 SATC 75.
[2297] The English translation of the Judge's Afrikaans words in this case meaning: more or less keep the asset permanently so as to produce income. See *Bloch v SIR,* 1980 (2) SA 401 (C), 42 SATC.
[2298] *SIR v The Trust Bank of Africa Ltd* 1975 (2) SA 652 (A), 37 SATC 87.

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> 'In an enquiry as to the intention with which a transaction was entered into for the purpose of the law relating to income tax, a court of law is not concerned with that kind of subjective state of mind required for the purposes of the criminal law, but rather with the purpose for which the transaction was entered into (*CIR v Paul* 1956 (3) SA 335 at 340-341). It is true that although the Special Court found that there was no evidence that the shares in question were acquired with a view to a profitable resale, it nevertheless took into account that resale was never entirely ruled out as a future possibility, given a sufficiently tempting offer, which is exactly what in fact eventually occurred. Indeed there was some evidence that the merits of the participation as a possible profitable investment were seriously considered at the relevant time and that it was a factor in the decision of the management committee. No one, however, readily buys property if he expects that he will eventually have to sell it at a loss, and the taxpayer is not required to exclude the slightest contemplation of a profitable resale of the asset (Commissioner of Taxes v Levy (1952 (2) SA 413 (AD) at 421)).'[2299]

In *Bloch v Secretary for Inland Revenue,* the court held that in order to show that a receipt was of a capital nature, the taxpayer would have to demonstrate that his dominant purpose in holding the shares was to hold them more or less permanently so as to produce income.[2300] This onus that had to be discharged was the ordinary one that is applied in civil cases, namely on a balance of probabilities.[2301] In *Commissioner for Inland Revenue v Guardian Assurance SA Ltd*, counsel for the Commissioner submitted that, as a general proposition, it was inherent in the management of any share portfolio that a measure of share dealing for profit would be involved, namely that investors in shares inherently have a profit-making intention.[2302] Shares, so the argument ran, are by their very nature risk investments which have to be reviewed from time to time. A portfolio comprising a number and variety of counters will therefore necessitate continuous review and adjustment as and when required.[2303] Consequently an investor in shares must necessarily deal in such shares and a simple intention to hold such shares indefinitely or for a long time can make no difference. Unless and until the shares are made part of the permanent structure of the investor on which its business rests and the shares are in effect taken out of its business they remain part of its floating capital.[2304] The court gave the following response to the Commissioner's argument:

> 'Neither case is authority for the proposition that a genuine investor in long-term dividend-producing shares is obliged to hold on to each and every counter in his portfolio irrespective of the fortunes - or possible demise - of the companies concerned or run the risk of being taxed as a share dealer. Indeed both cases are based on the hypothesis that there is a distinction between

[2299] *SIR v The Trust Bank of Africa Ltd* 1975 (2) SA 652 (A), 37 SATC 87 at 106.
[2300] *Bloch v SIR,* 1980 (2) SA 401 (C), 42 SATC.
[2301] *Bloch v SIR,* 1980 (2) SA 401 (C), 42 SATC.
[2302] *CIR v Guardian Assurance SA Ltd,* (1991) 2 All SA 193 (A).
[2303] *CIR v Guardian Assurance SA Ltd,* (1991) 2 All SA 193 (A).
[2304] *CIR v Guardian Assurance SA Ltd,* (1991) 2 All SA 193 (A).

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a share investor and a share dealer and both taxpayers were found to have been an amalgam, using their investments as both an income-producing capital base and at the same time as stock-in-trade for sale at a profit. … nothing in the reasoning of the learned judge can be regarded as authority for the broad proposition that the management of a wide and varied share investment portfolio, irrespective of the care and long-term investment intention with which it had been compiled, causes it to be regarded as floating capital … Neither in law nor in logic can dogged adherence to a counter or carelessness in the management of a share portfolio be posited as prerequisites for qualification as a capital investor. Prudence and foresight cannot be equated with an intention to speculate.'[2305]

Similarly, in *African Life Investment Corporation (Pty) Ltd v Commissioner for Inland Revenue* it was held that whether or not the taxpayer set out to deal in shares for profit, the varying of its many risk investments would be an inherent feature of its activities.[2306] It may be that such variations, however gainful, need not in themselves, in the case of an investment company, necessarily lead to the conclusion that resultant profits are to be regarded as income.[2307] Another factor that the courts have found to be relevant in determining the intention of the taxpayer in respect of share investments is the period for which the shares were held.[2308] In the case of *ITC 1756*, where a trust held a portfolio of shares for a period of between two to four years, it was held that the proceeds from the disposal of the shares were of a capital nature.[2309] The trustees had given written instructions that a share portfolio was to be managed with maximum growth for the beneficiaries of the trust as a priority, and that management was to be in accordance with a medium to long term philosophy (namely the purpose for which the shares were purchased was long term capital growth).[2310] The court held that the intention of the trustees when the shares were acquired showed that they set out to acquire blue chip shares as long term investments, and that the trustees had established that they had the intention of holding the shares which they acquired with a necessary element of permanence, despite the fact that the shares were sold at a handsome profit within a short period.[2311]

It is clear that the intention with which, or the purpose for which, shares were acquired is fundamental to the question whether the eventual proceeds from the disposal of the shares are of a capital or revenue nature for tax purposes.[2312] Where the shares represent a long term investment by the

[2305] *CIR v Guardian Assurance SA Ltd,* (1991) 2 All SA 193 (A) at 47.
[2306] *African Life Investment Corporation (Pty) Ltd v CIR,* 1969 (4) SA 259 (A).
[2307] *African Life Investment Corporation (Pty) Ltd v CIR,* 1969 (4) SA 259 (A) at paragraph 51.
[2308] See *ITC 1756*, (1997) 65 SATC 375.
[2309] *ITC 1756*, (1997) 65 SATC 375.
[2310] *ITC 1756*, (1997) 65 SATC 375.
[2311] *ITC 1756* (1997) 65 SATC 375. See *African Life Investment Corporation (Pty) Ltd v CIR,* 1969 (4) SA 259 (A).
[2312] Olivier, L. and Honiball, M. (2011), 'International Tax: A South African Perspective', Blue Weaver Marketing. See South African Revenue Service (SARS) (2010), 'The ABC of Capital Gains Tax For Individuals', Legal and Policy Division of SARS. Available at www.marwick.co.za/docs/ABCofCGTforIndividuals.pdf., accessed in June 2015.

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taxpayer which form part of the taxpayer's permanent income producing structure, the proceeds from their eventual disposal would be of a capital nature.[2313] However, where the shares were merely acquired in the ordinary course of the taxpayer's share dealing operations, the proceeds from their eventual disposal would be of a revenue nature. What is clear, however, is that a taxpayer needs not hold on to a share investment forever and exclude any thought of possibly selling the shares in question before the investment can be considered part of the taxpayer's fixed capital.[2314] Therefore, where a taxpayer makes a private equity investment for long term investment purposes, although the sale of the shares may be inevitable, the proceeds from the disposal of the shares at the end of the investment may be of a capital nature.

There is no definitive list of tax issues that might arise in every acquisition or divestiture of an equity stake by the private equity fund in the underlying investee company. The specific tax considerations for a transaction will depend on the particular facts and circumstances of that particular deal. Certain tax issues and terms, however, many of which are interrelated, are far more common than others. Attention should also be given to the tax consequences of future distributions of the acquired company's earnings and the ultimate disposition of the investee company or its assets. There are certain key goals that are common to most acquisition transactions. These goals should emerge from the analysis of the actual structure for the implementation of the proposed transaction. A primary issue is the basic structure of the transaction namely whether the transfer is devised as a share acquisition or an asset acquisition, and whether the transaction can be structured as a tax-free reorganisation, or if the transfer will be immediately taxable. The second issue is the stepping-up in the base cost of the assets so as to reduce the capital gains charge when the assets are subsequently disposed of by the private equity fund. Nevertheless, having concluded the discussion on the general guidelines developed by South African courts in determining whether a disposal is on capital or revenue account, it is evident that the South African tax regime so far does not provide specific tax relief to private equity funds. As mentioned earlier, this thesis does not argue for the introduction of specific tax relief for private equity funds without understanding the real impact on existing policy and the economy at large.

Venture Capital Company

The Venture Capital Company ('VCC') initiative is the only South African specific tax incentive scheme encouraging investment in unlisted companies and is regulated by section 12J of the Income Tax Act 58 of 1962. The VCC scheme was first introduced in South Africa in 2009 and this initiative provides for tax allowances or deductions to investors for expenditure incurred in acquiring equity

[2313]Olivier, L. and Honiball, M. (2011), 'International Tax: A South African Perspective', Blue Weaver Marketing. See also Emslie, T. and Davis, D. (2012), 'Income Tax Cases and Materials', The Taxpayer.
[2314]See *Commissioner of Taxes v Levy,* 1952 (2) 413 (A).

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shares in the VCC.[2315] The VCC scheme is directed at individuals, listed companies and controlled group companies of listed companies.[2316] In terms of the South African National Budget Review of 2008, limited access to equity finance by small and medium-sized businesses was identified as one of the main challenges to the growth of the small and medium sized sector of the economy.[2317] To this end, the South African Government introduced section 12J of the Income Tax Act 58 of 1962. Section 12J was inserted into the Income Tax Act 58 of 1962 by section 27(1) of the Revenue Laws Amendment Act 60 of 2008 with effect from 1st July 2009. The section was substantially amended by the Taxation Laws Amendment Act 24 of 2011, with most of the amendments applying to years of assessment commencing on or after 1st January 2012.[2318] The VCC regime is subject to a twelve year sunset clause and thus will end on 30th June 2021. This will allow for review of the efficacy of VCC regime and a decision will then be made by the South African Government as to whether it should be continued.[2319] In terms of section 12J(11) no deduction will be granted under section 12J for VCC shares acquired after 30th June 2021.[2320]

In terms of the VCC regime, individuals can deduct up to R750 000 per investment in the year of assessment in which the VCC qualifying shares are issued, with an aggregate lifetime limit of R2,25 million.[2321] A listed company and its controlled group companies are not subject to a limit, but the VCC shares held by that company or within its group may not constitute more than forty percent of the VCC's equity shares. A VCC must (i) have management of investments in qualifying companies as its sole objective; (ii) be unlisted; (iii) be tax resident in South Africa; and (iv) not control any qualifying companies in which it holds shares.[2322] The South African Revenue Service ('SARS') must approve a company as a VCC and the VCC must submit annual returns to SARS in the prescribed form.

[2315] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 8.8, at pages 195-198.
[2316] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 8.8, at pages 195-198.
[2317] See South African Revenue Service (SARS) (2012), 'External Guide: Venture Capital Companies', Effective date of 1st November 2012, GEN-REG-48-G01, Revision 4. Available at www.sars.gov.za/AllDocs/OpsDocs/Guides/GEN-REG-48-G01., accessed in June 2015.
[2318] South African Revenue Services ('SARS') (2014), 'Interpretation Note No: 43 on the Income Tax Act 58 of 1962', 17th February 2014 at page 12.
[2319] See South African Revenue Service (SARS) (2012), 'External Guide: Venture Capital Companies', Effective date of 1st November 2012, GEN-REG-48-G01, Revision 4. Available at www.sars.gov.za/AllDocs/OpsDocs/Guides/GEN-REG-48-G01., accessed in June 2015.
[2320] South African Revenue Services ('SARS') (2014), 'Interpretation Note No: 43 on the Income Tax Act 58 of 1962', 17th February 2014 at page 13.
[2321] See South African Revenue Service (SARS) (2012), 'External Guide: Venture Capital Companies', Effective date of 1st November 2012, GEN-REG-48-G01, Revision 4. Available at www.sars.gov.za/AllDocs/OpsDocs/Guides/GEN-REG-48-G01., accessed in June 2015.
[2322] See South African Revenue Service (SARS) (2012), 'External Guide: Venture Capital Companies', Effective date of 1st November 2012, GEN-REG-48-G01, Revision 4. Available at www.sars.gov.za/AllDocs/OpsDocs/Guides/GEN-REG-48-G01., accessed in June 2015.

In terms of the South African National Budget Review of 2014, the South African Government announced that it would propose one or more of the following amendments to the VCC regime, namely (i) making tax deductions permanent if investments in the VCC are held for a certain period of time; (ii) allowing transferability of tax benefits when investors dispose of their VCC holdings; (iii) increasing the total asset limit for qualifying investee companies, namely that companies in which the VCC may invest, from R20 million to R50 million, and from R300 million to R500 million in the case of junior mining companies; and (iv) waiving capital gains tax on the disposal of assets by the VCC, and expanding the permitted business forms.[2323] The reasons for the aforementioned proposals were based on the fact that since the VCC tax incentive took effect from 1st July 2009, the uptake for this tax incentive scheme has been limited.[2324]

A VCC is a company that provides individual and corporate investors with access to a wide range of trading companies which have the potential for growth.[2325] The VCC raises funds by issuing equity shares to investors and the capital raised is then used to invest in such wide ranging trading companies which have the potential for growth.[2326] VCCs are taxed in the following way (i) capital gains on qualifying investments disposed of by the VCC were taxable but became exempt after the first proposal mentioned in the Budget Review of 2014 was implemented;[2327] (ii) dividends received from the companies making up the portfolio are exempt from dividends tax; and (iii) interest income is taxable. VCCs are subject to 18,6 percent capital gains tax on shares sold by the VCC and should capital gains tax be removed at the VCC level then investor returns will improve by 18,6 percent. An investor that subscribes for VCC shares receives an immediate tax deduction equal to 100 percent of the amount invested with no annual limit or lifetime limit.[2328] The relief is available provided that the investor subscribes for equity shares, as opposed to buying them from other investors. The deduction under section 12J(2) read with section 12J(3), (3A) and (4) of the Income Tax Act 58 of 1962 covers only the acquisition of newly issued shares, in other words the deduction does not apply to secondary trading in VCC shares.[2329] The upfront income tax relief reduces the cost of the investment, which in turn would imply that overall returns should be higher.[2330] The upfront income

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[2323]Department National Treasury Republic of South Africa (2014), 'Budget Review 2014', 26th February 2014, Chapter 4: Revenue Trends and Tax Proposals, at pages 51-52.
[2324]Department National Treasury Republic of South Africa (2014), 'Budget Review 2014', 26th February 2014, Chapter 4: Revenue Trends and Tax Proposals, at pages 51-52.
[2325]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 8.8, at pages 195-198.
[2326]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 8.8, at pages 195-198.
[2327]See Department National Treasury Republic of South Africa (2014), 'Budget Review 2014', 26th February 2014, Chapter 4: Revenue Trends and Tax Proposals, at pages 51-52.
[2328]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 8.8, at pages 195-198.
[2329]South African Revenue Services ('SARS') (2014), 'Interpretation Note No: 43 on the Income Tax Act 58 of 1962', 17th February 2014, at page 13.
[2330]For instance, say a VCC shares are priced at R10, therefore such shares effectively only cost R6 after tax relief for individual investors or R7,20 where the investor is a company. In addition, the VCC shares only needs to increase by R2 or R4,40 where the investor is a company and the investor's investment in the VVC would

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tax relief is temporary because in terms of the current VCC tax rules, the taxable recoupment of the section 12J deduction is provided for if the investor disposes of the VCC shares and recovers the previous deduction.[2331]

As mentioned above, in terms of the South African National Budget Review of 2014 the proposal was considered and subsequently implemented making the deduction permanent if the VCC shares are held for a certain period of time.[2332] In terms of the four 2014 Budget Review proposals mentioned above, the first and the third proposals were implemented as legislation.[2333] The VCC tax regime also provides for dividends tax relief, whereby VCC shares are subject to a fifteen percent dividends tax unless the investor qualifies for an existing dividend tax exemption. For instance, investors which are South African resident companies will enjoy the company-to-company dividend tax exemption.[2334] The tax schemes discussed previously with regard to Canada and particular Australia offered capital gains tax relief to an investor, however the VCC scheme offers no capital gains tax relief. In terms of the VCC scheme capital gains tax is payable when investors sell their VCC shares at the rate applicable to the relevant investor.[2335] In addition, there is no reinvestment relief afforded to investors, unlike those for example provided for under the closed-ended Collective Investment Vehicles ('CIVs') and Venture Capital Limited Partnership ('VCLP') regimes in Australia and the Income Tax Act 58 of 1962 with regard to unit trusts operating under Collective Investment Schemes Control Act 45 of 2002 (discussed further below). It is therefore not possible for an investor to defer the gain on another investment by applying the sale proceeds to subscribe for VCC shares.[2336] For instance, an investor that sells shares with the intention to reinvest the proceeds of such sale in VCC shares will be subject to capital gains tax on the gain realised on the sale of such shares. The VCC scheme does however offer tax relief for capital losses on the disposal of VCC shares which can be offset against an investor's capital gains. However, it is not possible to offset capital losses against the investors' income.[2337]

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have doubled. On the other hand, the VCC shares only need to drop by at least R4 or R2,80 where the investor is a company before a loss is incurred.

[2331]See South African Revenue Services ('SARS') (2014), 'Interpretation Note No: 43 on the Income Tax Act 58 of 1962', 17th February 2014, at pages 12-13.

[2332]Department National Treasury Republic of South Africa (2014), 'Budget Review 2014', 26th February 2014, Chapter 4: Revenue Trends and Tax Proposals, at pages 51-52.

[2333]Department National Treasury Republic of South Africa (2016), 'Budget Review 2016', February 2016. In terms of the South African National Budget Review of 2014, the South African Government announced that it would propose one or more of the following amendments to the VCC regime, namely (i) making deductions permanent if investments are held for a certain period of time; (ii) allowing transferability of tax benefits when investors dispose of their holdings; (iii) increasing the total asset limit for qualifying investee companies from R20-million to R50-million, and from R30- million to R500-million in the case of junior mining companies; (iv) waiving capital gains tax on the disposal of assets, and expanding the permitted business forms.

[2334]South African Revenue Services ('SARS') (2014), 'Interpretation Note No: 43 on the Income Tax Act 58 of 1962', 17th February 2014.

[2335]It is 18.6% for corporate investors; 26.6% for investors which are trusts. It is 13.3% for individual investors.

[2336]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 8.8, at pages 195-198.

[2337]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 8.8, at pages 195-198.

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It is widely accepted the VCC regime was primarily introduced by South African policy makers to increase the amount of funding for small to medium sized high growth companies in South Africa.[2338] The generous tax credits offered to VCC investors as an incentive to invest is and will be at a significant cost to ordinary South African taxpayers. Common sense will dictate that South Africans who are investing in VCCs are doing so not because they provide a high rate of return or because they are investing in South African companies, but rather to receive generous tax credits. It is submitted that the VCC scheme is an inferior way to organize a private equity fund in South Africa for several reasons. Firstly, VCC are constrained as to the size and nature of their investments in any given investee company. Furthermore, they must invest a certain percentage of the funds they raise within a period of time regardless of economic conditions. These financial restrictions, as well as investment time limits, can lead to pressure on VCC managers to invest in businesses regardless of market conditions, and can result in investments in inferior investee companies.[2339] Furthermore, as mentioned above, only individuals and companies are permitted to invest in VCCs. This differs from the majority of private equity funds that receive significant funding from institutional investors such as pension funds. In addition, part of the VCCs mandate is that they can accept much smaller investments than conventional private equity funds which would result in VCCs having many shareholders each holding a small portion of the fund. Also VCC managers typically contract out investment management services to other professional managers as opposed to operating the VCC themselves, unlike a typical private equity fund where the private equity fund manager forms an integral part of the day-to-day management of the fund. This 'abstract' relationship between investors and fund managers in the VCC structure creates a lack of accountability to investors.[2340] This is exacerbated by the large number of small investors making small investments in the VCC who have no real motive to actively monitor or take action against fund managers of VCCs.[2341] According to Cumming and MacIntosh:

> 'the atomization of share ownership sacrifices most if not all of these benefits, since collective action and free rider problems ensure that few if any shareholders have the appropriate incentives to monitor or discipline fund managers.'[2342]

In other words, people who invest a small amount in a VCC will be less likely to effectively express dissatisfaction with fund managers than an investor in a private limited partnership for instance, who

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[2338]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 8.8, at pages 195-198.
[2339]See Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', 2nd Edition, Elsevier Inc., at paragraph 9.6.3.
[2340]For example for poor performance.
[2341]Johan, S., Schweizer, D. and Zhan, F. (2014), 'The Changing Latitude: Labor-Sponsored Venture Capital Corporations in Canada', Corporate Governance: An International Review, 22(2), pages 145-161.
[2342]Cumming, D.J. and MacIntosh, J.G. (2006), 'Crowding Out Private Equity: Canadian Evidence', Journal of Business Venturing, 21(5), at page 582.

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invests a larger amount and has a more direct relationship with the fund manager.[2343] As a result, VCC fund managers have less incentive to perform well than do managers of private equity funds.[2344] Another way to think about the issue is to postulate the view that VCCs in South Africa will impede the ability of fund managers to operate effectively as managers of private equity funds that do not have the same regulations in South Africa.[2345] VCCs could have a negative impact on the local private equity industry's development because it impedes more effective private equity funds and this could even result in a reversal of the intended South African Government objective by lowering the level of capital available for South African investee companies. If South African policymakers wish to improve South Africa's private equity market, characterised by more funds raised and more investee companies securing funding, they should eliminate VCCs by making room for more effective private equity funds.

(f) Analysis

As mentioned above, collective investment schemes in South Africa offer several benefits compared to other investment vehicles. By amending CISCA, the 'private equity CIS' will enjoy certain exemptions with regard to paying capital gains tax. The CIS investors will only incur capital gains tax (once) when they sell their units in a CIS.[2346] In terms of CISCA, when a portfolio manager restructures a CIS portfolio, that is sells an underlying share or bond in adherence to its mandate, capital gains tax will not be incurred.[2347] Currently, a private equity fund (either trust or partnership), in comparison, will not be as tax effective. They will sustain a capital gains tax cost every time a transaction in the portfolio is realised, which could occur many times over the lifetime of a fund. Having capital gains tax paid outside of the CIS means that CIS portfolio managers can focus on their core business of managing an investment portfolio according to a mandate, rather than being distracted by tax issues. This could result in more focused and better investment performance. The

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[2343]Cumming, D.J. and MacIntosh, J.G. (2006), 'Crowding Out Private Equity: Canadian Evidence', Journal of Business Venturing, 21(5), at page 582.

[2344]Cumming, D.J. and MacIntosh, J.G. (2006), 'Crowding Out Private Equity: Canadian Evidence', Journal of Business Venturing, 21(5), at pages 569-609.

[2345]Hypothetical Scenario: VCC tax credits to a degree substitute for a rate of return and with part of the VCCs rate of return provided by tax credits, the VCC managers can pay more for an investment than a conventional private equity fund (namely a non-VCC) while still meeting the VCC required rate of return. Therefore VCCs can execute transactions they would perhaps otherwise not be able to acquire. At the same time the VCC can pay more for a financing deal which implies that a VCC can acquire interest in investee companies that could have been financed by a private equity fund (namely a non-VCC). As a consequence the returns to private equity funds could be lower which makes such funds less attractive for potential investors that would have otherwise invested in such private equity fund. See Cumming, D.J. and MacIntosh, J.G. (2006), 'Crowding Out Private Equity: Canadian Evidence', Journal of Business Venturing, 21(5), at pages 569-609.

[2346]See De Koker, A.P., Williams, R.C., Silke, J.M. and Silke, A.S. (2013), 'Silke tax yearbook 2012-2013', Butterworth Publishers, Durban.

[2347]See Department of National Treasury of the South African Government (2013), 'Explanatory Memorandum on the Taxation Laws Amendment Bill of 2013', 24th October, Pretoria, South Africa.

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capital gains tax rate applicable to CIS investors could be as low as 4.5 percent depending on the investor's marginal tax rate, or as high as 10.5 percent, which is on par with shares.[2348] The CIS investors are empowered to decide when to become liable for capital gains tax, allowing them to defer tax and to plan their investments appropriately. In addition, capital gains tax policy for CISs is transparent because investors will know when capital gains tax is incurred.[2349] Finally, capital gains tax policy is in line with the objective of a CIS as a medium to long term savings and investment vehicle and should encourage CIS investors to treat them as such.[2350]

Tax treatment of CIS as provided for in the Income Tax Act 58 of 1962 was amended so that it now applies to specific CIS in Securities.[2351] Included in the definition of a 'company' in section 1 of the Income Tax Act 58 of 1962 is any 'portfolio comprised in any collective investment in securities …., managed or carried on by any company registered as a manager under section 42 of the Act….'. Thus, in order to be treated as a company under paragraph (e)(i) of the above definition in the Income Tax Act 58 of 1962, an investment fund would need to fall within the definition of a CIS in Securities as contained in the CISCA, and the fund manager would have to be registered under the CISCA.[2352] There is no provision in the Income Tax Act 58 of 1962 that realisation gains derived by CISs from the disposal of share investments are of a capital nature. Paragraph 61 of the Eighth Schedule to the Income Tax Act 58 of 1962 provides that 'a portfolio in a collective investment scheme contemplated in paragraph (e)(i) of the definition of company in section 1, must disregard any capital gain or capital loss'. Accordingly, paragraph 61 merely provides that CISs and other CIS in Securities must disregard any capital gains or losses realised by the schemes.[2353] Before the exclusion can apply, it must firstly be established that the gains or losses realised by the scheme are of a capital nature.[2354] If general case law guidelines on the distinction between capital and revenue gains were to be applied strictly to the realisation gains derived by CISs, it would be difficult to justify the capital nature of such proceeds. More so because of the fact that CISs deal much more aggressively and frequently in their portfolios than private equity funds or the other investors considered in this document. There is no indication that share investments held by CISs are held 'for keeps'. The CISs generally dispose of their share investments on a regular basis, while pursuing maximum growth

[2348]See Organisation for Economic Co-Operation and Development ('OECD') (2012), 'Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Review: South Africa 2012, Combined: Phase 1 + Phase 2, OECD Publishing, October 2012 (Reflecting the legal and regulatory framework as at June, 2012).
[2349]De Koker, A.P., Williams, R.C., Silke, J.M. and Silke, A.S. (2013), 'Silke tax yearbook 2012-2013', Butterworth Publishers, Durban.
[2350]See Department of National Treasury of the South African Government (2013), 'Explanatory Memorandum on the Taxation Laws Amendment Bill of 2013', 24th October, Pretoria, South Africa.
[2351]In terms of the Taxation Laws Amendment Act, 17 of 2009.
[2352]See De Koker, A.P., Williams, R.C., Silke, J.M. and Silke, A.S. (2013), 'Silke tax yearbook 2012-2013', Butterworth Publishers, Durban.
[2353]See South African Revenue Services ('SARS') (2009), 'Binding Private Ruling: BPR 031 of the Income Tax Act 58 of 1962', 29th May 2009, issued by Legal and Policy Division: Advance Tax Rulings of SARS.
[2354]See South African Revenue Services ('SARS') (2009), 'Binding Private Ruling: BPR 031 of the Income Tax Act 58 of 1962', 29th May 2009, issued by Legal and Policy Division: Advance Tax Rulings of SARS.

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and not dividend yields for the unit holders. Despite this, in terms of SARS practice realisation gains from the disposal of share investments by CISs are not taxed as revenue gains in the CIS's hands, but treated as gains of a capital nature.[2355]

As mentioned above, paragraph 61 of the Eighth Schedule of the Income Tax Act 58 of 1962 provides for the exclusion for CISs from capital gains tax. However, before the realisation gains of a CIS can qualify for this exclusion, it must be established that those gains are of a capital nature in terms of general case law.[2356] The existence of the exclusion is confirmation of SARS' practice of treating realisation gains by CISs as being of a capital nature, despite their frequent trading activities. A collective investment scheme in shares is an investment vehicle operating on behalf of portfolio unit holders. Although technically treated as a company for Income Tax purposes, a number of rules exist to ensure that the collective investment scheme is effectively free from tax at the collective investment scheme level. When receiving ordinary revenue, the amount received by the collective investment scheme will be exempt from income tax as long as the collective investment scheme distributes that amount, with the generic trust deed requiring the distribution to occur within twelve months of receipt.[2357] Capital gains of the collective investment scheme are simply exempt (and are in practice, not distributed). Portfolio unit holders of a collective investment scheme are generally viewed as receiving taxable dividends when the collective investment scheme distributes ordinary revenue to those unit holders.[2358] The unit holders also receive capital gains when disposing of those units to other parties, or when surrendering those units back to the collective investment scheme if the collective investment scheme is distributing capital growth in exchange.[2359]

In terms of the analysis of the key issues in South Africa and lessons learned from international experience, the following policy consideration is submitted. This being: the establishment of an appropriate legal and regulatory framework for a local private equity investment vehicle to be regulated under the existing Collective Investment Schemes Control Act 45 of 2002 ('CISCA'). CISCA should be amended to include the passage of a new law that sets a framework for private equity investing. Such an amendment should generally establish, as a minimum, a definition of an appropriate investment vehicle that serves as a tax pass-through so that only the investor is subject to the assessment of taxes. The proposed new flow through, closed-ended collective investment vehicle ('CIV') will be a South African domiciled onshore private equity vehicle, intended for

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[2355]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.
[2356]Olivier, L. and Honiball, M. (2011), 'International Tax: A South African Perspective', Blue Weaver Marketing.
[2357]See South African Revenue Services ('SARS') (2009), 'Binding Private Ruling: BPR 031 of the Income Tax Act 58 of 1962', 29th May 2009, issued by Legal and Policy Division: Advance Tax Rulings of SARS.
[2358]See South African Revenue Services ('SARS') (2009), 'Binding Private Ruling: BPR 031 of the Income Tax Act 58 of 1962', 29th May 2009, issued by Legal and Policy Division: Advance Tax Rulings of SARS.
[2359]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023. See also Olivier, L. and Honiball, M. (2011), 'International Tax: A South African Perspective', Blue Weaver Marketing.

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investment by resident and non-resident investors. The definition of the collective investment vehicle should encompass *en commandite* partnerships and *bewind* trusts and any future vehicle which meets the criteria, irrespective of whether it is aimed at larger and/or smaller private equity transactions.

Whereas the current CISCA defines a collective investment scheme in terms of Section 1, as having to be an '…open-ended… vehicle…' the proposal is that the definition should also include 'closed-ended' vehicles. This is because investment vehicles such as private equity funds are fairly illiquid, and internationally mutual funds that hold illiquid assets are structured as closed-ended vehicles.[2360] For example, property and private equity funds structured as collective investment schemes are typically all closed-ended. Very similar to Australian private equity funds structured as closed-ended collective investment vehicles regulated in terms of the Australian Corporations Act of 2001.

CISCA should be amended to accommodate private equity vehicles because of its favourable treatment of capital gains tax in favour of investors. Investors in private equity funds structured as *bewind* trusts or *en commandite* partnerships in South Africa currently do not enjoy the same favourable capital gains tax advantages enjoyed by collective investment schemes ('CIS') under CISCA.[2361] In addition, CISCA offers investors and unit holders various protections not available to current local private equity investors.[2362] The benefits enjoyed by CIS investors with regard to capital gains tax and unit holder protection should be extended as far as practically possible to the traditional self-liquidating, closed-end, third party private equity funds. The reform should include the deferment of taxes on investors until a distribution is made by the fund, as well as the establishment of a regulatory framework directed toward investment by qualified retail and institutional investors.[2363] Where the private equity is limited to such investors, the regulatory regime can be focused on adequate disclosure rather than on detailed substantive regulation.

The proposal in this instance is not for a listed closed-end private equity vehicle, but an unlisted one. CISCA should be amended to make provision for the establishment of a closed-ended, unlisted, tax transparent private equity vehicle that is subject to an indirect tax regime. In brief, the salient features of such a vehicle would be: a closed-ended fund which would consist of a limited number of units, because of the private equity vehicle or fund's initial fixed capitalisation (open-end funds are constantly redeeming and issuing new units); the fund manager does not need to worry about ill-

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[2360]See Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', 2nd Edition, Elsevier Inc.

[2361]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.

[2362]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.

[2363]South African Revenue Services ('SARS') (2009), 'Binding Class Ruling: BCR 004 of the Income Tax Act 58 of 1962', 14th May 2009, issued by Legal and Policy Division: Advance Tax Rulings of SARS.

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timed redemptions; and is never under pressure to sell investments in order to raise cash for redemptions. In addition, a closed-end fund does not redeem its units, except at termination of the fund.[2364] In a weak market, the fund manager of an open-ended fund is often forced to sell shares at low prices in order to raise cash for redemptions. A manager of a closed-end fund can also buy into relatively illiquid assets because the fund is free of the redemption pressures that could force it to liquidate in an unfavourable environment.[2365]

It is submitted that the proposed closed-end unlisted collective investment vehicle to be regulated under CISCA must contain the following minimum features, namely allow flow through; complete transparency, including flow through of losses, so that there are equivalent tax results for direct investment and indirect investment through the collective investment vehicle; the regime should allow legal entities of different types to elect, irrevocably, to be collective investment vehicles; the new regime should have a specific designation that can be easily incorporated into future Double Tax Agreement negotiations; and allow accumulation and reinvestment for all investors. In addition 'private equity CIS' will enjoy certain exemptions with regard to paying capital gains tax, in that CIS investors will only incur capital gains tax (once) when they sell their units in the 'private equity CIS'.

A counter policy argument to this proposal could centre on one crucial question;[2366] namely, do private equity firms that manage private equity funds merely act as investors or do they manage the underlying portfolio investee companies they acquire on behalf of the private equity funds in order to generate profits for the private equity firm? For instance, private equity firms make the legal argument that they only invest, but their marketing material more than often state that they actively intervene in the management of distressed investee companies before on selling (exiting) them at a profit. This counter proposal would be premised on the argument that these private equity firms earn their profits in the course of a trade or business.[2367] Thus, as with any company that makes a profit as part of its trade or business, its returns should be taxed as ordinary income. This counter argument to the CISCA proposal would thus be that private equity firms compensation (carried interest) should not be treated as capital gains, but rather be taxed at the higher ordinary income rate. This provoking policy argument would imply that the returns to private equity funds, as well as the private equity firms (carried interest) are already ordinary income under current South African law; which furthermore means that SARS and the South African tax courts have been incorrect all this time to the benefit of private equity funds, private equity firms and ultimately its investors. Nevertheless, the general argument throughout is that private equity funds and the private equity firms are long term

[2364]Department of National Treasury of the South African Government (2013), 'Explanatory Memorandum on the Taxation Laws Amendment Bill of 2013', 24th October, Pretoria, South Africa.
[2365]Department of National Treasury of the South African Government (2013), 'Explanatory Memorandum on the Taxation Laws Amendment Bill of 2013', 24th October, Pretoria, South Africa.
[2366]The proposal for the amendment of CISCA to accommodate private equity vehicles is because of CISCA's favourable treatment of capital gains tax in favour of investors.
[2367]Acquiring distressed or start-up companies, improving their management then on selling them at a profit.

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investors and not managers of the underlying portfolio investee companies they acquire on behalf of private equity funds, therefore the profits they generate should continue to be treated at the lower of capital gains rates.

The next paragraph 2.2 will discuss the taxation of share options in the US, Canada, Australia, UK and South Africa. The taxation of share options is an important tax consideration particularly when used as an incentive mechanism in underlying portfolio investee companies. The discussion to follow is aimed at analysing how the above mentioned jurisdictions have addressed the taxation of share options with regard to their respective private equity industries in a manner which could be beneficial to South African law.

2.2 Taxation of Share Options in Investee Companies

(a) United States ('US')

A private equity investment in an underlying portfolio company could typically involve a share incentive scheme offered by the investee company to its managers. As mentioned earlier in this chapter, Lerner *et al* stated that the Stock Options Law of 1981 has had a wide-ranging effect on the US private equity industry.[2368] The latter piece of legislation provided that taxes on share options are to be paid when shares are sold, instead of when the options were exercised. Tax structuring alternatives may be available to partially mitigate the amount of capital gains tax in this regard. In the US, share options are taxed at capital gains rates when the shares are sold if certain requirements are met.[2369] No tax is due when they are exercised and therefore the issuer is not entitled to a tax deduction. To achieve capital gains treatment, the shares must be held for both two years following the share options' grant date; and one year after the share option is exercised by the manager.[2370]

A Section 83(b) election in the US would for example be a situation where a portfolio company grant managers profit interests in the company in exchange for performing services for the company.[2371] Profit interests represent the right to a share of the company's future profits and are treated as capital gains at the level of the manager, to the extent that the underlying income is a capital gain.[2372] When

[2368] Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', 5th Edition, Wiley and Sons. In terms of Economic Recovery Tax Act of 1981. The Economic Recovery Tax Act of 1981 provides special tax treatment for certain employee options with the introduction of 'incentive stock options' into the US Internal Revenue Code.

[2369] Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', 5th Edition, Wiley and Sons.

[2370] Marples, D. (2014), 'Taxation of Hedge Fund and Private Equity Managers', Congressional Research Service, RS22689, 7th March 2014. Available at www.crs.gov, accessed in June 2015.

[2371] US Code: Title 26 of the Internal Revenue Code, Subtitle A, Chapter 1, Subchapter B, Part II, Section 83 that relates to property transferred in connection with performance of services.

[2372] Marples, D. (2014), 'Taxation of Hedge Fund and Private Equity Managers', Congressional Research Service, RS22689, 7th March 2014. Available at www.crs.gov, accessed in June 2015.

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the portfolio company is sold the gain is treated as capital gains at the level of the manager. However, it must be noted that this differs from ordinary income from the exercise of non-qualified share options or the vesting of restricted shares without a section 83(b) election.[2373] A section 83(b) election is a tax election to include in the taxpayers' income the fair market value of property he/she have received in connection with the performance of services which he/she may not get to keep.[2374] Generally, under the tax code, if the taxpayer receives property in connection with the performance of services that he/she may not get to keep, and which he/she cannot transfer, then he/she does not have to take the fair market value of that property into income until it is determined that he/she will either get to keep it, or the property becomes transferable.[2375] Section 83(b) also provides an opportunity to elect to be taxed at the time of the receipt of the property instead of waiting for the property to become transferable or is no longer subject to a risk of forfeiture.[2376]

For instance, a startup company's founder is issued founders' shares that are subject to a company repurchase at the shares cost, but the repurchase right lapses over a service based lapsing period.[2377] Basically this is the company allowing its founders to purchase equity in the company as a way of incentivising them to use their best efforts to grow and expand the business. This founder has received shares, but because the shares are subject to a substantial risk of forfeiture, the founder does not have to pay tax on his receipt of the shares until it vests.[2378] However, the founder may prefer to make a Section 83(b) election to pay tax on the value of the shares today because its value is lower than it is expected to be when it vests or because the founder paid full value for it today, so the Section 83(b) election costs him no additional tax today.[2379] The making of the Section 83(b) election also starts the founder's capital gains holding period.[2380]

It is a common misconception, but a Section 83(b) election generally cannot be made with respect to the receipt of a private company share option.[2381] The option must first be exercised and the shares acquired before a Section 83(b) election can be made, and the taxpayer would only make a Section 83(b) election in that instance if the taxpayer exercised the option and

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[2373]Section 83(b) election of the US Internal Revenue Code. US Code: Title 26 of the Internal Revenue Code, Subtitle A, Chapter 1, Subchapter B, Part II, Section 83 relates to property transferred in connection with performance of services.
[2374]US Code: Title 26 of the Internal Revenue Code, Subtitle A, Chapter 1, Subchapter B, Part II, Section 83 deals with shares transferred in connection with performance of services.
[2375]US Code: Title 26 of the Internal Revenue Code, Subtitle A, Chapter 1, Subchapter B, Part II.
[2376]US Code: Title 26 of the Internal Revenue Code, Subtitle A, Chapter 1, Subchapter B, Part II.
[2377]See Schenk, D.H. (2014), 'Federal Taxation of S Corporations', Law Journal Press, at pages 3-44.
[2378]See Schenk, D.H. (2014), 'Federal Taxation of S Corporations', Law Journal Press, at pages 3-44.
[2379]See Schenk, D.H. (2014), 'Federal Taxation of S Corporations', Law Journal Press, at pages 3-44.
[2380]Marples, D. (2014), 'Taxation of Hedge Fund and Private Equity Managers', Congressional Research Service, RS22689, 7th March 2014. Available at www.crs.gov, accessed in June 2015.
[2381]See generally, Swartz, L.Z. (2012), 'A Layman's Guide to LLC Incentive Compensation', Cadwalader, Wickersham and Taft LLP, article last updated, 25th July 2012. Available at www.mondaq.com/unitedstates/x/188646/tax+authorities/A+Laymans+Guide+To+LLC+Incentive+Compensation., accessed in June 2015.

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acquired unvested shares (if the shares acquired on exercise of the share option was vested, there would be no reason to make a Section 83(b) election).[2382] Another common misconception is that Section 83 does not apply to restricted shares that are purchased at fair market value.[2383] Section 83 applies even to shares that have been purchased at fair market value, if the shares are subject to a substantial risk of forfeiture and received in connection with the performance of services.[2384] In *Alves v Commissioner of Inland Revenue,* the appellant taxpayers, a husband and wife, sought a review of a tax court decision sustaining a US federal income tax deficiency finding.[2385] The issue was section 83 which required that an employee who purchased restricted shares in connection with his performance of services must include as ordinary income the share's appreciation in value between the time of purchase and the time the restrictions lapse, unless at the time of purchase he elected to include as income the difference between the purchase price and the fair market value.[2386] The appellant husband, who paid full market value for the shares, argued that the purchase was not in connection with services, and that the statute should not apply where full market price was paid. The court affirmed the decision, holding that the statute's language and history dictated its application.[2387] To avoid the tax on appreciation, the taxpayer was required to elect in the year of purchase.[2388]

The legal issue the court had to decide was whether the taxpayer had to pay the appreciation value of the shares when he paid full market value at the time he originally purchased or when it became unrestricted? The legal rule was that Section 83, which required an employee who purchased restricted shares in connection with performance of services to include the shares' appreciation as ordinary income, applied even where the employee paid full market value for the shares. The court ruled against the appellant taxpayers.[2389] The court held that Section 83, which required an employee who purchased restricted shares in connection with performance of services to include the shares' appreciation as ordinary income, applied even where the employee paid full market value for the shares.[2390]

(b) United Kingdom ('UK')

[2382] Sheinfeld, M.M., Witt, F.T., and Hyman, M.B. (2013), 'Collier on Bankruptcy Taxation', 15th edition, LexisNexis, ISBN 1579111084, 9781579111083.
[2383] Restricted stock or shares in terms of US law are shares that have been granted to an employee that is non-transferable and subject to forfeiture under certain conditions, such as termination of employment or failure to meet either corporate or personal performance benchmarks.
[2384] Sheinfeld, M.M., Witt, F.T., and Hyman, M.B. (2013), 'Collier on Bankruptcy Taxation', 15th edition, LexisNexis, ISBN 1579111084, 9781579111083.
[2385] *Alves v Commissioner of Inland Revenue*, 79, T.C. 864 (1982), 13.03 (A)(1), 13.04 (E).
[2386] *Alves v Commissioner of Inland Revenue*, 79, T.C. 864 (1982), 13.03 (A)(1), 13.04 (E).
[2387] *Alves v Commissioner of Inland Revenue*, 79, T.C. 864 (1982), 13.03 (A)(1), 13.04 (E).
[2388] *Alves v Commissioner of Inland Revenue*, 79, T.C. 864 (1982), 13.03 (A)(1), 13.04 (E). See *Shulman v Commissioner of Inland Revenue*, 93, US Tax Court, 623, (1989). The court held that section 83 governs the issuance of an option to acquire a partnership interest as compensation for services provided as an employee.
[2389] *Alves v Commissioner of Inland Revenue*, 79, T.C. 864 (1982), 13.03 (A)(1), 13.04 (E).
[2390] *Alves v Commissioner of Inland Revenue*, 79, T.C. 864 (1982), 13.03 (A)(1), 13.04 (E).

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Founders and employees may be incentivised in a number of ways. Generally speaking, management in UK companies can be incentivised *inter alia* by way of the granting shares or options to acquire shares.[2391] The area of employee shares schemes in the UK are complex and far reaching and a detailed discussion thereof falls beyond the scope of this discussion. Broadly speaking, certain employee share schemes are either regulated by UK legislation and others are not. The main difference is that employees do not usually pay income tax when they acquire shares under a regulated scheme.[2392] In the UK, where regulated employee share plans apply, the employee taxpayer is generally treated for capital gains purposes as acquiring the applicable shares at the date when he/she exercised the option.[2393] The basic principle is that the employee will only be taxed on the growth in share value when he/she disposes of the shares, and at that stage, under the capital gains tax regime.[2394] However, this will be subject to all conditions set out in the relevant UK tax legislation having been fulfilled.

UK Government regulated statutory schemes can be categorised into three broad types. The main statutory scheme where shares can be offered free is the Share Incentive Plan ('SIP'), under which shares must be offered, with certain exceptions, to the entire workforce. Employees' shares are held in a special employee trust.[2395] Beneficial tax treatment is available if the shares are held in trust for three years and the value of the shares will be free of all taxes if the shares are held for at least five years. This is in line with the UK Government's policy objective of encouraging employers to offer incentives linked to share price performance over the medium term and not as a short term substitute for taxable salary.[2396] A second type of statutory scheme allows employees to receive the opportunity to purchase shares on favourable terms through the SIP using gross employment income.[2397] In this instance, shares are bought for the current market value but the company can offer one or two free shares for each share bought.[2398] The third category of regulated share plan statutory schemes consist of three employee share option schemes, namely the Enterprise Management Incentive

[2391]Rayney, P. (2013), 'Tax Planning for Family and Owner-Managed Companies 2013/14', Bloomsbury Publishing Plc.
[2392]Sinclair, W. And Lipkin, E.B. (2013), 'St. James's Place Tax Guide 2013-2014', 42nd Edition.
[2393]Sinclair, W. And Lipkin, E.B. (2013), 'St. James's Place Tax Guide 2013-2014', Forty Second Edition, St. James's Place Wealth Management.
[2394]Sinclair, W. And Lipkin, E.B. (2013), 'St. James's Place Tax Guide 2013-2014', 42nd Edition.
[2395]See HM Revenue and Customs (2014), 'ESSUM40100 to ESSUM48000: Company Share Option Plan (CSOP)', HM Revenue and Customs. Available at www.hmrc.gov.uk/manuals/essum/ESSUM40000.htm, accessed in June 2015.
[2396]See HM Revenue and Customs (2014), 'ESSUM40100 to ESSUM48000: Company Share Option Plan (CSOP)', HM Revenue and Customs.
[2397]See HM Revenue and Customs (2014), 'ESSUM40100 to ESSUM48000: Company Share Option Plan (CSOP)', HM Revenue and Customs.
[2398]Rayney, P. (2013), 'Tax Planning for Family and Owner-Managed Companies 2013/14', Bloomsbury Publishing Plc.

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('EMI') option scheme, the Company Share Option Plan ('CSOP')[2399] and Save-As-You-Earn ('SAYE') option scheme.[2400] In terms of these three broad categories of employee share plans the general rule is that there is no tax on grant and generally no tax on exercise.[2401] Any gains realised on the ultimate sale of the shares will be subject to capital gains tax, not income tax, and any capital gains tax may be reduced by the annual personal capital gains tax exemption.[2402]

Two further UK schemes that fall outside of the above mentioned three broad categories, namely Enterprise Investment Scheme ('EIS') and the Entrepreneurs' Relief ('ER') are not specific employee share options, but can be categorised as regulated targeted tax incentive schemes generally available to underlying portfolio investee company managers investing in their company.[2403] In fact all the schemes mentioned above can be applied in a private equity context as schemes available to underlying portfolio investee company managers. However, not all regulated schemes may be suitable in all circumstance despite the applicable tax benefits.[2404] For instance, not all companies can meet the statutory conditions for tax beneficial regulated employee share plans. The three regulated tax schemes available to underlying portfolio investee company managers that are relevant to the discussion at hand are the Enterprise Investment Scheme ('EIS'), the Entrepreneurs' Relief ('ER') and Enterprise Management Incentive ('EMI').[2405] The rules governing all three schemes are strictly drawn and are generally restricted to small and medium size companies, however they highlight UK policymakers acknowledgement of the importance of employee ownership models as a means to incentivising growth.[2406] In addition, they align the interests of employees with those of the shareholders of the applicable company, albeit that the shareholder might be a private equity fund.

Entrepreneurs' Relief ('ER') Incentive

Entrepreneurs' Relief ('ER') incentive scheme reduces the amount of the capital gains tax on a disposal of qualifying business assets on or after 6th April 2008, as long as the taxpayer has met the qualifying conditions throughout a one-year qualifying period either up to the date of disposal or the

[2399] See HM Revenue and Customs (2014), 'ESSUM40100 to ESSUM48000: Company Share Option Plan (CSOP)', HM Revenue and Customs. Available at www.hmrc.gov.uk/manuals/essum/ESSUM40000.htm, accessed in June 2015.
[2400] In terms of the Save-As-You-Earn ('SAYE') option scheme which can be offered to employees, the offer must be made to the entire workforce generally and the tax advantages accrue over the medium term. Up to a 20 percent discount is allowed on the value of the shares at the date of grant and employees have a formal saving contract over a three or five year period which can be used to pay for the shares or employees can take their savings in cash.
[2401] Sinclair, W. And Lipkin, E.B. (2013), 'St. James's Place Tax Guide 2013-2014', 42nd Edition.
[2402] Sinclair, W. And Lipkin, E.B. (2013), 'St. James's Place Tax Guide 2013-2014', 42nd Edition. In the UK, the capital gains tax rate have been reduced since 1988 from 40 percent to 10 percent for higher-rate taxpayers for long-term investments, although the personal threshold is only £7,100.[2402] The CGT rate increased again from 10 percent to 18 percent in 2008.
[2403] See McLaughlin, M. (2013), 'Tax Planning 2013/14', Bloomsbury Publishing Plc.
[2404] See McLaughlin, M. (2013), 'Tax Planning 2013/14', Bloomsbury Publishing Plc.
[2405] See Langley, A. (2013), 'Employee Reward Structures', 5th Edition, Spiramus Press.
[2406] See Langley, A. (2013), 'Employee Reward Structures', 5th Edition, Spiramus Press.

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date the business ceased.[2407] ER gives managers an allowance of £10 million of capital gains on qualifying business disposals on which tax is charged at 10 percent.[2408] Gains in excess of the threshold are charged at the normal capital gains tax rates.[2409] The £10 million allowance does not apply to past disposals and begins when the relief is first claimed.[2410] The latter allowance is a lifetime allowance and a tax rate of 10 percent can be claimed for any number of qualifying disposals that take place from 6th April 2008 onwards, until the cumulative limit of £10 million is reached.[2411] ER is available to individuals but it is not available to companies or personal representatives of deceased persons.[2412]

ER is available on a disposal of shares by an individual[2413] (for example a manager), provided that throughout a period of one year ending on the date of disposal, the applicable company is a trading company or a holding company of a trading group; the applicable manager is an officer or employee of the company or a group company; and such manager owns at least 5 percent of the ordinary share capital of the company, which gives the manager at least five percent of the voting rights.[2414] ER tax relief is also available on the disposal of all or part of a business that an individual has owned for at least one year prior to the date of disposal.[2415] The disposal must be of assets comprising the business, and not just of assets used in the business.[2416] In the UK there have been a few cases that have considered the latter distinction. In the tribunal case of *Gilbert v HMRC*, it was held that entrepreneurs' relief could be claimed on the basis that the one ninth part of the business sold did constitute a mini business in its own right, namely that it could be run as a separate and individual business.[2417] The Appellant had carried on a business of selling food on commission, representing nine different suppliers. In 2008, the Appellant agreed to sell part of his business to one of the suppliers. The sale agreement defined 'business' sold as that part of the Appellant's business consisting of the sale of the suppliers products to customers. The sale agreement stated that the purchase was to include the customer database relating to the business and goodwill, the trade marks which the Appellant had registered relating to various brands and business information,

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[2407]See Langley, A. (2013), 'Employee Reward Structures', 5th Edition, Spiramus Press, at page 261.
[2408]See Cockburn, R. (2011), 'Small Business Tax Planning: All you need to know from start-up to retirement', 1st Edition, Harriman House Ltd.
[2409]Which are currently 18 percent and 28 percent respectively, depending on whether the individual is a basic or higher-rate taxpayer.
[2410]Rayney, P. (2013), 'Tax Planning for Family and Owner-Managed Companies 2013/14', Bloomsbury Publishing Plc.
[2411]Limits of £5 million for disposals before 6th April 2011, £2 million for disposals before 23rd June 2010 and £1 million for disposals before 6th April 2010 also apply.
[2412]Cockburn, R. (2011), 'Small Business Tax Planning: All you need to know from start-up to retirement', First Edition, Harriman House Ltd.
[2413]Not companies, partnerships, limited liability partnerships or other corporate bodies.
[2414]McLaughlin, M. (2013), 'Tax Planning 2013/14', Bloomsbury Publishing Plc.
[2415]McLaughlin, M. (2013), 'Tax Planning 2013/14', Bloomsbury Publishing Plc.
[2416]HM Revenue and Customs (2014), 'Helpsheet 275: Tax year 6 April 2013 to 5 April 2014, Entrepreneurs' Relief (2014)', HM Revenue and Customs. Available at www.hmrc.gov.uk/helpsheets/hs275.pdf, accessed in June 2015.
[2417]*Gilbert v HMRC* 2011, UKFTT, 705 (TC).

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together with the benefit and burden of unperformed contracts and the records.[2418] After the sale the Appellant could no longer use the trademarks nor have any contact with the customers of the supplier. The Appellant in his 2008/09 tax return showed a gain from the disposal of the assets of £285,000 and sought to claim Entrepreneurs' Relief which reduced the amount of the gain by four-ninths. HMRC enquired into the return and decided that Entrepreneurs' Relief was not available.[2419]

Her Majesty's Revenue and Customs ('HMRC') argued that for the Appellant to qualify for ER tax relief was not enough for him to make a disposal of assets used in the business, there needed to be the disposal of an identifiable part of the business which on its own was separately definable.[2420] Whilst the Appellant sold the brands and customer base, HMRC's view was that, in the scheme of how the business itself operated, those disposals did not amount to the disposal of a separately definable business. HMRC accepted that if the changes to the business caused by the sale of the assets could lead to the conclusion that the position after the sale was wholly different from the position before the sale, then it might be reasonable to say that the business after the sale was not the same as the one before, and therefore part of the business must have been sold.[2421] However, HMRC contended that the operation of the business in this case did not appear to have changed wholly or even noticeably after the disposal of the brands/customer base. HMRC submitted that on the facts the same business was being carried on after the sale as before. Therefore there was not a material disposal within the meaning of the legislation so that ER was not available.[2422]

The Appellant submitted that effectively there were nine separate businesses. The sale by the Appellant was of all the business connected to the supplier and various brands. The Appellant argued this was clearly a separate and definable part of the business. In delivering its judgment, the Tribunal took in account each party's submissions and the only question for the Tribunal was whether there had been a 'disposal of....part of a business'.[2423] Assessing the facts, the Tribunal found that the Appellant did dispose of the business as a going concern, judging that the business sold was a 'viable section'.[2424] The Tribunal referred to Lord Walker's comments in *Maco Door and Window Hardware (UK) Ltd v HMRC* where he stated that a business is recognisable as a business even

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[2418]Commentary: *Gilbert v HMRC* 2011, UKFTT, 705 (TC). Available at www.burges-salmon.com/Practices/tax/complex_compliance_and_disclosure/News/9640.aspx., accessed in June 2015.
[2419]Watt, G. (2014), 'Trusts and Equity', Oxford University Press. Commentary: *Gilbert v HMRC* 2011, UKFTT, 705 (TC).
[2420]Watt, G. (2014), 'Trusts and Equity', Oxford University Press. Commentary: *Gilbert v HMRC* 2011, UKFTT, 705 (TC).
[2421]Watt, G. (2014), 'Trusts and Equity', Oxford University Press. Commentary: *Gilbert v HMRC* 2011, UKFTT, 705 (TC).
[2422]Watt, G. (2014), 'Trusts and Equity', Oxford University Press. Commentary: *Gilbert v HMRC* 2011, UKFTT, 705 (TC).
[2423]Watt, G. (2014), 'Trusts and Equity', Oxford University Press. Commentary: *Gilbert v HMRC* 2011, UKFTT, 705 (TC).
[2424]*Gilbert v HMRC* 2011, UKFTT, 705 (TC).

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when separated from the whole.[2425] The Tribunal reached this conclusion because the transfer of business included the customer database, goodwill, trademarks, business information, and the benefit and burden of unperformed contracts and records.[2426] Particularly, the sale of the customer database was regarded as a crucial asset in distinguishing a sale of a going concern from mere sale of assets.[2427]

However, the UK High Court case of *Russell v HMRC* did not allow the sale of thirty five percent of farmland to qualify for ER tax relief because the court held that the sale did not relate to the sale of a business but was rather the sale of a business asset which did not therefore qualify.[2428] The position has historically been that the sale of some of the farmland is not a disposal of part of a farming business. The court held that the test is to look at the nature and extent of the business activities before and after the transaction.[2429] If the business is run in exactly the same way both before and after the sale, the sale will probably not be considered as a sale of a business and so will not qualify for ER tax relief and the standard rate of capital gains tax will be charged on the gain arising on the sale.[2430] Furthermore, ER tax relief will apply to a disposal of one or more qualifying assets used for the purposes of a business at the time when it ceased to be carried on, provided both of the following conditions are met: (i) the business has been owned by the individual (whether as a sole trader or in partnership) throughout the period of one year ending on the date on which the business ceases to be carried on and (ii) the business ceased to be carried on in the period of three years ending with the date of the disposal.[2431] Assets held for investment purposes and assets that are not used for the business purposes are excluded from entrepreneurs' relief. For example, companies with large cash deposits could be excluded from entrepreneurs' relief. It may be advantageous in such situations to review whether a dividend payment could improve the position for the taxpayer.[2432]

In addition, ER tax relief will apply to a disposal by a partner or shareholder of a personally-owned asset that is used in the business will benefit provided that certain conditions are met. These conditions include that the disposal is 'material' and that the partner or shareholder is withdrawing

[2425] *Maco Door and Window Hardware (UK) Ltd v HMRC*, 2008, UKHL 54. The Tribunal in the Gilbert case also referred to *Bestway (Holdings) Ltd v Luff*, 1998, BTC 69.
[2426] *Gilbert v HMRC* 2011, UKFTT, 705 (TC).
[2427] *Gilbert v HMRC* 2011, UKFTT, 705 (TC). See also Rayney, P. (2013), 'Tax Planning for Family and Owner-Managed Companies 2013/14', Bloomsbury Publishing Plc.
[2428] *Russell v HMRC*, 2012, UK FTT, 623 TC02299.
[2429] *Russell v HMRC*, 2012, UK FTT, 623 TC02299.
[2430] McLaughlin, M. (2013), 'Tax Planning 2013/14', Bloomsbury Publishing Plc.
[2431] See Rayney, P. (2013), 'Tax Planning for Family and Owner-Managed Companies 2013/14', Bloomsbury Publishing Plc.
[2432] See HM Revenue and Customs (2014), 'Helpsheet 275: Tax year 6 April 2013 to 5 April 2014, Entrepreneurs' Relief (2014)', HM Revenue and Customs. Available at www.hmrc.gov.uk/helpsheets/hs275.pdf, accessed in June 2015.

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from the business.[2433] A further condition is that the asset was used by the partnership or company for the purposes of its business throughout the period of one year ending with the date of the disposal and not for unconnected purposes.[2434] In many cases partners receiving a capital sum on retirement from partnership can benefit from entrepreneurs' tax relief providing that the settlement deed is structure correctly.[2435]

Enterprise Management Incentive ('EMI') Options

A second form of such tax incentive in the UK is the Enterprise Management Incentive ('EMI') options. EMI was introduced in the UK in 2000 by the Finance Act 2000 and offer tax-advantaged and flexible incentives for companies which meet the various qualifying criteria.[2436] They are intended to help smaller companies with growth potential to recruit and retain the best employees, and offer generous tax advantages to employees of those companies which qualify.[2437] There are several legal requirements which companies must satisfy in order for their share options to qualify as EMIs, including:[2438] (i) the company must carry on a 'qualifying trade' in the UK.[2439] If the option is for a group of companies, at least one company in the group must carry on such a trade; (ii) the company or group of companies must not have gross assets exceeding £30million at the time the share option is granted; (iii) the company whose shares are used may be listed or unlisted on a stock exchange, but it must be an independent company which implies that, in the case of a group of companies, the options must be over shares in the parent company to meet the EMI requirements; and (iv) the company or group of companies must have fewer than 250 full-time equivalent employees at the time the share option is granted.[2440] Only companies that are deemed independent, qualify, therefore companies controlled by a private equity fund could be 'disqualified' to take advantage of the scheme.[2441] Also the scheme only holds for employees who spend the majority of their time working

[2433]HM Revenue and Customs (2014), 'Helpsheet 275: Tax year 6 April 2013 - 5 April 2014, Entrepreneurs' Relief (2014)', HM Revenue and Customs. Available at www.hmrc.gov.uk/helpsheets/hs275.pdf, accessed in June 2015.
[2434]See McLaughlin, M. (2013), 'Tax Planning 2013/14', Bloomsbury Publishing Plc.
[2435]See McLaughlin, M. (2013), 'Tax Planning 2013/14', Bloomsbury Publishing Plc.
[2436]Moody, K. (2013), 'Employment-Related Securities and Unlisted Companies', 2nd Edition, Spiramus Press.
[2437]Gibson, E. (2014), 'Tax Schedule: A Guide to Warranties and Indemnities', 2nd Edition, Spiramus Press.
[2438]Gibson, E. (2014), 'Tax Schedule: A Guide to Warranties and Indemnities', 2nd Edition, Spiramus Press.
[2439]According HMRC interpretation of 'qualifying trade' is one that is carried out with the intention of making a profit. Available at http://webarchive.nationalarchives.gov.uk/+/http://www.hmrc.gov.uk/shareschemes/emi-new-guidance.htm, accessed in June 2015.
[2440]The company or group of companies must have fewer than 250 full-time equivalent employees. A full-time employee is one who works 35 hours a week or more, and the company must include fractions representing part-time employees. Non-executive directors and overseas employees and employees of "qualifying subsidiaries" in which the parent company owns a controlling stake, must also be counted. In order to qualify, participating employees, including executive directors, must spend at least 25 hours per week or, if less, 75 percent of their working time, on the business of the company or group of companies. Employees must give written declarations confirming that they meet this working time requirement, and the company must retain those declarations. Individuals with a 'material interest' (broadly a 30 percent interest) in the company or any of its subsidiaries, either on their own or together with one or more associates, are also unable to participate.
[2441]Moody, K. (2013), 'Employment-Related Securities and Unlisted Companies', 2nd Edition, Spiramus Press Ltd.

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for the company.[2442] In addition, EMI options can be subject to restrictions but they must be ordinary shares which are fully paid up and not redeemable or convertible.[2443] Also, there is a company limit of £3million on the total value of shares, as at the grant date which may be available under EMI options at any given time.[2444] There is also an individual limit on the value of shares, as at the grant date which any one employee may hold under the EMI option. This limit is £250,000.[2445] Once this maximum has been reached, no further qualifying EMI options can be granted until three years after the last of those options was granted.[2446] Options under any Company Share Option Plan ('CSOP') operated by the company also count towards this limit.[2447] A company can seek advance clearance from the HMRC that it satisfies the above mentioned requirements.[2448]

For an individual, the tax treatment of an EMI share option means that there are no tax implications when the option is granted.[2449] Capital gains tax is only payable on the sale of the option shares. On the sale of shares following exercise, the gain made over the value of the shares at grant or the option exercise price, if higher is a chargeable gain for capital gains tax purposes from 23rd June 2010, this is subject to a rate of 18 percent or 28 percent depending on whether the individual is a basic or higher-rate taxpayer.[2450] Since 6th April 2008, the relevant period of ownership for capital gains tax for entrepreneurs' relief purposes assuming the qualifying conditions are met, which may be rare in a portfolio company begins on the acquisition of shares following exercise of an EMI option.[2451]

Typically no income tax will be payable when an employee exercises the share option within ten years of grant,[2452] unless the exercise price is less than the market value of the shares on grant then the lower figure is used to calculate the tax liability.[2453] If an EMI option is granted with an exercise price below the market value of the shares at the date of grant and is then exercised, income tax is payable on the excess of the aggregate market value of the shares at the date of grant over the aggregate option exercise price.[2454] If the aggregate market value of the shares at the date of exercise is lower than the aggregate market value of the shares at the date of grant, income tax is

[2442]Moody, K. (2013), 'Employment-Related Securities and Unlisted Companies', 2nd Edition, Spiramus Press.
[2443]Gibson, E. (2014), 'Tax Schedule: A Guide to Warranties and Indemnities', 2nd Edition, Spiramus Press.
[2444]Gibson, E. (2014), 'Tax Schedule: A Guide to Warranties and Indemnities', 2nd Edition, Spiramus Press.
[2445]Gibson, E. (2014), 'Tax Schedule: A Guide to Warranties and Indemnities', 2nd Edition, Spiramus Press.
[2446]Moody, K. (2013), 'Employment-Related Securities and Unlisted Companies', 2nd Edition, Spiramus Press.
[2447]See HMRC Employee Share Schemes User Manual (ESSUM), available at www.hmrc.gov.uk/manuals/essum/ESSUM50000.htm, accessed in June 2015.
[2448]See HMRC Employee Share Schemes User Manual (ESSUM), available at www.hmrc.gov.uk/manuals/essum/ESSUM50000.htm, accessed in June 2015.
[2449]Langley, A. (2013), 'Employee Reward Structures', 5th Edition, Spiramus Press.
[2450]Langley, A. (2013), 'Employee Reward Structures', 5th Edition, Spiramus Press.
[2451]Moody, K. (2013), 'Employment-Related Securities and Unlisted Companies', 2nd Edition, Spiramus Press.
[2452]Employees must be able to exercise EMI share options within ten years. The option terms must be set out in a written agreement which must detail any restrictions on the shares.
[2453]Cohen, D. (2013), 'Emi Share Options: The Complete Guide', Bloomsbury Publishing Plc. See also available at www.hmrc.gov.uk/manuals/essum/ESSUM54300.htm, accessed in June 2015.
[2454]Moody, K. (2013), 'Employment-Related Securities and Unlisted Companies', 2nd Edition, Spiramus Press.

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payable on the excess of the aggregate market value of the shares at the date of exercise over the aggregate option exercise price.[2455] The employing company must account for the income tax under pay-as-you-earn ('PAYE') and social security payments are also due, if the shares are readily convertible assets for tax purposes.[2456]

In addition, the exercise of an option does not give rise to a liability to income tax or social security obligations if the favourable tax treatment has not been lost through a disqualifying event.[2457] Such an event could be (i) the company ceasing to carry out a qualifying trade; (ii) the option holder ceasing to be a qualifying employee; (iii) the option holders being granted an additional tax-advantaged company share option (CSOP) taking them over their individual (£250,000) EMI limit; (iv) the company being taken over; and (v) certain alterations to the company's share capital. In addition to these substantial tax advantages, the employer company may also be able to claim corporation tax relief on the option gain.[2458]

According to HMRC, it is recommended that unlisted companies establish the market value of the shares that will be put under option before EMI options are granted.[2459] The value can be formally agreed with HMRC or the company can use its own valuation although it would then be open to HMRC to query this.[2460] For companies and employees who meet the qualifying conditions, EMIs are a flexible and tax-favoured share incentive arrangement, however only companies that are deemed independent, qualify. By the very nature of the private equity business model companies controlled by a private equity fund would not qualify to take advantage of the scheme. Private equity funds hold numerous underlying portfolio investee company interests and any one of these investee companies cannot be regarded as independent.

Enterprise Investment Scheme ('EIS') Relief

[2455]Cohen, D. (2013), 'Emi Share Options: The Complete Guide', Bloomsbury Publishing Plc.

[2456]HM Revenue and Customs (2014), 'ESSUM57100 to ESSUM57900: Taxation of EMI Options', HM Revenue and Customs. Available at www.hmrc.gov.uk/manuals/essum/ESSUM57000.htm, accessed in June 2015.

[2457]HM Revenue and Customs (2014), 'ESSUM57430 to ESSUM57480: Taxation of EMI Options', HM Revenue and Customs. Available at www.hmrc.gov.uk/manuals/essum/ESSUM57000.htm, accessed in June 2015.

[2458]HM Revenue and Customs (2014), 'ESSUM57430 to ESSUM57480: Taxation of EMI Options', HM Revenue and Customs. Available at www.hmrc.gov.uk/manuals/essum/ESSUM57000.htm, accessed in June 2015.

[2459]See HMRC Employee Share Schemes User Manual (ESSUM), available at www.hmrc.gov.uk/manuals/essum/ESSUM50000.htm, accessed in June 2015. If EMI options in an unlisted company are granted the company can, if it wishes, agree the market value of the shares with HMRC Shares and Assets Valuation (SAV). To agree a market value with them the company will need to propose a value for the shares and provide background information to support the proposal. It will need to complete form Val 231 for EMI options. The form outlines the information needed to support the proposed valuation. When it is complete, it should be sent it to HMRC Shares and Assets Valuation (SAV).

[2460]HM Revenue and Customs (2014), 'Helpsheet 275: Tax year 6 April 2013 - 5 April 2014, Entrepreneurs' Relief (2014)', HM Revenue and Customs. Available at www.hmrc.gov.uk/helpsheets/hs275.pdf, accessed in June 2015.

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A third form of such tax incentive in the UK falls under the Enterprise Investment Scheme ('EIS'). EIS relief is available where a qualifying company issues new shares. The purpose of issuing these shares, and any others issued at the same time, must be to raise money for a qualifying business activity.[2461] The EIS shares must be subscribed wholly in cash and the cash must be paid in full by the time the shares are issued.[2462] In order to benefit from the relief, the relevant shares must be held for at least three years after issue or, if later, three years after the company begins to trade. To take advantage of this relief, the EIS investor must not dispose of the shares for at least three years after the date of issue or, if later, three years after the company begins to carry on a qualifying trade. The relief consists of an initial thirty percent income tax saving and exemption from capital gains tax when the EIS shares are disposed of. It may be possible for EIS shareholders to defer an existing capital gains tax liability by rolling it into the EIS shares which is referred to as EIS reinvestment relief.[2463] Shareholders may also be able to obtain further income tax relief if the shares are later sold at a loss. If the investor makes a loss when disposing of the shares that person can elect for the amount of that loss, less any income tax relief given, to be set against income made in the year in which the shares were disposed of, or any income from the previous year, instead of being set off against any capital gains.[2464]

The individual's income tax liability for the year of the share issue will be reduced by thirty percent of the amount used to subscribe for shares. In effect, this means that up to thirty percent of the cost of the individual's share investment will be paid for by the HMRC.[2465] The maximum amount of EIS relief which a person can claim in any one tax year is £1 million. Unused EIS relief cannot be carried forward to be used in later years. Provided that the EIS relief has not been withdrawn, no capital gains tax will be payable when the EIS shares are disposed of other than on any gain rolled over into those shares under the reinvestment relief provisions.[2466]

There are certain restrictions affecting the investor, the main one being that the EIS investor cannot be 'connected' with the company. An investor will be connected with a company if the investor and the investor's associates' interest in the company exceeds thirty percent.[2467] According to Slorach and Ellis, 'interest' includes the company's share capital, voting rights or assets on a winding up; if the investor or any of the investor's associates is an employee or partner of the company; if the

[2461]Squire Sanders Hammonds (UK) LLP (2013), 'Tax Aspects of the Purchase and Sale of a Private Company's Shares', Twenty Second Edition, Bloomsbury Publishing Plc.
[2462]Slorach, J.S. and Ellis, J.G. (2013), 'Business Law 2013-2014', 21st Edition, Oxford University Press UK.
[2463]Slorach, J.S. and Ellis, J.G. (2013), 'Business Law 2013-2014', 21st edition, Oxford University Press UK.
[2464]Squire Sanders Hammonds (UK) LLP (2013), 'Tax Aspects of the Purchase and Sale of a Private Company's Shares', Twenty Second Edition, Bloomsbury Publishing Plc.
[2465]Watson, L. (2010), 'Taxation of EIS and VCT Investments', LTax Publishing.
[2466]Watson, L. (2010), 'Taxation of EIS and VCT Investments', LTax Publishing.
[2467]Watson, L. (2010), 'Taxation of EIS and VCT Investments', LTax Publishing.

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investor or any of the investor's associates is a director of the company.[2468] However, an investor who has not previously been connected with the company or employed in the business can take an active role in its management after making the investment through becoming an unpaid or a paid director, 'reasonable and necessary' remuneration will be permissible.[2469] EIS can therefore be used for management buy-ins, but not for management buy-outs since in this case the directors would have been connected with the company beforehand.[2470] These relief rules are strictly drawn and relief is not generally available for an employee or manager investing in his own company unless he is a business angel.[2471] This exemption is very restricted but directors may qualify for relief if they are connected with the company only as directors of the company or subsidiary.[2472] Any remuneration they receive or are entitled to receive is reasonable for their services rendered to the company as directors.[2473] They subscribed for eligible shares at a time when they had never been either connected with the issuing company; or involved as sole trader, employee, partner or director in carrying on its trade, business, profession or vocation, for instance, as part of a buyout team.[2474]

All three the above mentioned schemes were intended by UK policy makers to help UK companies with growth potential to recruit and retain the best employees, and offer generous tax advantages to employees of those companies which qualify.[2475] The common thread of all three schemes involve the reduction of the amount of the capital gains tax and the allowance of no income tax being payable when an employee exercises the share option, unless the exercise price is less than the market value of the shares on grant then the lower figure is used to calculate the tax liability. Capital gains tax in terms of all three schemes, is only payable on the sale of the applicable shares and that the gain made over the value of the shares at grant or the option exercise price, if higher is a chargeable gain for capital gains tax purposes. In addition, if investors in all three schemes make a loss when disposing of the shares that person can elect for the amount of that loss, less any income tax relief given, to be set against income made in the year in which the shares were disposed of, or any income from the previous year, instead of being set off against any capital gains.

Nonetheless, specific commercial factors may outweigh the tax benefits of regulated employee share plans or regulated tax schemes such as EIS and ER, therefore unregulated share incentive plans

[2468]Slorach, J.S. and Ellis, J.G. (2013), ‘Business Law 2013-2014’, 21st Edition, Oxford University Press UK.
[2469]Squire Sanders Hammonds (UK) LLP (2013), ‘Tax Aspects of the Purchase and Sale of a Private Company's Shares’, Twenty Second Edition, Bloomsbury Publishing Plc.
[2470]Squire Sanders Hammonds (UK) LLP (2013), ‘Tax Aspects of the Purchase and Sale of a Private Company's Shares’, Twenty Second Edition, Bloomsbury Publishing Plc.
[2471]Squire Sanders Hammonds (UK) LLP (2013), ‘Tax Aspects of the Purchase and Sale of a Private Company's Shares’, Twenty Second Edition, Bloomsbury Publishing Plc. See also Mason, C.M. (2011), ‘Business Angels’, in World Encyclopaedia of Entrepreneurship, edited by Dana, L.D., published by Edward Elgar Publishing Limited, at page 1 for definition of ‘business angels’.
[2472]Sinclair, W. And Lipkin, E.B. (2013), ‘St. James's Place Tax Guide 2013-2014’, 42nd Edition.
[2473]Watson, L. (2010), ‘Taxation of EIS and VCT Investments’, LTax Publishing.
[2474]Slorach, J.S. and Ellis, J.G. (2013), ‘Business Law 2013-2014’, 21st Edition, Oxford University Press UK.
[2475]Lam, J. (2014), ‘Enterprise Risk Management: From Incentives to Controls’, 2nd Edition, John Wiley and Sons.

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are still used in the UK. The most straightforward plans, which do not enjoy the tax benefits as do regulated schemes, would for instance be the granting of share options. Such schemes are still regulated by statute but enjoy no special reliefs.[2476] In the UK, where unregulated employee share plans apply, the basic principle is that if the employee exercised an unapproved share option before 10th April 2003, the capital gains cost of the shares is the market value at the time the employee exercised the option.[2477] If the taxpayer exercised an unregulated share option after 9th April 2003, the capital gains cost of the shares is the total of what was paid for the option plus the price paid for the shares when the employee exercised the option, and the amount chargeable to income tax on the exercise.[2478] However, should an employee receive free shares or acquire discounted shares in terms of an unregulated scheme and not by exercising a share option, the capital gains cost is the market value at the date of receipt or acquisition respectively.[2479]

The questions of whether and if so, when taxable income was derived in terms of a share option taxation benefit was discussed in the leading UK case of *Abbott v Philbin.*[2480] The facts of the case was that in 1954 the taxpayer paid to acquire an option to purchase 2000 shares in his employer at a fixed price being the market value at the time the options were granted. In 1956 he exercised the option and acquired 250 shares. The UK Revenue Office in terms of Schedule E of the Income Tax Act of 1952 included an amount in his assessable income based on the difference between the exercise price and the market value in 1956.[2481] In accordance with what was then the common practice of the UK Revenue Office at the time, a sum equal to the difference between the current market price and the amount paid for the shares, together with a proportionate part of the cost of the option, was included in the taxpayer's assessment for the year in which the option was exercised.[2482] However, The House of Lords held by majority that no amount could be included as income in 1956 and also implied that any tax consequences arose only in 1954 when the option was granted.[2483] The House of Lords held that the benefit of the option contract could be converted into money, even though it was not assignable, because the employee could have obtained money from a third party by agreeing to exercise the option when instructed and thereupon transfer the shares, and that as such it was a 'perquisite of office or employment' so as to attract tax under Schedule E of the Income Tax Act of 1952, which was taxable on its value at the time of grant and not on the value when

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[2476]McLaughlin, M. (2013), 'Tax Planning 2013/14', Bloomsbury Publishing Plc.
[2477]McLaughlin, M. (2013), 'Tax Planning 2013/14', Bloomsbury Publishing Plc.
[2478]McLaughlin, M. (2013), 'Tax Planning 2013/14', Bloomsbury Publishing Plc.
[2479]McLaughlin, M. (2013), 'Tax Planning 2013/14', Bloomsbury Publishing Plc.
[2480]*Abbott v Philbin* , 1961, AC 352.
[2481]*Abbott v Philbin* , 1961, AC 352.
[2482]*Abbott v Philbin* , 1961, AC 352.
[2483]*Abbott v Philbin* , 1961, AC 352. See O'Connell, A. (2010), 'Employee Share Ownership Plans in Australia: Cross Border Issues Arising From Employee Share Ownership Plans', The Employee Share Ownership Project, Centre for Corporate Law and Securities Regulation and The Tax Group, The University of Melbourne.

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exercised.[2484] The law relating to share options was subsequently amended in the UK to over-rule the decision in *Abbott v Philbin.*[2485] The current UK legislation provides statutory support to what was then the common practice of the UK Revenue Office in respect of unregulated employee share option rights.

(c) Canada

This discussion is not intended to be a detailed review of all the relevant tax considerations affecting share option plans in terms of Canadian tax legislation and the assessing policies and practices of the Canadian Revenue Agency ('CRA'). In Canada, employee share options are taxed under the provisions of the Income Tax Act (Canada) ('ITA').[2486] The two main provisions are sections 7 and 110 of the ITA. Section 7 of the ITA deals with share options agreements under which employees of a company acquire rights to acquire shares of the applicable company.[2487] Section 110 of the ITA provides various deductions that may be claimed in computing a taxpayer's taxable income.[2488] Subsection 7(7) of the ITA defines the expressions 'qualifying person' and 'security' for the purposes of section 7 and certain other provisions of the ITA relating to such agreements. 'Qualifying person' is defined as a corporation or a mutual fund trust. 'Security' is defined as a share issued by a corporation or a unit of a mutual fund trust.[2489] Subsection 7(7) was amended in 1998 to have these definitions also apply for the purposes of subsections 110(1.7) and (1.8) of the ITA.[2490]

The income tax consequences of exercising the option depend on whether the company granting the option is a Canadian-controlled private corporation ('CCPC'),[2491] the period of time the employee

[2484] *Abbott v Philbin* , 1961, AC 352. See O'Connell, A. (2010), 'Employee Share Ownership Plans in Australia: Cross Border Issues Arising From Employee Share Ownership Plans', The Employee Share Ownership Project, Centre for Corporate Law and Securities Regulation and The Tax Group, The University of Melbourne.
[2485] Smith, D.G. and Macpherson, A. (2008), 'Hong Kong Taxation: Law and Practice', 2008-09 Edition, Hong Series, The Chinese University Press.
[2486] Income Tax Act, R.S.C., 1985, c. 1 (5th Supp), as amended.
[2487] Sections 7(1)(a) to (e) of the ITA stipulate various rules that apply where a company have agreed to issue shares to an employee of it or another company with which it does not deal at arm's length (an 'option agreement'). Similar rules apply to mutual fund trusts as per section 7(7) of the ITA.
[2488] Canadian Department of Finance (2012), 'Explanatory Notes Relating to the Income Tax Act Part 5: Clause 237', Canadian Government, 19th October 2012. Available at www.fin.gc.ca/drleg-apl/nwmm-amvm-1012n-05-eng.asp., accessed in June 2015.
[2489] Canadian Department of Finance (2012), 'Explanatory Notes Relating to the Income Tax Act Part 5: Clause 171, Canadian Government, 19th October 2012. Available at www.fin.gc.ca/drleg-apl/nwmm-amvm-1012n-05-eng.asp., accessed in June 2015.
[2490] Canadian Department of Finance (2012), 'Explanatory Notes Relating to the Income Tax Act Part 5: Clause 171, Canadian Government, 19th October 2012. Available at www.fin.gc.ca/drleg-apl/nwmm-amvm-1012n-05-eng.asp., accessed in June 2015.
[2491] See Canadian Interpretation Bulletin IT-73R6 (2002), 'Income Tax Act: The Small Business Deduction', 25th March 2002. In general terms, a 'CCPC' means a 'private corporation' that is a 'Canadian corporation' (as defined in terms of section 125(7) of the ITA) and also that is not controlled by non-residents, 'public corporations' or by any combination thereof. The definition of 'CCPC' does not require control by Canadian residents, but rather requires a lack of control by non-residents of Canada. For instance, a 'private corporation' that is owned 50 percent by non-residents of Canada and 50 percent by residents of Canada qualifies as a 'CCPC'. Available at www.cra-arc.gc.ca/E/pub/tp/it73r6/it73r6-e.html., accessed in June 2015.

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holds the shares before selling such shares and whether the employee deals at arm's-length with the company.[2492] The company may provide its employees with the right to acquire shares in the company at a fixed price for a limited period.[2493] Typically the shares will be worth more than the purchase price at the time the employee exercises the option. Thus, when and if the employee decides to exercise the option, the employee will realise a gain if the market price of the share is higher than the exercise price in accordance with section 7 of the ITA.[2494] For instance, an employee is provided with an option to acquire 100 shares at $50 each which is the fair market value for the share at grant of the option.[2495] Subsequently the share price increases to $100 and the employee exercises his/her option to acquire the shares for $5000 resulting in a $5000 profit for the employee.[2496]

The difference between the fair market value of the shares at the time the option was exercised and the option price will be taxed as employment income in the year the shares are sold.[2497] This gain will be considered employment income and if certain conditions are met as set out in terms of section 110 of the ITA, the employee will be entitled to deduct half of the amount for income tax purposes.[2498]

[2492]In terms of section 7(1)(a) of the ITA the employee is deemed to have received a benefit from his or her employment at the time that he or she acquires shares under the option agreement unless, in the case of the exercise of an option agreement by an arm's length employee to acquire shares of a CPCC the recognition of this benefit is deferred until the time that the employee disposes of the shares. However, no deferral election is possible after 4th March 2010 because of the repeal of subsection 7(8) announced in Canadian Federal Budget of 2010. The Canadian Federal Government Budget of 2010 introduced section 180.01 into the ITA and the section establishes the conditions for taxpayer eligibility for the special elective tax treatment and sets out the rules applicable in respect of the election by the taxpayer to benefit from the relief measure. Section 180.01 of the ITA is a special elective tax treatment for taxpayers who elected under subsection 7(8) to defer tax liability on their stock option benefit until the disposition of the optioned securities. Subsection 180.01(1) set out the conditions that a taxpayer must fulfill in order to make an election to obtain relief from the deferred tax liability. The taxpayer must have made an election under former subsection 7(8) to defer tax liability on an employment benefit deemed to have been received in respect of rights exercised on a stock option agreement under paragraph 7(1)(*a*). The taxpayer may make the election for the special relief in any year before 2015 in which he or she is required to include in income a qualifying deferred stock option benefit.

[2493]Marcil, M.C. and Tassé, L. (2014), 'Stock Options: Tax Treatment of Cash Payments in Lieu of Exercise', Issue 1, 9th January 2014, Tax Intelligence Series, Couzin Taylor LLP in association with Ernst and Young LLP.

[2494]In the case of *Steen v The Queen*, 86 DTC 6498, [1986] 2 CTC 394 (FCTD), the court ruled that where an employee 'acquires' shares pursuant to a share option agreement at the time when he exercises his option to purchase shares from his corporate employer, rather than at the time of the granting of the option. The court held that the word 'value' in section 7(1)(a) is essentially synonymous to 'fair market value' or 'market value'.

[2495]In terms of section 7(1)(a) of the ITA, the amount of the benefit is equal to the 'value' of the shares at the time of their acquisition by the employee minus the exercise price, namely the amount paid by the employee under the option agreement to acquire the shares. In the unusual circumstance where the employee have paid an amount to acquire the option agreement, the amount of the computed benefit is correspondingly reduced. The amount of the computed benefit then is included in the employee's income under section 6(1)(a) of the ITA.

[2496]Marcil, M.C. and Tassé, L. (2014), 'Stock Options: Tax Treatment of Cash Payments in Lieu of Exercise', Issue 1, 9th January 2014, Tax Intelligence Series, Couzin Taylor LLP in association with Ernst and Young LLP.

[2497]Marcil, M.C. and Tassé, L. (2014), 'Stock Options: Tax Treatment of Cash Payments in Lieu of Exercise', Issue 1, 9th January 2014, Tax Intelligence Series, Couzin Taylor LLP in association with Ernst and Young LLP.

[2498]Canadian Department of Finance (2012), 'Explanatory Notes Relating to the Income Tax Act Part 5: Clause 237', Canadian Government, 19th October 2012. Available at www.fin.gc.ca/drleg-apl/nwmm-amvm-1012n-05-eng.asp., accessed in June 2015.

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Subsections 110(1.7) and (1.8) of the ITA was introduced into the ITA and applies after 1998. Subsection 110(1.7) ensures that a reduction in the exercise price under an employee share option will not disqualify the employee from claiming the share option deduction under section 110(1)(*d*) of the ITA, provided certain conditions are met.[2499] For instance, these conditions include a minimum exercise price requirement under the option giving rise to the benefit under subsection 7(1) of the ITA.[2500] Thus, half of the difference between the ultimate disposal price and the fair market value of the shares at the date the option was exercised will be the taxable capital gain.[2501] In the instance of the above example, it will be the $5000 profit made by the employee.[2502]

As a general rule, the taxable benefit and the share option deduction, if any, have to be included in the individual's income tax return for the year in which the option is exercised.[2503] However, there are measures that allow the employee to defer the taxation of the taxable benefit relating to the stock option until the shares are sold.[2504] This deferral is available for options exercised by employees of a CCPC and until 4th March 2010 to certain options exercised by public company employees. In terms of the Canadian tax regime, there are different rules that apply for publicly traded corporations and CCPC's, however the basic principles are the same and the employer cannot claim a deduction on the issuance of share options to its employees.[2505] No deferral election is possible after 4th March 2010 because of the repeal of subsection 7(8) announced in Canadian Federal Budget of 2010.[2506]

The applicable rule introduced by the Canadian Federal Budget of 4th March 2010 implies that when an employee exercises a share option and buys shares in the applicable company, such employee must immediately pay tax on any unrealised profit despite such employee not even having sold any of the shares.[2507] Thus prior to the 4th March 2010 budget an employee could defer the tax on any

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[2499] Subsection 110(1.8) sets out the conditions that must be met in order for subsection 110(1.7) to apply.
[2500] Canadian Department of Finance (2012), 'Explanatory Notes Relating to the Income Tax Act Part 5: Clause 237', Canadian Government, 19th October 2012. Available at www.fin.gc.ca/drleg-apl/nwmm-amvm-1012n-05-eng.asp., accessed in June 2015.
[2501] Paragraph 110(1)(*d*) of the ITA provides a deduction in computing taxable income in circumstances where subsection 7(1) of the Act deems an employee to have received a benefit from employment in connection with the exercise, transfer or disposition of rights under an employee option agreement. The deduction is equal to one-half of the amount of the employment benefit, and the effect of the deduction is to tax the benefit at a rate equivalent to the capital gains inclusion rate.
[2502] Stikeman, H.H. (2006), 'Income Tax Act ... Annotated', R. De Boo Publishers.
[2503] Stikeman, H.H. (2006), 'Income Tax Act ... Annotated', R. De Boo Publishers.
[2504] Subsection 7(8) of the ITA.
[2505] Lee, J.Y. (2010), 'Stock Option Plans and Other Equity-Based Incentives', 2010 Tax Law for Lawyers, 30th May – 4th June 2010, Osler, Hoskin and Harcourt LLP.
[2506] The Canadian Federal Government Budget for the 2010-2011 fiscal year was presented to the Canadian House of Commons by Finance Minister Jim Flaherty on the 4th March 2010. Subsections 7(8) to (15) of the ITA set out the rules allowing for the deferral of taxation under certain conditions on an employment benefit realised when an employee acquires shares underlying employee share options granted by a public corporation or a mutual fund trust. These deferral measures have been repealed pursuant to proposals announced in the Canadian Federal Government Budget of March 2010. The repeal of subsections 7(8) to (15) applies in respect of share options exercised after 4th March 2010.
[2507] Lee, J.Y. (2010), 'Stock Option Plans and Other Equity-Based Incentives', 2010 Tax Law for Lawyers, 30th May – 4th June 2010, Osler, Hoskin and Harcourt LLP.

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artificial profits until the year in which he/she sells the shares that he/she acquired. In addition, the CRA post-March 2010 requires that the applicable company withhold the tax on such artificial profits.[2508] According to Lee:

> 'The rationale given (by the CRA) for the repeal is that it will prevent situations in which an employee is unable to meet his or her tax obligations as a result of the decrease in the value of shares following the election to defer recognition of the employment benefit.'[2509]

In Canada, companies treated as Canadian-controlled private corporations ('CCPC') are characterised as receiving tax advantages and one such benefit is that employees of such companies with share options do not pay capital gains tax when they exercise their shares. Such employees only pay capital gains tax when the shares are sold. It is submitted that the repealing of section 7(8) of the ITA is a step backward for the Canadian private equity industry because share option exercises should not be taxed in the first instance until actual financial benefits are realised, like in the US and the UK.

(d) Australia

The current Australian legislation on employee share option plans and employee share schemes came into effect in July 2009. In terms of these rules, gains are assessed as ordinary income and can be taxed prior to the gains being realised.[2510] The Australian Private Equity and Venture Capital Association Limited's ('AVCAL') position is that employees of companies who receive benefits under employee share option plans and employee share schemes should only be taxed when a realisation event occurs, and this should only be on capital account.[2511] Australian income tax is payable on assessable income, which falls under two broad categories, namely ordinary income[2512] and statutory income. Statutory income is income that is not ordinary income and that a taxpayer will

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[2508]Marcil, M.C. and Tassé, L. (2014), 'Stock Options: Tax Treatment of Cash Payments in Lieu of Exercise', Issue 1, 9th January 2014, Tax Intelligence Series, Couzin Taylor LLP in association with Ernst and Young LLP.
[2509]Lee, J.Y. (2010), 'Stock Option Plans and Other Equity-Based Incentives', 2010 Tax Law for Lawyers, 30th May – 4th June 2010, Osler, Hoskin and Harcourt LLP, at page 10.
[2510]In Australia, the Corporations Act 2001 regulates the offer to and investment by investors, including employees in their employer bodies. The offer of securities and other financial products to investors, including to employees, is regulated under Ch 6D of the Corporations Act (for securities) and under Ch 7 (for other financial products). Unless a relevant exemption applies, the Corporations Act 2001 requires bodies establishing an employee share scheme to provide a prospectus or other disclosure document to employees and, in some instances, to obtain an Australian financial services (AFS) licence. The Act also prohibits certain other conduct in relation to offers under the scheme. The purpose of these provisions is to ensure that investors have adequate information to make an informed investment decision.
[2511]Australian Private Equity and Venture Capital Association Limited (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014, page 10.
[2512]In terms of the Income Tax Assessment Act 1997 (Cth) section 6-5.

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include in assessable income because of a specific rule in the Australian tax legislation.[2513] For instance, a net capital gain is statutory income.

The taxation of employee share option plans and employee share schemes are dealt with under the Australian income tax system by a special division within the Income Tax Assessment Act 1997, namely Division 83A.[2514] In terms of Section 83A-10 of the Income Tax Assessment Act 1997, an employee share scheme is defined as a scheme under which 'employee share scheme' is provided to employees including past or prospective employees of the company or a subsidiary in relation to an employee's employment. The discounts in relation to such shares or options are included in assessable income under section 6-10 of the Income Tax Assessment Act 1997 which deals with statutory income.[2515] If an amount can be both ordinary income and statutory income, the statutory provisions apply unless a contrary intention is found.[2516] According to O'Connell, Division 83A of the Income Tax Assessment Act 1997 applies rather than the ordinary income provision, other than in the absence of such a contrary intention.[2517] In terms of Division 83A of the Income Tax Assessment Act 1997, the default position is that shares or rights received in respect of the provision of services will be subject to tax on receipt.[2518] Division 83A of the Income Tax Assessment Act 1997 provides that discounts on shares and rights acquired under an employee share scheme are included in assessable income[2519] and the discount amount being the market value of the shares or options less any amount paid or to be paid to acquire them.[2520]

There were two critical amendments to the Income Tax Assessment Act 1997 that adversely impact the ability of Australian companies to use employee share option plans and employee share schemes since 1st July 2009. The first was the removal of the ability of an employee to elect to pay tax upfront. The second was the deferral of tax until vesting rather than exercise of options or cessation of employment.[2521] Prior to the 1st July 2009 amendments, employees could elect to be

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[2513] Bernhard, S. (2010), 'Employee Share Schemes: What you Need to Know about the New Tax Rules', Allens Arthur Robinson, 6th May 2010. Available at www.allens.com.au/pubs/pdf/tax/paptaxmay10.pdf., accessed in June 2015.
[2514] Inserted into the Income Tax Assessment Act 1997 by the Tax Laws Amendment (2009 Budget Measures No 2) Employee Share Schemes Act 2009.
[2515] The term 'discount' is not defined in the legislation. Under the previous legislation it was defined as the difference between the market value of the share or right less any consideration paid or given by the taxpayer: section 139CC of the Income Tax Assessment Act 1936.
[2516] Section 6-25(3) of the Income Tax Assessment Act 1997.
[2517] O'Connell, A. (2010), 'Employee Share Ownership Plans in Australia: Cross Border Issues Arising From Employee Share Ownership Plans', The Employee Share Ownership Project, Centre for Corporate Law and Securities Regulation and The Tax Group, The University of Melbourne, at page 10.
[2518] O'Connell, A. (2010), 'Employee Share Ownership Plans in Australia: Cross Border Issues Arising From Employee Share Ownership Plans', The Employee Share Ownership Project, Centre for Corporate Law and Securities Regulation and The Tax Group, The University of Melbourne, at page 10.
[2519] Section 83A-25 Income Tax Assessment Act 1997.
[2520] Explanatory Memorandum, note 9, para 1.102.
[2521] Bernhard, S. (2010), 'Employee Share Schemes: What you Need to Know about the New Tax Rules', Allens Arthur Robinson, 6th May 2010. Available at www.allens.com.au/pubs/pdf/tax/paptaxmay10.pdf., accessed in June 2015.

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taxed up front and any eventual realised gains were taxed under the capital gains tax.[2522] In terms of the current legislative regime employees can no longer elect to pay tax up front and consequently tax would arise on vesting even though the gain was not realised at that point in time.[2523] The up-front taxation of employee share options means that employees will be taxed when they receive their share options from the applicable company.[2524] The employee must therefore pay tax on the options, despite such shares not having been realised, even when employees resign or are made redundant. According to the AVCAL, this represents a significant impediment to companies offering share option plans and employee share schemes to employees because tax can be imposed prior to a realisation event, either at vesting or cessation of employment; and that the gain is assessed as ordinary income rather than a discount capital gain.[2525] The employee is taxed on the imputed value of the option at the time of his/her departure instead of when the option is realised. For instance, an employee may have an option with an exercise price of $100 per share, but when they leave the company the share price drops to $50. The employee would still be taxed at the exercise price of $100 despite the share being worth only $50. Prior to 2009, employees could defer the tax on shares or rights for up to a period of ten years, however post-2009 legislation meant that tax must be paid immediately.[2526]

AVCAL submitted two critical policy recommendations to the Australian Government in this regard.[2527] Firstly, Australia should follow a US approach where the employee will only be taxed when a realisation event occurs.

> 'The exercise price is typically equal to the underlying market value of the ordinary shares so that the employee can share in growth in the value of the company from the date of grant. However, tax would arise on vesting even though the gain was not realised at that time. Taxing unrealised gains is prohibitive especially because the recipient of the benefit may never actually receive any benefit from the ESOP and ESS. The use of cessation of employment as a taxing point should also be removed, as this is a significant disincentive to accept options.'[2528]

[2522] Bernhard, S. (2010), 'Employee Share Schemes: What you Need to Know about the New Tax Rules', Allens Arthur Robinson, 6th May 2010. Available at www.allens.com.au/pubs/pdf/tax/paptaxmay10.pdf., accessed in June 2015.

[2523] O'Connell, A. (2010), 'Employee Share Ownership Plans in Australia: Cross Border Issues Arising From Employee Share Ownership Plans', The Employee Share Ownership Project, Centre for Corporate Law and Securities Regulation and The Tax Group, The University of Melbourne, at page 10.

[2524] O'Connell, A. (2010), 'Employee Share Ownership Plans in Australia: Cross Border Issues Arising From Employee Share Ownership Plans', The Employee Share Ownership Project, Centre for Corporate Law and Securities Regulation and The Tax Group, The University of Melbourne, at page 10.

[2525] Australian Private Equity and Venture Capital Association Limited (2014), 'Financial System Inquiry: Submission Two', Australian Private Equity and Venture Capital Association Limited Report, April 2014, page 10.

[2526] See CCH Australia Staff, Cch. (2012), 'Australian Master Tax Guide 2012', CCH Australia Limited.

[2527] Australian Private Equity and Venture Capital Association Limited (2014), 'Employee Share Schemes and Startups', Australian Private Equity and Venture Capital Association Limited Submission to the Australian Government on Employee Share Schemes and Startups, February 2014.

[2528] Australian Private Equity and Venture Capital Association Limited (2014), 'Employee Share Schemes and Startups', Australian Private Equity and Venture Capital Association Limited Submission to the Australian Government on Employee Share Schemes and Startups, February 2014, at page 6.

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Secondly, when the employee realises a gain such as when they exercise their right to sell the shares and any gain should only be taxed as a capital gain.

> 'An option issued with a zero inherent value (i.e. the exercise price is equal to the underlying price of the share at the time of issue) under an employee share option plan should be deemed to have no taxable value. Tax on any gains would then be calculated on capital account and the taxing point would only arise when the options are sold or cancelled or if the options are exercised, when the shares are sold. This would align the tax treatment with the US, where upon making a statutory election under section 83(b) of Internal Revenue Code, the options are taxed on grant. However, the options are considered to have zero value if the exercise price equals the market value of the underlying share, determined in accordance with section 409A. Any further gains on such options are taxed on capital account on the date the property is transferred … It would also bring Australia into alignment with countries such as the US and the UK.'[2529]

The Australian Securities and Investments Commission ('ASIC') regard employee incentive schemes as a critical mechanism for companies to retain staff, and a means for employees to share in the success of a company.[2530]

(e) South Africa

In South Africa, an employee may be subject to income tax when they acquire shares from their employer or from an employee share purchase trust set up by the employer.[2531] In this regard, any gain or loss on shares acquired is determined in accordance with special rules contained in sections 8A, 8B and 8C of the Income Tax Act 58 of 1962. Section 8A applies specifically to shares or options acquired before 26th October 2004 and any revenue gain determined under section 8A will be included in an employee's income.[2532] Typically, such a gain will arise when the employee exercises an option to acquire shares from his/her employer and the price paid for the shares is less than the market price at the time of acquisition.[2533] When an employer does not allow an employee to sell the

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[2529]Australian Private Equity and Venture Capital Association Limited (2014), 'Employee Share Schemes and Startups', Australian Private Equity and Venture Capital Association Limited Submission to the Australian Government on Employee Share Schemes and Startups, February 2014, at page 5.

[2530]Australian Securities and Investments Commission ('ASIC') (2013), 'Consultation Paper 218: Employee Incentive Schemes', Issued 14th November 2013 and is based on the Corporations Act 2001 at the date of issue.

[2531]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 11, at pages 395-403.

[2532]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 11, at pages 395-403. See De Koker, A.P., Williams, R.C., Silke, J.M. and Silke, A.S. (2013), 'Silke tax yearbook 2012-2013', Butterworth Publishers, Durban.

[2533]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 11, at pages 395-403..

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shares before a certain date, the employee can elect to delay the taxation of the gain until that date. Once an employee has been subject to income tax under section 8A on the shares acquired from the employer a further gain or loss may arise when the shares are disposed.[2534] The capital or revenue nature of this further gain or loss is determined in the normal way; that is, shares held as capital assets will be subject to capital gains tax, while shares held as trading stock will be subject to income tax in full.[2535] For capital gains tax purposes the base cost of the shares will be the market value that was taken into account in determining the section 8A gain.[2536]

Section 8B of the Income Tax Act 58 of 1962 applies to qualifying broad-based employee share plans when at least eighty percent of the employees in the company are entitled to participate. In order for an employee to qualify, the market value of the shares given to him/her in the current and immediately preceding four years of assessment must not exceed R50 000.[2537] If an employee holds a share acquired under such a plan for at least five years, the gain on disposal will be of a capital nature and subject to capital gains tax.[2538] However, if an employee disposes of the share within five years, any gain will be taxed as income in the hands of such employee, and section 9C of the Income Tax Act 58 of 1962 which deems shares held for at least three years to be on capital account, will not apply. This serves as an encouragement for an employee to hold his/her shares for at least five years. The benefits of section 8B do not apply if an employee was a member of any other employee share incentive scheme at the time when he/she received the shares. In such a case the employee will be taxed under section 8C.[2539] Section 8B is restricted to a specific type of scheme, coupled by a restrictive quantum of R50 000. Section 8C replaced section 8A of the Income Tax Act 58 of 1962 and applies to shares and options acquired from an employer on or after 26th October 2004. A revenue gain or loss will arise when a share or option vests in the taxpayer/employee.[2540] Vesting will usually happen when an employee acquires the share with no restrictions, or when all restrictions are lifted. If an employee is restricted from disposing of the share, the revenue gain or loss will be

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[2534]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 11, at pages 395-403. See De Koker, A.P., Williams, R.C., Silke, J.M. and Silke, A.S. (2013), 'Silke tax yearbook 2012-2013', Butterworth Publishers, Durban.

[2535]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 11, at pages 395-403..

[2536]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 11, at pages 395-403..

[2537]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 11, at pages 395-403. See Croome, B.J. (2010), 'Taxpayers' Rights in South Africa', Juta and Company.

[2538]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 11, at pages 395-403. See Croome, B.J. and Olivier, L. (2010), 'Tax Administration', Juta and Company.

[2539]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 11, at pages 395-403. See Haupt, P. (2014), 'Notes on South African Income Tax', Thirty Third Edition, H and H Publications.

[2540]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 11, at pages 395-403.

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determined at the time when the restriction is lifted.[2541] This differs from section 8A in which the revenue gain was frozen at the time of acquisition of a share and on election deferred until the restriction ended.[2542] Once an employee has been subject to income tax under section 8C on the shares acquired from his/her employer, a further gain or loss may arise when the employee disposes of such shares.[2543] In the important judgment of *Bosch and Another v CSARS,* handed down on the 20th November 2012 by the full bench of the Western Cape High Court.[2544] In this case the court held:

> '[95] Section 8 C provides that 'a taxpayer must include... in his or her income for a year of assessment any gain... determined in terms of subsection (2) in respect of the vesting during that year of any equity instrument if that equity instrument was acquired by the taxpayer (i) by virtue of his or her employment.' For s 8C to apply, the relevant scheme shares must have been acquired by the appellant within the meaning of s 8C and s 8 (2)(b) of the Act 32 of 2004 and; that is the relevant scheme shares must not have been acquired by way of the exercise of any right granted before 26 October 2004 and in respect of which s 8A applied. [96] On the evidence, the relevant scheme shares were acquired, by the exercise of rights which were granted to the appellant before 26 October 2004. Section 8A therefore applies pursuant to our analysis above and therefore s 8C is not applicable to this dispute.'[2545]

The facts of the case were that the appellants were employees of the Foschini group of companies and participants in an employee share incentive scheme.[2546] The effect of the scheme was that the provisions of section 8A of the Income Tax Act 58 of 1962 were circumvented. The appellants were assessed by SARS for income tax in respect of shares received in respect of the scheme. The employees were granted options to purchase shares, which they had to exercise within twenty one days.[2547] Once the option was exercised, delivery and payment in respect of the shares were delayed and would take place in three tranches, each two years apart. However, before delivery and payment, the employees could not vote on the shares, dispose of or encumber the shares and were not entitled to dividends.[2548] Therefore, the risks and benefits did not pass to the employees until delivery and payment. The scheme provided that employees could sell their shares back to the

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[2541] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 11, at pages 395-403.
[2542] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 11, at pages 395-403.
[2543] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 11, at pages 395-403.
[2544] *Bosch and Another v CSARS* (2012) ZAWCHC 188; (2013) 2 All SA 41 (WCC).
[2545] *Bosch and Another v CSARS* (2012) ZAWCHC 188; (2013) 2 All SA 41 (WCC), at paragraphs 95-96. The main judgment was written by Davis J (Baartman J concurring) and a separate judgment was written by Waglay J. The matter was on appeal from the Tax Court.
[2546] *Bosch and Another v CSARS* (2012) ZAWCHC 188; (2013) 2 All SA 41 (WCC).
[2547] *Bosch and Another v CSARS* (2012) ZAWCHC 188; (2013) 2 All SA 41 (WCC), at paragraph 12.
[2548] *Bosch and Another v CSARS* (2012) ZAWCHC 188; (2013) 2 All SA 41 (WCC), at paragraph 12.

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employer if the share price fell below the price that was payable on delivery; and the employees had to sell their shares back to the employer for the same price payable on delivery if they terminated their service for any reason other than sequestration, death, superannuation or ill health. [2549] The court held that only gains arising within the twenty one day option period would be subject to section 8A and be taxable as income in the hands of the employees, as opposed to the full gains over the longer periods until delivery and payment.[2550] In short, *Bosch and Another v CSARS* dealt with the issue of simulated transactions.[2551] The court accepted the view that parties are free to arrange their affairs so as to avoid the provisions of the Income Tax Act 58 of 1962.[2552] Judge Davis stated that the mere existence of an avoidance motive or purpose, on its own, would not be sufficient to conclude that a transaction is simulated; and that the only question is whether the parties truly intended for their agreement to have the legal effect, as between them, subject to the terms of such an agreement.[2553]

In South Africa, in terms of section 8C of the Income Tax Act 58 of 1962, a revenue gain or loss will arise when a share or option vests in the taxpayer. In addition, once the employee is subject to income tax under section 8C of the Income Tax Act 58 of 1962 on the shares acquired from the employer a further gain or loss may arise when the employee disposes of them.[2554] The effect of section 8C of the Income Tax Act 58 of 1962 is that if the option generates a gain, the taxpayer is required to include such gain in his income for the tax year in which the instrument vests in him. The gain is calculated by subtracting from the market value of the equity instrument at the time that it vests in the taxpayer the sum of any consideration paid by the taxpayer in respect of the equity instrument.[2555] This means that the gain will be subject to income tax at the taxpayer's marginal income tax rate. If the equity instrument/option generates a loss, the taxpayer is required to deduct that loss from his income for the tax year in which the equity instrument vests in him.[2556] The tax liability on the part of the taxpayer arises on the date that the equity instrument vests in the taxpayer. This enables the tax authorities to tax as much of the growth in the value of the equity instrument as

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[2549] *Bosch and Another v CSARS* (2012) ZAWCHC 188; (2013) 2 All SA 41 (WCC), at paragraph 13.
[2550] An argument raised by SARS was that the scheme was a simulated transaction and that there was no real unconditional sale at the time of exercise of the option, but that the parties actually intended that the sale be subject to the suspensive condition that the employees remain employed until the date of delivery and payment. SARS's argument as to simulation was rejected. For this and other reasons the appeal was upheld.
[2551] *Bosch and Another v CSARS* (2012) ZAWCHC 188; (2013) 2 All SA 41 (WCC).
[2552] *Bosch and Another v CSARS* (2012) ZAWCHC 188; (2013) 2 All SA 41 (WCC). At paragraph 72, Judge Davis stated: '… while accepting the fundamental principle that a taxpayer is entitled to arrange his or her affairs as to remain outside of the provisions of the Act …'.
[2553] *Bosch and Another v CSARS* (2012) ZAWCHC 188; (2013) 2 All SA 41 (WCC), at paragraphs 79-83. The main judgment was written by Judge Davis (Baartman J concurring).
[2554] Emslie, T. and Davis, D. (2012), 'Income Tax Cases and Materials', The Taxpayer. See also Organisation for Economic Co-Operation and Development ('OECD') (2013), 'Tax Administration 2013: Comparative Information on OECD and Other Advanced and Energy Economies', OECD Publishing.
[2555] Emslie, T. and Davis, D. (2012), 'Income Tax Cases and Materials', The Taxpayer. See also Organisation for Economic Co-Operation and Development ('OECD') (2013), 'Tax Administration 2013: Comparative Information on OECD and Other Advanced and Energy Economies', OECD Publishing.
[2556] See Croome, B.J. (2010), 'Taxpayers' Rights in South Africa', Juta and Company.

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possible.[2557] After the equity instrument has vested in the taxpayer, any further growth in the value of the equity instrument may be subject to capital gains tax which is levied at a lower rate than income tax.[2558]

Therefore the fundamental policy considerations with regard to share incentive schemes throughout the jurisdictions discussed above are to afford employees the opportunity to share in the growth of the applicable company and also afford the employer to recruit and retain employees. In 1997, the Katz Commission highlighted the benefits of employee share ownership plans. The Katz Commission referred to a report by the Employee Share Ownership Plans Association in the US, where it stated:

> 'The growth of employee ownership in recent decades has been a significant development in the areas of business competitiveness, employee compensation, corporate finance and business continuation. Though there are several forms of employee ownership, employee stock ownership plans, or ESOPs, have achieved the most widespread acceptance and support. The rapid and continuing growth in the number of ESOPs being established and the breadth of industries covered have important ramifications for employees, corporations and the economy as a whole ... The ESOP concept is based on the theories of capital ownership developed by Dr. Louis O. Kelso. Kelso reasoned that only through widespread capital ownership could modern economies provide for more equitable distribution of wealth. According to Kelso, the concentration of wealth in the U.S. economy results from the fact that capital-producing assets are owned by a small minority of individuals. In an economy in which capital is inexorably replacing labour as the means by which wealth is produced, Kelso emphasized the importance of providing the majority who do not presently own capital with a means of achieving substantial stock ownership. Only by sharing in the ownership of productive capital would workers be able to obtain through the market a second income to supplement the wages they earn through their labour. Since the average worker does not have the financial capability to buy that capital with his or her own earnings, Kelso conceived of the ESOP as a means of providing employees with access to capital credit. By giving employees a stake in corporate financial transactions, their capital ownership could be paid out of the future earnings produced by the corporation. Widespread application of the ESOP concept would thus promote broadened ownership of wealth through free-enterprise initiatives, rather than resorting to government redistribution through taxation. Promoted as a means of broadening the ownership of capital and improving the productivity of the American workforce, ESOPs have been at the forefront of a movement for employee ownership that is having profound effects on methods

[2557] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 11, at pages 395-403. See De Koker, A.P., Williams, R.C., Silke, J.M. and Silke, A.S. (2013), 'Silke tax yearbook 2012-2013', Butterworth Publishers, Durban.

[2558] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 11, at pages 395-403.

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of employee compensation, techniques of corporate finance and efforts to increase corporate America's performance and competitiveness.'[2559]

To this end, the reasons advanced for the adoption of the employee share ownership plans concept in the US are applicable to prevailing socio-economic conditions in South Africa. The 2011 introduction of section 10(1)(k)(i)(dd) into the Income Tax Act 58 of 1962 is somewhat puzzling and seems to be counterintuitive to the fundamental policy considerations with regard to share incentive schemes in South Africa. Under the current South African tax regime, subject to certain exceptions, local dividends received and accrued to a South African tax residents are exempt from normal tax in terms of section 10(1)(k) of the Income Tax Act 58 of 1962. Section 10(1)(k)(i)(dd) of the Income Tax Act 58 of 1962 is an exception that applies to employee share schemes. Section 10(1)(k)(i)(dd) of the Income Tax Act 58 of 1962, which was introduced from the 1st January 2011, states that a dividend will not be exempt from normal tax if such dividend is received or accrued in respect of a restricted equity instrument (as defined in section 8C) unless:

'A) the restricted equity instrument constitutes an equity share, other than an equity share that would have constituted a hybrid equity instrument as defined in section 8E(1) but for the three-year period requirement contemplated in that definition;

B) the dividend constitutes an equity instrument as defined in that section; or

C) the restricted equity instrument constitutes an interest in a trust and, where that trust holds shares, all of those shares constitute equity shares, other than equity shares that would have constituted hybrid equity instruments as defined in section 8E(l) but for the three-year period requirement contemplated in that definition.'

Prior to the above mentioned legislative enactment, an employee's income tax liability would only incur (in the case of restricted equity instruments) when the underlying equity instrument increases in value over the period of the restriction.[2560] However, the introduction of an additional income tax on dividends received during the restriction period implies that employees will pay income tax on the realised benefits of their investment, as well as income tax on the underlying gains on the investment itself.[2561] This basically contradicts the purpose of employee incentive plans which is to retain employees by locking them in for a specific period of time by way of such restrictions.

[2559] South African Revenue Services ('SARS') (1997), 'Third Interim Report of the Katz Commission into Tax Reform', 7th March 1997, Pretoria, chapter 16 at sub-paragraph 16.1.2 to 16.1.3. Available at www.polity.org.za/polity/govdocs/commissions/katz16-17.html, accessed in June 2015.

[2560] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 11, at pages 395-403. See also Organisation for Economic Co-Operation and Development ('OECD') (2012), 'Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Review: South Africa 2012, Combined: Phase 1 + Phase 2, OECD Publishing, October 2012 (Reflecting the legal and regulatory framework as at June, 2012).

[2561] Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 1, January 2017, paragraph 11, at pages 395-403.

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(f) Analysis

In general, South African policy makers should provide that taxes on share options are to be paid when shares are sold, instead of when the options vest or are exercised. In the US, share options are taxed at capital gains rates when the shares are sold if certain requirements are met.[2562] No tax is due when they are exercised and therefore the issuer is not entitled to a tax deduction. Employee compensation is a significant expense for most companies and South African companies should find it easier to pay a portion of their employees' compensation in the form of shares, particularly as an incentive mechanism in the context of the private equity business model. Not only will this form of compensation reduce the amount of cash compensation, but it will also serve as an incentive for increased employee productivity and allow employees to use their best efforts to grow and expand the business.[2563] Nonetheless, capital gains treatment of share options should become a key part of South African tax law and should be based on the principle of reward for those who take entrepreneurial risk and provide risk capital that will ultimately foster greater capital formation and economic growth.

The employee share option tax framework in South Africa should be simplified and there should be no need for a special tax dispensation for employee share options. As a starting point policy makers should repeal the counterintuitive provisions introduced by section 8C of the Income Tax Act 58 of 1962. Also section 10(1)(k)(i)(dd) of the Income Tax Act 58 of 1962 which states that a dividend will not be exempt from normal tax if such dividend is received or accrued in respect of a restricted equity instrument (as defined in section 8C), should be repealed. Generally, any gain made by an employee in terms of an employee share scheme must be regarded as being of a capital nature. In addition, gains from employee share scheme should continue to be taxable in accordance with the current South African capital gains tax rules. South African policy makers should also consider the policy framework used in jurisdictions such as the US and UK as a starting point for what would constitute a workable employee share scheme tax framework for South African private companies. For instance, the earlier analysis of the UK's Enterprise Management Incentive ('EMI') scheme is a precedent of how a tax-advantaged share option scheme can be drafted to assist small to medium sized companies in attract and retain key employees.

An obvious reason for the current legislative status quo is that SARS would be concerned about tax avoidance structuring where high-income taxpayers would be able to structure their remuneration

[2562]Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', Fifth Edition, Wiley and Sons. See also Organisation for Economic Co-Operation and Development ('OECD') (2013), 'Tax Administration 2013: Comparative Information on OECD and Other Advanced and Energy Economies', OECD Publishing.

[2563]Marples, D. (2014), 'Taxation of Hedge Fund and Private Equity Managers', Congressional Research Service, RS22689, 7th March 2014. Available at www.crs.gov, accessed in June 2015.

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packages to reduce their tax liability out of proportion to what SARS would consider being fair. However, such avoidance or perceived 'abuse' would in all likelihood be restricted mainly to high income earners. The consequences of the recommendation put forward would be outweighed by the potential economic growth suggested above, which is intended to extend beyond high-income taxpayers. Nevertheless, as mentioned previously, this thesis does acknowledge that the submission put forward could raise unintended tax policy concerns which are beyond the scope of this thesis.

The next paragraph 2.3 will discuss the taxation of carried interest in the US, Canada, Australia, UK and South Africa. The discussion to follow is aimed at analysing how the above mentioned jurisdictions have addressed the taxation of carried interest with regard to their respective private equity industries in a manner which could be beneficial to South African law.

2.3 Taxation of Carried Interest

(a) United States ('US')

As mentioned above, a private equity fund located in the US will typically be structured as a limited partnership because of the lack of an entity-level tax on partnerships under US tax law. The limited partners will be the investors and general partner will be the manager of the fund. The carried interest is the share of profits that the fund manager receives from his/her ownership interest in the fund's assets.[2564] Carried interest is an important part of private equity investing and is received by the fund manager for negotiating, structuring and implementing the investments of the private equity fund. In addition, carried interest is intended to align the fund manager's interests with those of the investors.[2565] In terms of current US law, the investments made by a private equity fund in capital assets and the gains and losses realised by the private equity fund on the realisation of such capital assets are appropriately treated as capital gains and losses.[2566] The fund manager's carried interest in a private equity fund is taxed on a 'pass-through' basis, like any other equity interest in any other partnership. For tax purposes, the fund's income, gains, losses, and deductions flow through to the partners in the fund, including the fund manager, with the same timing and character as recognised by the fund.[2567] If the fund's returns include ordinary income or loss, the carried interest is taxed as such; and to the extent that the fund's returns are long-term capital gains or losses, the proportionate share of those items is allocated to the fund manager in connection with its carried interest.[2568]

[2564]Rosenzweig, A.H. (2009), 'Not All Carried Interests Are Created Equal', Northwestern Journal of International Law and Business, 29(3), at pages 713-762. See also Rosenzweig, A.H. (2014), 'Revisiting the Law of Moses' Rod: The Case of Inversions', Tax Notes, 145(4), at pages 429-435.

[2565]See Harris, R.S., Jenkinson, T. and Kaplan, S.N. (2014), 'Private equity performance: What do we know?', The Journal of Finance, 69(5), at pages 1851-1882.

[2566]See Stoff, I. and Braun, R. (2014), 'The Evolution of Private Equity Fund Terms Beyond 2 and 20', Journal of Applied Corporate Finance, 26(1), at pages 65-75.

[2567]Marples, D. (2014), 'Taxation of Hedge Fund and Private Equity Managers', Congressional Research Service, RS22689, 7th March 2014. Available at www.crs.gov, accessed in June 2015.

[2568]Marples, D. (2014), 'Taxation of Hedge Fund and Private Equity Managers', Congressional Research Service, RS22689, 7th March 2014. Available at www.crs.gov, accessed in June 2015.

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There is an ongoing debate in the US over the taxation of carried interest.[2569] This debate pertains to the treatment of carried interest as capital gain for the managers of private equity funds.[2570] Under current US tax law,[2571] income resulting from carried interests is often taxed at capital gains rates (as broadly mentioned above).[2572] However, in terms of legislative proposals in the US carried interest income would be taxed at the higher ordinary income tax rates.[2573] In terms of the US Internal Revenue Code of 1986, a service partner is not taxed on the receipt of a 'profits interest'[2574] in a partnership.[2575] A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership.[2576] The tax-free receipt of a profits interest does not apply if the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high quality net lease, or in certain other limited circumstances.[2577] On the other hand, a partnership capital interest received for services is generally includable in the partner's income upon receipt.[2578] A partnership capital interest is generally an interest that would entitle the receiving partner to a share of the proceeds if the partnership's assets were sold at fair value and the proceeds were distributed in liquidation.[2579] The character of partnership items[2580] passes through to the partners as if the income items were realised directly by the partners.[2581] Therefore, to the extent a service partner is allocated income, the character of the income passes through. In a typical US private equity structure, the private equity fund will recognise capital gain income on the disposition of its investment and, therefore, the service partner generally

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[2569]Cochran, W.G. (2014), 'Searching for Diamond in the Two-and-Twenty Rough: The Taxation of Carried Interests', Stanford Law Review, 66, at 953. See also Field, H.M. (2014), 'The Real Problem with Carried Interests', Hastings Law Journal, 65(2).

[2570] See Winchester, R. (2014), 'Carried Interest for the Common Man', Tax Notes, 142(11), at 1250. See also Borden, B.T. (2014), 'Notable Partnership Articles from 2013', Tax Notes, 143, at 1513.

[2571]Section 702 of the Internal Revenue Code of 1986, as amended.

[2572]See Harris, R.S., Jenkinson, T. and Kaplan, S.N. (2014), 'Private equity performance: What do we know?', The Journal of Finance, 69(5), at pages 1851-1882.

[2573]See Marples, D. (2014), 'Taxation of Hedge Fund and Private Equity Managers', Congressional Research Service, RS22689, 7th March 2014. Available at www.crs.gov, accessed in June 2015. See also Field, H.M. (2012), 'The Return-Reducing Ripple Effects of the Carried Interest Tax Proposals', Florida Tax Review, 13(1), at pages 1-40.

[2574]Namely carried interest.

[2575]Revenue Procedure ('Rev. Proc.') 93-27, 1993-2 C.B. 343; and Rev. Proc. 2001-43, 2001-2 C.B. 191 of section 702 of the Internal Revenue Code of 1986, as amended.

[2576]Winchester, R. (2014), 'Carried Interest for the Common Man', Tax Notes, 142(11), at 1250. See also Burke, K.C. (2010), 'Sound and Fury of Carried Interest Reform', Columbia Journal of Tax Law, 1(1), at pages 1-44.

[2577]Rev. Proc. 93-27, 1993-2 C.B. 343; and Rev. Proc. 2001-43, 2001-2 C.B. 191 of section 702 of the Internal Revenue Code of 1986, as amended. See Weisbach, D.A. (2008), 'The Taxation of Carried Interests in Private Equity', Virginia Law Review, at pages 715-764.

[2578]See Stoff, I. and Braun, R. (2014), 'The Evolution of Private Equity Fund Terms Beyond 2 and 20', Journal of Applied Corporate Finance, 26(1), at pages 65-75. See also Levin, J.S., Rocap, D.E. and Welke, W.R. (2010), 'Carried Interest Legislative Proposals and Enterprise Value Tax', Tax Notes, 1st November 2010.

[2579]Rev. Proc. 93-27, 1993-2 C.B. 343 of section 702 of the Internal Revenue Code of 1986, as amended.

[2580]Either capital gains or ordinary income.

[2581]See Harris, R.S., Jenkinson, T. and Kaplan, S.N. (2014), 'Private equity performance: What do we know?', The Journal of Finance, 69(5), at pages 1851-1882. See also Levin, J.S., Rocap, D.E. and Welke, W.R. (2010), 'Carried Interest Legislative Proposals and Enterprise Value Tax', Tax Notes, 1st November 2010.

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receives capital gain treatment on its allocable share of that income resulting from the carried interest.[2582] According to Rosenzweig:

> 'This debate has focused on whether private equity fund managers who earn a percentage of the returns generated by the fund should be entitled to preferential 'capital gain' treatment on such returns. The primary concern in this debate revolves around whether managers are effectively being compensated for services normally taxed at higher rates while receiving the benefit of preferential rates reserved for capital gains. Proponents of reform point to the services being performed by the managers, while proponents of the current system point to the investment exposure to the underlying assets of the fund. In reality, however, both sides are partially correct: carried interest is 'blended' in that it represents both a return to services and a return on capital. Since carried interest is blended in this manner, an analogy to either proves less than satisfying.'[2583]

In the US during 2013, the Ways and Means Committee in the House of Representatives had solicited industry comments on various aspects of tax policy that the Committee and its Working Groups were considering as part of the tax reform in the US.[2584] An important tax policy under consideration was the possible increase of the tax rate on carried interest. This consideration represents a possible major setback for the US private equity industry, because it was the substantial reduction of capital gains tax in the first place that was instrumental in increasing the flow of capital into the US private equity industry.[2585] In a letter by the PEGCC to Dave Camp, the Chairman of the Committee on Ways and Means of the US House of Representatives, the PEGCC set forth clear reasons opposing a proposal for increasing the current tax treatment of carried interest.[2586] In the letter, the PEGCC argued that:

> 'A carried interest tax increase would nearly double taxes on businesses that facilitate investment and job growth in the United States. While some supporters of the tax increase claim it is only a

[2582]Harris, R.S., Jenkinson, T. and Kaplan, S.N. (2014), 'Private equity performance: What do we know?', The Journal of Finance, 69(5), pages 1851-1882. See Stoff, I. and Braun, R. (2014), 'The Evolution of Private Equity Fund Terms Beyond 2 and 20', Journal of Applied Corporate Finance, 26(1), pages 65-75. See Cory M. Vargo, C.M. (2012), 'Carried Interest Taxation and Private (and Horizontal) Equity', Tax Notes, 22nd October 2012.

[2583]Rosenzweig, A.H. (2009), 'Not All Carried Interests Are Created Equal', Northwestern Journal of International Law and Business, 29(3), at pages 713-762. See also Rosenzweig, A.H. (2014), 'Revisiting the Law of Moses' Rod: The Case of Inversions', Tax Notes, 145(4), at pages 429-435.

[2584]Available at www.pegcc.org/issues/comment-letters/pegcc-comment-letter-on-flow-through-pass-through-taxation/#sthash.BQQlUci1.dpuf, accessed in April 2015.

[2585]See Harris, R.S., Jenkinson, T. and Kaplan, S.N. (2014), 'Private equity performance: What do we know?', The Journal of Finance, 69(5), at pages 1851-1882. See also Stoff, I. and Braun, R. (2014), 'The Evolution of Private Equity Fund Terms Beyond 2 and 20', Journal of Applied Corporate Finance, 26(1), at pages 65-75. See also Field, H.M. (2014), 'The Real Problem with Carried Interests', Hastings Law Journal, 65(2). See also Winchester, R. (2014), 'Carried Interest for the Common Man', Tax Notes, 142(11), at 1250. See also Borden, B.T. (2014), 'Notable Partnership Articles from 2013', Tax Notes, 143, at 1513.

[2586]Dated 15th April 2013.

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tax on hedge fund managers, the proposed tax increase is squarely aimed at real estate, private equity, venture capital, and other businesses that make long-term investments that stimulate job creation and innovation. Tax rates on carried interest should remain fully aligned with the tax rates on all other similarly situated capital gains. Many countries with which the United States compete, tax carried interest as capital gains and often at lower rates than the United States. The carried interest tax increase also contains an enterprise value tax, which would deny long-term capital gains treatment on the value of an investment partnership business built over many years if the business is eventually sold in whole or in part. In short, under this proposal, investment partnerships would be the only form of business in America subject to this discriminatory treatment. While some proponents of the carried interest tax increase proposal have recognised that the enterprise value tax is problematic, none of the proposed fixes to date have adequately eliminated the enterprise value tax. The key criterion for capital gains treatment is whether the taxpayer has made an entrepreneurial investment of capital or labour in a long-lived asset, the return for which depends entirely on the growth in the value of the asset.'[2587]

According to Postlewaite, the primary concern over the taxation of carried interest is that fund managers are being compensated for their services but are receiving the benefit of the preferential rates applied to long-term capital gains.[2588] According to Rosenzweig, one way the law has attempted to address the issue was by imposing a 'holding period' requirement.[2589] In terms of this approach, not all investments are created equal, but rather only capital investments held for an arbitrary period of time while bearing the risk of loss qualify for preferential rates.[2590] Rosenzweig contends:

'It is precisely these rules that prevent managers of certain private funds, such as hedge funds, from obtaining the benefit of preferential capital gains tax rates for their carried interest in most instances. In other words, not all carried interests are created equal.'[2591]

[2587]Judge, S. (2013), 'Letter by Private Equity Group Capital Council to Dave Camp, the Chairman of the Committee on Ways and Means of the US House of Representatives', setting forth reasons opposing a proposal for increasing the current tax treatment of carried interest, 15th April 2013. Available at www.pegcc.org/issues/comment-letters/pegcc-comment-letter-on-flow-through-pass-through-taxation/#sthash.BQQlUci1.dpuf., accessed in April 2015.

[2588]Postlewaite, P.F. (2008), 'Fifteen and Thirty Five-Class Warfare in Subchapter K of the Internal Revenue Code: The Taxation of Human Capital Upon the Receipt of a Proprietary Interest in a Business Enterprise', Northwestern University School of Law, Faculty Working Paper 170, 28, at pages 1-68. See also Postlewaite, P.F. (2009), 'Taxation of Compensatory Profits Interests: The Blind Men and the Elephant', Northwestern University Journal of International Law and Business, 29(3), at pages 763-778.

[2589]Rosenzweig, A.H. (2009), 'Not All Carried Interests Are Created Equal', Northwestern Journal of International Law and Business, 29(3), at pages 713-762. See also Rosenzweig, A.H. (2014), 'Revisiting the Law of Moses' Rod: The Case of Inversions', Tax Notes, 145(4), at pages 429-435.

[2590]Rosenzweig, A.H. (2009), 'Not All Carried Interests Are Created Equal', Northwestern Journal of International Law and Business, 29(3), at pages 713-762. See also Rosenzweig, A.H. (2014), 'Revisiting the Law of Moses' Rod: The Case of Inversions', Tax Notes, 145(4), at pages 429-435.

[2591]Rosenzweig, A.H. (2009), 'Not All Carried Interests Are Created Equal', Northwestern Journal of International Law and Business, 29(3), at pages 713-762. See also Rosenzweig, A.H. (2014), 'Revisiting the Law of Moses' Rod: The Case of Inversions', Tax Notes, 145(4), at pages 429-435.

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According to Judge, the present US law tax treatment of carried interest is based on two established tax policies, namely that capital gains are designed to reward entrepreneurial risk-taking and secondly that partnership profits should be taxed on a pass-through basis.[2592] Judge argues that disturbing either of these established tax principles would have a negative affect not only on private equity funds, but also adversely affect the treatment of other enterprises that involve carried interest or are dependent upon the personal efforts of the owners.[2593] One of the principles why capital gains was historically reduced for long-term capital gains in the US is founded on the concept of entrepreneurial investment.[2594] Judge contends that capital gains treatment is intended to encourage risk-taking investment by rewarding those who invest in capital assets and realise capital gains.[2595] According to Postlewaite, entrepreneurial investments are not limited to capital investments, but also extend to investments of labour.[2596] The US tax system recognises that a taxpayer may be entitled to capital gains treatment with respect to the sale or exchange of property where the gains are attributable in whole or in part to the taxpayer's own personal efforts.[2597] The key criterion for capital gains treatment is not whether the gains are attributable to capital or to labour, but rather whether the taxpayer has made an investment of capital or labour in a long term asset, the return for which depends entirely on the value of the asset.[2598]

[2592]Judge, S. (2013), 'Letter by Private Equity Group Capital Council to Dave Camp, the Chairman of the Committee on Ways and Means of the US House of Representatives', setting forth reasons opposing a proposal for increasing the current tax treatment of carried interest, 15th April 2013. Available at http://www.pegcc.org/issues/comment-letters/pegcc-comment-letter-on-flow-through-pass-through-taxation/#sthash.BQQIUci1.dpuf., accessed in April 2015.
[2593]Judge, S. (2013), 'Letter by Private Equity Group Capital Council to Dave Camp, the Chairman of the Committee on Ways and Means of the US House of Representatives', setting forth reasons opposing a proposal for increasing the current tax treatment of carried interest, 15th April 2013. Available at http://www.pegcc.org/issues/comment-letters/pegcc-comment-letter-on-flow-through-pass-through-taxation/#sthash.BQQIUci1.dpuf., accessed in April 2015.
[2594]See Harris, R.S., Jenkinson, T. and Kaplan, S.N. (2014), 'Private equity performance: What do we know?', The Journal of Finance, 69(5), at pages 1851-1882. See also Stoff, I. and Braun, R. (2014), 'The Evolution of Private Equity Fund Terms Beyond 2 and 20', Journal of Applied Corporate Finance, 26(1), at pages 65-75. See also Field, H.M. (2014), 'The Real Problem with Carried Interests', Hastings Law Journal, 65(2). See also Winchester, R. (2014), 'Carried Interest for the Common Man', Tax Notes, 142(11), at 1250. See also Borden, B.T. (2014), 'Notable Partnership Articles from 2013', Tax Notes, 143, at 1513.
[2595]Judge, S. (2013), 'Letter by Private Equity Group Capital Council to Dave Camp, the Chairman of the Committee on Ways and Means of the US House of Representatives', 15th April 2013. Available at http://www.pegcc.org/issues/comment-letters/pegcc-comment-letter-on-flow-through-pass-through-taxation/#sthash.BQQIUci1.dpuf., accessed in April 2015.
[2596]Postlewaite, P.F. (2008), 'Fifteen and Thirty Five-Class Warfare in Subchapter K of the Internal Revenue Code: The Taxation of Human Capital Upon the Receipt of a Proprietary Interest in a Business Enterprise', Northwestern University School of Law, Faculty Working Paper 170, 28, at pages 1-68. See also Postlewaite, P.F. (2009), 'Taxation of Compensatory Profits Interests: The Blind Men and the Elephant', Northwestern University Journal of International Law and Business, 29(3), at pages 763-778.
[2597]Field, H.M. (2012), 'The Return-Reducing Ripple Effects of the Carried Interest Tax Proposals', Florida Tax Review, 13(1), at pages 1-40.
[2598]See Harris, R.S., Jenkinson, T. and Kaplan, S.N. (2014), 'Private equity performance: What do we know?', The Journal of Finance, 69(5), at pages 1851-1882. See also Stoff, I. and Braun, R. (2014), 'The Evolution of Private Equity Fund Terms Beyond 2 and 20', Journal of Applied Corporate Finance, 26(1), at pages 65-75. See also Cory M. Vargo, C.M. (2012), 'Carried Interest Taxation and Private (and Horizontal) Equity', Tax Notes, 22nd October 2012.

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According to Judge, the same principles apply in the pooled investment context, where the partners join together to invest capital and labour.[2599] The value of a private equity fund's investments is enhanced by the skill of the fund manager in sourcing investment opportunities, structuring the finance and later exiting the investment at an enhanced value.[2600] Furthermore, the private equity fund is entitled to capital gains treatment on the disposition of their underlying investments in recognition of the entrepreneurial risk they have taken by investing the capital and labour of their partners (both fund manager and investors).[2601] Judge further states that:

> 'The core notion of partnership taxation is that partners receive a "distributive share" of income jointly derived from pooled labour and capital. The tax system has long recognised that parties in a venture may organize as a partnership, and arrange their equity interests to allocate the income, gains, losses, and deductions of the partnership among themselves as they see fit, so long as those allocations reflect the economics of the venture. By adopting a flexible system of pass-through taxation for partnerships, the tax law respects the parties' contractual arrangements, and enables joint ventures with complex equity structures to be conducted on a predictable tax basis. As a matter of long-standing tax principle, if the parties genuinely agree to share the profits of a venture in a particular way (whether those profits are operating income, dividends, capital gains, or interest), that agreement will be respected for tax purposes.'[2602]

Nevertheless, in a private equity fund the fund manager's carried interest represents its share of the gains and losses of the fund.[2603] If the gains are from long-term capital assets, amounts received by the fund manager will be taxed at capital gains rates.[2604] The tax treatment of income received under a carried interest on a pass-through basis based on the amount and character of a partnership's gains and losses, albeit the fund manager or investor(s), properly reflects the underlying premise of the taxation of private equity fund arrangements.[2605] Nonetheless, the US Congress decided there

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[2599] Judge, S. (2013), 'Letter by Private Equity Group Capital Council to Dave Camp, the Chairman of the Committee on Ways and Means of the US House of Representatives', 15th April 2013. Available at www.pegcc.org/issues/comment-letters/pegcc-comment-letter-on-flow-through-pass-through-taxation/# sthash.BQQlUci1.dpuf., accessed in April 2015.
[2600] See Harris, R.S., Jenkinson, T. and Kaplan, S.N. (2014), 'Private equity performance: What do we know?', The Journal of Finance, 69(5), at pages 1851-1882.
[2601] See Stoff, I. and Braun, R. (2014), 'The Evolution of Private Equity Fund Terms Beyond 2 and 20', Journal of Applied Corporate Finance, 26(1), at pages 65-75.
[2602] Judge, S. (2013), 'Letter by Private Equity Group Capital Council to Dave Camp, the Chairman of the Committee on Ways and Means of the US House of Representatives', 15th April 2013. Available at http://www.pegcc.org/issues/comment-letters/pegcc-comment-letter-on-flow-through-pass-through-taxation/#sthash.BQQlUci1.dpuf., accessed in April 2015.
[2603] See Harris, R.S., Jenkinson, T. and Kaplan, S.N. (2014), 'Private equity performance: What do we know?', The Journal of Finance, 69(5), at pages 1851-1882.
[2604] See Harris, R.S., Jenkinson, T. and Kaplan, S.N. (2014), 'Private equity performance: What do we know?', The Journal of Finance, 69(5), at pages 1851-1882.
[2605] See Stoff, I. and Braun, R. (2014), 'The Evolution of Private Equity Fund Terms Beyond 2 and 20', Journal of Applied Corporate Finance, 26(1), at pages 65-75. See also Field, H.M. (2014), 'The Real Problem with Carried Interests', Hastings Law Journal, 65(2). See also Winchester, R. (2014), 'Carried Interest for the

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should be lower tax rates for capital gains for a variety of reasons, all of which ironically are applicable to private equity.[2606]

(b) Canada

As mentioned previously, the limited partnership is the predominant legal structure used in Canada as a vehicle for private equity funds.[2607] Canadian limited partnerships are fiscally transparent in terms of the Canadian Income Tax Act ('ITA').[2608] The ITA generally does not impose entity-level tax on a partnership, but it does require that the income or loss of the partnership initially be computed as if the partnership were a separate person and that the income or loss then be allocated to the partners.[2609] In terms of section 96(1)(c) of the ITA the determination of the capital gains of a partnership is made as if the partnership were a separate person and under section 96(1)(f) of the ITA, any capital gains so determined are then allocated to the partners in accordance with their respective shares. In addition, section 96(1)(f) of the ITA ensures that the character of allocated income, which depends on the source of the income, is maintained in the hands of the partner.[2610] Accordingly, the question of whether the gain allocated to the partner is ordinary income or capital gains is determined at the partnership level so that a gain realised by the partnership is either all realised on capital account or all realised on income account.[2611]

On the 29th November 2011, the Canadian Revenue Agency ('CRA') introduced an administrative policy with regard to the interpretation of section 96(1)(c) of the ITA, which stated that:

> 'the treatment of amounts allocated to a partner as on income account or capital account will turn on the particular circumstances of the partner rather than on whether the amount was or was not realised by the partnership on capital account.'[2612]

Furthermore, with regard to the question on the taxation in Canada of carried interests earned by the private equity fund manager, the Directorate for the CRA stated:[2613]

Common Man', Tax Notes, 142(11), at 1250. See also Borden, B.T. (2014), 'Notable Partnership Articles from 2013', Tax Notes, 143, at 1513.

[2606]Marples, D. (2014), 'Taxation of Hedge Fund and Private Equity Managers', Congressional Research Service, RS22689, 7th March 2014. Available at www.crs.gov, accessed in June 2015.

[2607]As discussed in paragraph 3.5 of chapter two.

[2608]Canadian Income Tax Act, R.S.C., 1985, (5th Suppl), as amended.

[2609]Hogg, P.W., Magee, J.E. and Li, J. (2013), 'Principles of Canadian Income Tax Law', Carswell Publishers.

[2610]Hogg, P.W., Magee, J.E. and Li, J. (2013), 'Principles of Canadian Income Tax Law', Carswell Publishers.

[2611]Hogg, P.W., Magee, J.E. and Li, J. (2013), 'Principles of Canadian Income Tax Law', Carswell Publishers.

[2612]Canadian Interpretation Bulletin T.I. 2011-0424591M4 (2011), 'Income Tax Act: Section 9 Capital vs Profit – Partnership Interests', 29th November 2011. Available at http://taxinterpretations.com/?page_id=317&highlight=carried+interest., accessed in July 2014.

[2613]Canadian Interpretation Bulletin T.I. 2011-0424591M4 (2011), 'Income Tax Act: Section 9 Capital vs Profit – Partnership Interests', 29th November 2011. Available at http://taxinterpretations.com/?page_id=317&highlight=carried+interest., accessed in July 2014.

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> 'Carried interest is a term often used to describe an arrangement in which a manager of a financial partnership, such as a hedge fund, private equity fund, or venture capital fund, receives an equity participation in the fund in exchange for his or her services. Determining whether a gain or loss from such activities will be taxed as either an income gain or loss or as a capital gain or loss is ultimately a question of fact that can be determined only on a case-by-case basis. Generally, the gains and losses of a taxpayer who is a trader or dealer or who carries on a business of trading in securities are taxed as an income gain or loss. The factors considered in making such a determination are discussed in Interpretation Bulletin IT-479R.'[2614]

In terms of Interpretation Bulletin IT-479R,[2615] a taxpayer's gain or loss from the disposition of shares or a debt obligation such as a bond, debenture, bill, note or hypothec will be taxed as either an income gain or loss or as a capital gain or loss. The full amount of income gains is subject to tax while fifty percent of the amount of capital gains is subject to tax.[2616] In terms of section 39(4) of the ITA, where a taxpayer has disposed of a Canadian security[2617] such taxpayer may elect in the return of income for that year and any subsequent year to deem a disposition of a capital property to be either a capital gain or loss. The effect of such an election is that all Canadian security dispositions in the year of election and all subsequent years, must be given capital gain or loss treatment[2618] and the election cannot be rescinded.[2619] Section 39(4) of the ITA provides that the taxpayer may elect in the return of income for that year that:

[2614]See Canadian Interpretation Bulletin IT-479R (1984), 'Income Tax Act: Transactions in Securities', 29th February 1984. Available at www.cra-arc.gc.ca/E/pub/tp/it479r/it479r-e.html., accessed in June 2015.

[2615]Canadian Interpretation Bulletin IT-479R (1984), 'Income Tax Act: Transactions in Securities', 29th February 1984. Available at www.cra-arc.gc.ca/E/pub/tp/it479r/it479r-e.html., accessed in June 2015.

[2616]Canadian Interpretation Bulletin IT-2013-0505111I7E (2013), 'Income Tax Act: Mark-to-market property', 13th November 2013. Available at http://taxinterpretations.com/?p=24210&highlight=Interpretation+Bulletin+IT-479R, accessed in June 2015.

[2617]This term is defined in subsection 39(6) of the ITA as a security (other than a prescribed security) that is a share of the capital stock of a corporation resident in Canada, a unit of a mutual fund trust (applicable to 1979 and subsequent taxation years) or a bond, debenture, bill, note, mortgage, hypothec or a similar obligation issued by a person resident in Canada.

[2618]Pursuant to subsection 39(5) of the ITA, the election under subsection 39(4) does not apply to a disposition of a Canadian security by a taxpayer who, at the time the security is disposed of, is (a) a trader or dealer in securities, (b) a bank to which the Bank Act or the Quebec Savings Bank Act applies, (c) a corporation licensed or otherwise authorised under the laws of Canada or a province to carry on in Canada the business of offering to the public its services as trustee, (d) a credit union within the meaning assigned by subsection 137(6), (e) a non-resident, or, after November 12, 1981 (f) an insurance corporation, (g) a corporation whose principal business is the lending of money or the purchasing of debt obligations or a combination thereof, or any combination thereof. An election that have been made under subsection 39(4) does not apply to any securities disposed of during the time that subsection 39(5) applies to a taxpayer. If subsection 39(5) ceases to apply, a previous election under subsection 39(4) becomes re-applicable after that time.

[2619]Canadian Interpretation Bulletin IT-479R (1984), 'Income Tax Act: Transactions in Securities', 29th February 1984. Modified 6th September 2002. Available at www.cra-arc.gc.ca/E/pub/tp/it479r/it479r-e.html., accessed in June 2015.

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> '(a) every Canadian security owned by the taxpayer in that year or any subsequent year is deemed to be capital property owned in those years, and (b) every disposition of every Canadian security owned by the taxpayer in that and any subsequent year is deemed to be a disposition of a capital property.'

Where a taxpayer has not elected under subsection 39(4) of the ITA or does not qualify for the election, the taxpayer must determine whether the transaction in securities is on income account or capital account.[2620] Therefore some security transactions are clearly on income account and for other security transactions it will be necessary to examine the facts of the specific case in order to determine whether a transaction is on income or capital account. The tests that the Canadian Courts have applied in making such a determination are those of 'course of conduct' and 'intention'.[2621] In the Canadian case *Gardner Securities Ltd v MNR*, the Supreme Court recognised that shares 'constitutes something the purchase of which is, in itself, an investment' and that the entering into of a transaction with the intention of disposing of shares at a profit as soon as there was a reasonable opportunity of doing so was not, by itself, sufficient to make that transaction an adventure in the nature of trade.[2622]

In the *Gardner* case, the taxpayer which was a securities dealer, ceased in 1938 to comply with requirements of the investment dealers' association of which it was a member as a result of bank advances to it being too high relative to the value of securities held by it.[2623] It accordingly transferred its physical equipment, records and goodwill to a new company in consideration for shares, and itself ceased to be a member of the investment dealers' association, but retained the securities and the bank debts, and traded those securities and other securities between 1938 and the end of the Second World War.[2624] In finding that the taxpayer's gains were on income account, Judge Rand stated:

> 'Investments, in the sense urged, look primarily to the maintenance of an annual return in dividends or interest. Substitutions in the securities take place, but they are designed to further that primary purpose and are subsidiary to it. On the facts before us, there cannot, in my opinion, be any real doubt that there was no such dominant purpose here.'[2625]

Respecting a submission that a purchase of the shares of a particular corporation was effected in 1944 in order to obtain effective control of that corporation, thereby permitting the principal of the

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[2620] Hogg, P.W., Magee, J.E. and Li, J. (2013), 'Principles of Canadian Income Tax Law', Carswell Publishers.
[2621] See *Gardner Securities Ltd v MNR*, 54 DTC 1015, (1954) CTC 24, (1964) S.C.R. 66.
[2622] *Gardner Securities Ltd v MNR*, 54 DTC 1015, (1954) CTC 24, (1964) S.C.R. 66. Section 248(1) of the ITA.
[2623] *Gardner Securities Ltd v MNR*, 54 DTC 1015, (1954) CTC 24, (1964) S.C.R. 66.
[2624] *Gardner Securities Ltd v MNR*, 54 DTC 1015, (1954) CTC 24, (1964) S.C.R. 66.
[2625] *Gardner Securities Ltd v MNR*, 54 DTC 1015, (1954) CTC 24, (1964) S.C.R. 66, at page 1016.

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taxpayer to introduce his sons to industrial management, Judge Rand stated that a business could include:

> '...a business of taking over, by means of stock control, run down industries, building them up, and disposing of them.'[2626]

The general rule is that in share transactions if the whole course of conduct indicates that the taxpayer is disposing of shares in a way capable of producing gains and with that object in view, and that the transactions are of the same kind and carried on in the same way as those of a trader or dealer in securities then the proceeds of sale will normally be considered to be income from a business and, therefore, on income account.[2627] Furthermore, subsection 248(1) of the ITA defines the term 'business' to include 'an adventure or concern in the nature of trade' and the courts have held that 'an adventure or concern in the nature of trade' can include an isolated transaction in shares where the 'course of conduct' and 'intention' clearly indicate it to be such.[2628]

A taxpayer's intention to sell at a gain is not sufficient, by itself, to establish that the taxpayer was involved in an adventure or concern in the nature of trade.[2629] According to Hogg *et al*, the latter intention is almost invariably present even when a true investment has been acquired if circumstances should arise that would make it financially more beneficial to sell the investment than to continue to hold it.[2630] In the case of *Imperial Stables (1981) Ltd v The Queen*, the court held that something more is required in order for a purchase of shares to be on income account, for instance the length of time for which the shares were held, the trading volume and/or the background of the taxpayer.[2631] Such factors together with other factors may assist in finding that the shares were

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[2626] *Gardner Securities Ltd v MNR*, 54 DTC 1015, (1954) CTC 24, (1964) S.C.R. 66, at page 1016.
[2627] See Edgar, T., Sandler, D., Cockfield, A.J. and Brooks, N. (2010), 'Materials on Canadian Income Tax', Carswell Publishers.
[2628] Edgar, T., Sandler, D., Cockfield, A.J. and Brooks, N. (2010), 'Materials on Canadian Income Tax', Carswell Publishers.
[2629] Hogg, P.W., Magee, J.E. and Li, J. (2013), 'Principles of Canadian Income Tax Law', Carswell Publishers.
[2630] Hogg, P.W., Magee, J.E. and Li, J. (2013), 'Principles of Canadian Income Tax Law', Carswell Publishers.
[2631] *Imperial Stables (1981) Ltd v The Queen*, 90 DTC 6135 (FCTD), affirmed 92 DTC 6189 (FCA). The taxpayer, which for convenience was referred to in the reasons for judgment by the name of its controlling individual shareholder ('Culley), who had a history of making large stock market purchases of shares which were held for a very short period of time. The taxpayer purchased, primarily in the summer of 1981, over $1.2 million of Dome Petroleum shares, held those shares through a falling market and eventually liquidated its position commencing in June 1982 for a loss of over $900,000. Judge Martin had no doubt that 'there was in Mr. Culley's mind at the time he acquired the Dome shares the possibility that he would sell them quickly if the price should rise to an acceptable level', at page 6141 Judge Martin accepted the view of the Crown's expert witness that the Dome share transactions did not have the hallmarks of those of a trader or dealer in securities. 'The trader or dealer is characterised by buy/sell, buy/sell and not by buy/buy/buy which is what Culley did', at page 6140. When the market price of Dome shares declined, Culley averaged down rather than quickly cutting its losses. In addition, Culley had no specialized knowledge of the market, acquired the shares with its cash rather than borrowed funds, and made no special effort to study factors which would affect the price of the Dome shares. 'The fact that there was no income from the shares by way of dividends is of no significance for no doubt Culley was expecting, when [it] eventually sold the shares, to sell them at a profit', at page 6141. The court held that the loss sustained by Culley was a capital loss.

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acquired on income account. Therefore the dispositions of shares are *prima facie* on capital account.[2632] In the case *Atwater Western Corp v MNR*, two individuals with extensive experience in the purchase and sale of real estate incorporated the taxpayer to acquire a long-term lease of Montreal land with a view to constructing thereon a large multi-purpose building, and then had the taxpayer contribute the lease to a joint venture company ('West End'), with the taxpayer also subscribing for 200 of the 1 000 shares of West End at $1 per share.[2633] Four years later, the majority shareholder forced the taxpayer to sell its shares to such shareholder by threatening to abort the project if this were not done.[2634] In finding that the gain was on capital account, Judge Jackett held:

> 'there may be circumstances in which a subscription for shares in a new company, while *prima facie* a capital transaction, may be a mere step in the carrying on by the acquirer of a profit-making business or venture. If, for example, the acquirer made a business of taking over old businesses, giving them new images and corporate identities and then selling the shares in the new companies, a profit from the overall enterprise would be a profit from a business even though, looked at more narrowly, that profit were a profit from the sale of shares acquired by subscribing for the capital of a new company. However, I find no such enterprise here.'[2635]

According to Edgar *et al*, where the tests applied by the courts suggests an adventure or concern in the nature of trade and it can be established that the taxpayer's intention was to sell the property at the first opportunity, intention will be viewed as corroborative evidence.[2636] However, the inability to establish an intention to sell does not exclude a transaction from being regarded as an adventure or concern in the nature of trade if it can otherwise be so regarded pursuant to one or more of the applied tests.[2637] Therefore the general principles would be applied in determining whether flow-through shares were acquired on capital account. According to the CRA, the fact that there is a tax benefit to be derived from the purchase of such shares would not itself result in their being acquired as an adventure in the nature of trade.[2638] In addition, the CRA stated:

> 'where a taxpayer is obligated to sell a particular property for a pre-determined sale price that is less than its original acquisition price such that it results in an "economic loss" (ignoring the value of any relevant tax attributes connected with the property) but results in a gain or profit for income

[2632]Hogg, P.W., Magee, J.E. and Li, J. (2013), 'Principles of Canadian Income Tax Law', Carswell Publishers.
[2633]*Atwater Western Corp v MNR*, 70 DTC 6312, (1970) CTC 472 (Ex Ct).
[2634]*Atwater Western Corp v MNR*, 70 DTC 6312, (1970) CTC 472 (Ex Ct).
[2635]*Atwater Western Corp v MNR*, 70 DTC 6312, (1970) CTC 472 (Ex Ct), at page 6314.
[2636]Edgar, T., Sandler, D., Cockfield, A.J. and Brooks, N. (2010), 'Materials on Canadian Income Tax', Carswell Publishers.
[2637]Edgar, T., Sandler, D., Cockfield, A.J. and Brooks, N. (2010), 'Materials on Canadian Income Tax', Carswell Publishers.
[2638]Canadian Interpretation Bulletin TI-2012-0438651E5 (2012), 'Income Tax Act: Capital vs Income', 20th March 2012. Available at http://peartreefinserv.com/wp-content/uploads/2012/10/CRA-Technical-Interpretation-Capital-vs-Income-Mar-2012.pdf., accessed in July 2014.

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tax purposes as a result of the operation of the rules in the Act, the courts have held that such gain or profit cannot, absent the presence of other factors, result in income earned from an adventure in the nature of trade.'[2639]

The taxation of the carried interest income or loss of the private equity firm ('general partner') will initially be computed as if the partnership were a separate person and that the income or loss then be allocated to the partners. Thus, the determination of the capital gains of the private equity firm's carried interest[2640] is made as if the private equity firm were a separate person. In addition, section 96(1)(f) of the ITA ensures that the character of allocated income, which depends on the source of the income, is maintained in the hands of the private equity firm. As stated above, the dispositions of shares by a private equity fund structured as a limited liability partnership in terms of Canadian tax law are *prima facie* on capital account. The determination as to whether the private equity firm's carried interest constitutes a gain or loss from such activities will be taxed as either an income gain or loss or as a capital gain or loss is ultimately a question of fact that can be determined only on a case-by-case basis.

(c) Australia

Prior to the 2010 Australian Reform,[2641] profits on the disposal of assets that flow to the private equity firm via carried interest have generally been treated as capital gains, resulting in more favourable tax treatment than if they were treated as income.[2642] However, this position previously depended on the specific facts and circumstances, including the holding period and the intention in relation to the assets.[2643] The Australian Taxation Office ('ATO') confirmed its view in 2010 that profits on the disposal of assets by private equity funds can be income and not capital gains.[2644] The pre-2010 approach, adopted by the ATO was somewhat the same approach broadly applied in Canada.[2645]

[2639]Canadian Interpretation Bulletin TI-2012-0438651E5 (2012), 'Income Tax Act: Capital vs Income', 20th March 2012. Available at http://peartreefinserv.com/wp-content/uploads/2012/10/CRA-Technical-Interpretation-Capital-vs-Income-Mar-2012.pdf., accessed in July 2014.
[2640]In terms of section 96(1)(c) of the ITA.
[2641]Tax Laws Amendment Bill 2010, amended the Income Tax Assessment Act 1997 and the Income Tax Assessment Act 1936. The term 'carried interest' is defined in section 104–255 of the Income Tax Assessment Act 1997 to mean (a) the entitlement of a partner in a venture capital limited partnership or an Australian venture capital fund(s) to a distribution from partnership or fund, to the extent that the distribution is contingent upon the attainment of profits for the limited partners in the entity, or (b) the entitlement of a limited partner in a venture capital management partnership to a distribution from the venture capital management partnership, to the extent that the distribution is contingent upon the attainment of profits for the limited partners in certain specified venture capital entities in which the venture capital management partnership is a general partner.
[2642]Income Tax Assessment Act, 1997.
[2643]See Evans, C. and Kerr, J. (2012), 'Tax Reform and 'Rough Justice': Is it Time for Simplicity to Shine?', In Australian Tax Forum, 27(2), at pages 385-408. See also Eccleston, R. (2013), 'The Tax Reform Agenda in Australia', Australian Journal of Public Administration, 72(2), at pages 103-113.
[2644]Financial Services Council (FSC) Submission Report (2011), 'Commentary on the outcomes of the Review of the Tax Arrangements applying to Collective Investment Vehicles by the Board of Taxation, 1st March 2011.
[2645]See Eccleston, R. (2013), 'The Tax Reform Agenda in Australia', Australian Journal of Public Administration, 72(2), at pages 103-113. See also Taylor, G. and Richardson, G. (2013), 'The determinants of

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The general principle was that it was up to the managers of private equity funds to assess for themselves whether carried interest payments should be taxed as income or capital gains. This was based on the principle that the profits from private equity are mostly derived from long term assets they are usually classed as capital gains, which is taxed at a lower tax rate than income.[2646] However, currently in terms of the Income Tax Assessment Act 1997, the only circumstance in which carried interest payments can receive a capital gains tax concession is in the case of funds set up to satisfy all the requirements of the venture capital limited partnerships regime.[2647] Generally speaking, in Australia carried interest is treated as ordinary business income of a private equity firm.[2648]

The underlying question with which Australian policy makers were faced with was whether capital gains should include carried interest or should carried interest be taxed as ordinary income?[2649] Historically, the answer to this question was that capital gains interest should not be treated as regular income.[2650] For instance, the interest accrued for capital gains should not be taxed as ordinary income because the cash is not always immediately available or sufficiently liquid enough to be accessible.[2651] It would not make sense to tax someone for income in a year that was not available to them as cash in hand. On the other hand, there are those who do not believe capital gains should include carried interest. They regard carried interest as a loop hole that should be closed and the carried interest should be taxed as ordinary income.[2652] For instance, like the proposed reforms to carried interest put forth in the US as discussed earlier under paragraph 2.3(a) of this chapter. It is clear now that in terms of the 2010 tax law amendments, the Australian tax regime has taken the radical approach in treating carried interest on revenue account.[2653] Thus only in the case of venture capital limited partnership structures, will the private equity firm be allowed to treat the profit on a carried interest in the as capital and not trading income. This means that the

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thinly capitalized tax avoidance structures: Evidence from Australian firms', Journal of International Accounting, Auditing and Taxation, 22(1), at 12-25.

[2646]Laura, A., Johns, D., and Feros, P. (2012), 'Fund Formation: Australia', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut. C., published by Getting the Deal Through, at 6-154.

[2647]For instance the VCLP and ESVCLP discussed earlier under paragraph 2.1(c) of this chapter above.

[2648]Laura, A., Johns, D., and Feros, P. (2012), 'Fund Formation: Australia', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut. C., published by Getting the Deal Through, pages 6-154.

[2649]Financial Services Council (FSC) Submission Report (2011), 'Commentary on the outcomes of the Review of the Tax Arrangements applying to Collective Investment Vehicles by the Board of Taxation, 1st March 2011.

[2650]See Evans, C. and Kerr, J. (2012), 'Tax Reform and 'Rough Justice': Is it Time for Simplicity to Shine?', In Australian Tax Forum, 27(2), at pages 385-408.

[2651]See Eccleston, R. (2013), 'The Tax Reform Agenda in Australia', Australian Journal of Public Administration, 72(2), at pages 103-113.

[2652]Taylor, G. and Richardson, G. (2013), 'The determinants of thinly capitalized tax avoidance structures: Evidence from Australian firms', Journal of International Accounting, Auditing and Taxation, 22(1), at 12-25.

[2653]Tax Laws Amendment Bill 2010, amended the Income Tax Assessment Act 1997 and the Income Tax Assessment Act 1936. The term 'carried interest' is defined in section 104–255 of the Income Tax Assessment Act 1997 to mean (a) the entitlement of a partner in a venture capital limited partnership or an Australian venture capital fund(s) to a distribution from partnership or fund, to the extent that the distribution is contingent upon the attainment of profits for the limited partners in the entity, or (b) the entitlement of a limited partner in a venture capital management partnership to a distribution from the venture capital management partnership, to the extent that the distribution is contingent upon the attainment of profits for the limited partners in certain specified venture capital entities in which the venture capital management partnership is a general partner.

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private equity firm may be eligible for the capital gains tax discount on the profit if it holds the interest as an individual for a period in excess of twelve months.[2654] In any other circumstances and fund structures, carried interest would be treated as income.

The rationale for exceptional treatment for venture capital limited partnerships regime fund managers ('general partners') is to attract capital and fund manager expertise to the small to medium size private equity market.[2655] In addition, there is a need for consistency with overseas private equity regimes in order to make Australia's small to medium size private equity market globally competitive. This was confirmed by the Australian Board of Taxation in its review of the VCLP regime, whereby it was stated that:

> 'Unlike managers in the passive funds management industry, venture capital managers are actively involved in the management of the companies in which the funds invest and typically share in the capital gains on investments made by the fund after all the investors committed capital has been returned. This is referred to as the carried interest and is designed to strongly align the interests of the fund manager and investors. To ensure the capital gain treatment of such gains flows through to the individual fund managers, if the general partner is a limited partnership, it will also be treated as a flow-through entity for tax purposes. … Taxing the carried interest of venture capital managers as capital is also consistent with the international tax treatment of these gains. An internationally consistent tax treatment is critical in attracting highly skilled international venture capital managers to Australia. Such managers will contribute to the expertise and competitiveness of Australia's venture capital industry, which, in turn, will attract venture capital funds by offshore investors.'[2656]

Nevertheless, the history and nature of the private equity business model is based on the private equity firm taking calculated investment risks on investments that will yield a desirable return to investors over the long term. Thus the primary reason for taxing capital gains at favourable rates is to encourage individuals to take risks with their accumulated capital, thereby growing the economy in the process through job creation and a lower cost of capital.[2657] It is submitted that the tax increase effective after 2010 on carried interest from capital gains rates to ordinary income rates under Income Tax Assessment Act 1997, was intended to increase Australian tax revenue under the disguise of a punitive attack on a specific sector of the Australian private equity industry. The amendments to the

[2654]Section 118-425 of the Income Tax Assessment Act 1997.
[2655]Financial Services Council (FSC) Submission Report (2011), 'Commentary on the outcomes of the Review of the Tax Arrangements applying to Collective Investment Vehicles by the Board of Taxation, 1st March 2011.
[2656]Australian Government: The Board of Taxation (2011), 'Review of Taxation Arrangements under the Venture Capital Limited Partnership Regime: A Report to the Assistant Treasurer', The Board of Taxation, June 2011, at page 23. Available at www.taxboard.gov.au, accessed in May 2015.
[2657]Laura, A., Johns, D., and Feros, P. (2012), 'Fund Formation: Australia', in Private Equity in 32 Jurisdictions Worldwide', contributing editor Cogut. C., published by Getting the Deal Through, pages 6-154.

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Income Tax Assessment Act 1997 discussed above do not take into account the risks undertaken by the private equity firm in managing a private equity fund and its underlying portfolio of investee interests and treats carried interest income as if it were the fund managers salary. It is also submitted that carried interest is not guaranteed salary income to the fund manager instead it is the fund managers share of the profit. Management fees charged by the fund manager for managing the private equity fund are already taxed as ordinary income. In addition, carried interest cannot be valued at the time it is granted since its payment is contingent upon the ultimate success of the underlying investment. Therefore, it is more in the nature of a long term risk investment that should treated as capital gains. Effectively, the Australian tax regime has eliminated the incentives for fund managers to undertake the risks inherent to the private equity business model and this could have a significant negative impact on the Australian private equity industry. For instance, it would stem the flow of investment capital into the Australian private equity market.

(d) United Kingdom ('UK')

In the UK, most carried interest is taxed as gains and not as income under the UK capital gains tax rules.[2658] In 2003, HM Revenue and Customs ('HMRC') and the British Private Equity and Venture Capital Association ('BVCA') entered into a Memorandum of Understanding ('MOU') which had the effect that most carried interest gains continued to be taxed as capital gains and not as income.[2659] In 2007, the capital-gains tax rules were reformed to the extent that it increased the rate on gains to the current eighteen percent.[2660] The 2003 MOU is a crucial initiative to the UK private equity industry because before the application of this MOU, the Finance Act of 1972 provided that gains on investments acquired by reason of rights or opportunities offered to individuals as directors or employees were, subject to various exceptions, taxed as income and not capital gains.[2661] This may strictly have applied to the carried interests of most private equity executives despite them being partners and not employees of the applicable private equity fund, because they were often directors of the investee companies.[2662] The first agreement between HMRC and the BVCA was in 1987 which essentially provided that in most circumstances gains on carried interest were not taxed as

[2658]Income Tax (Earnings and Pensions) Act 2003 ('ITEPA 2003') as amended by Finance Act 2003.

[2659]HM Revenue and Customs (2003), 'HMERSM30520-Restricted Securities: Memorandum of Understanding between the BVCA and HM Revenue and Customs on the income tax treatment of managers' equity investments in venture capital and private equity backed companies', 25th July 2003. Available at www.hmrc.gov.uk/manuals/ersmmanual/ersm30520.htm., accessed in June 2015.

[2660]For 2013-2014 the following Capital Gains Tax rates apply in the UK: 18 percent and 28 percent for individuals. See HM Revenue and Customs (2013), 'HM Revenue and Customs: Capital Gains Tax: the basics'. Available at www.hmrc.gov.uk/cgt/intro/basics.htm., accessed in June 2015.

[2661]See Prassl, J. (2015), 'The Employment Impact of Private Equity Investors: A Return of the Barbarians?', Industrial Law Journal, 44(1), at pages 150-157. See also Moore, C.B., Payne, G.T., Bell, R.G. and Davis, J.L. (2015), 'Institutional Distance and Cross-Border Venture Capital Investment Flows', Journal of Small Business Management, 53(2), at 482-500.

[2662]The 2003 MOU describes a typical private equity limited partnership fund structure and sets out guidelines agreed by the BVCA and HMRC on the application of the provisions introduced by Schedule 22, Finance Act 2003, to a carried interest in a limited partnership fund structured in this way.

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income.[2663] Subsequently, the Finance Act of 2003 broadened the circumstances in which investment gains were treated as employment-related and therefore taxed as income. The 2003 MOU states:

> 'Section 2 of the agreed BVCA Statement on limited partnerships used as venture capital investment funds dated 26 May 1987 (the '1987 Guidelines'), provides that individual partners involved in the management of such a limited partnership, whether as directors or employees of the general partner or anybody corporate providing services to the general partner or otherwise, and who receive full arm's length remuneration for the services they perform as directors and employees, will not be considered to have acquired either their partnership interests or their interests in underlying investments of the partnership after they became partners by reason of rights conferred on them or opportunities offered to them as directors or employees for the purposes of section 79 of Finance Act 1972. This part of the 1987 Guidelines is of limited relevance following enactment of Finance Act 2003. This is because section 421B(3) Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003) deems securities to be employment-related if the right to acquire them is made available by the employer or a person connected with the employer. This memorandum therefore sets out what the parties believe to be the appropriate treatment that the Inland Revenue will apply in relation to 'carried interests' issued on or after 16 April 2003, under the provisions of Finance Act 2003.'[2664]

In practice, favourable tax treatment can be achieved by ensuring that the carried interest falls within the terms of the above mentioned MOU. Namely, that the MOU will only apply to carried interest which falls within the terms and conditions of the MOU.[2665] The benefits of structuring carried interest to fall within the MOU are for instance, (i) that there will be no UK employment tax on the acquisition of carried interest; (ii) that there will be no employment tax on carried interest returns or profits; and (iii) that carried interest returns derived from capital gains realised by the private equity fund will be taxed as capital gains in the hands of the private equity managers.[2666] Structuring carried interest to

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[2663] HM Revenue and Customs (1987), 'CTM36580-Companies in Partnership: British Venture Capital Association statement and guidelines', May 1987. Available at www.hmrc.gov.uk/manuals/ctmanual/ctm36580.htm., accessed in June 2015.

[2664] HM Revenue and Customs (2003), 'HMERSM30520-Restricted Securities: Memorandum of Understanding between the BVCA and HM Revenue and Customs on the income tax treatment of managers' equity investments in venture capital and private equity backed companies', 25th July 2003, at paragraph 1.2. Available at www.hmrc.gov.uk/manuals/ersmmanual/ersm30520.htm., accessed in June 2015.

[2665] See Wetherly, P. and Otter, D. (2014), 'The Business Environment: Themes and Issues in a Globalizing World', Third Edition, Oxford University Press, at pages 113-142. See also McFall, J. and Walker, D. (2007), 'Private equity: oral and written evidence', By Great Britain Parliament, House of Commons, Treasury Committee, 11th December 2007.

[2666] See Snieska, V. and Venckuviene, V. (2015), 'Venture Capital Impact on the Region's Competitiveness', Economics and Management, (14), at pages 961-967See Spangler, T. (2013), 'One Step Ahead: Private Equity and Hedge Funds After the Global Financial Crisis', Oneworld Publications. See also Spangler, T. (2012), 'The Law of Private Investment Funds', Second Edition, Oxford University Press, at chapter 6, paragraphs A-I.

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fall within the MOU is subject to several key requirements, one of which is that the MOU requires the carried interest to take the form of a limited partnership interest in a 'carry limited partner' that feeds into a private equity fund which is itself a limited partnership.[2667] For instance, in the UK carried interest is typically structured as a limited partnership interest in a feeder limited partnership. This is typically referred to as a carried interest limited partnership which is in itself a partner in the relevant private equity fund.[2668] The private equity fund will generally take the form of an English limited partnership as discussed previously. The private equity managers normally pay a nominal consideration for their interest in a carried interest limited partnership which as a carried interest will deliver returns only if and when investor returns from the private equity fund have achieved the applicable hurdle rate.[2669] In the case of UK fund managers employed by the private equity house, the acquisition of a partnership share in the carried interest limited partnership will be treated as remuneration from the manager's employment.[2670] The fund manager is therefore subject to employment income tax on the value of his a carried interest limited partnership interest to the extent that he does not pay full value for the interest.[2671]

However, in practice favourable tax treatment can be achieved by ensuring that the carried interest falls within the terms of the 2003 MOU. While other carry and fund structures may be possible, they are likely to be more difficult to comply with all the requirements of the 2003 MOU. The fund must be regarded as a private equity partnership which implies that the underlying investment objective must to invest in unlisted companies.[2672] Another impediment created by the MOU, is that the private equity fund managers must contribute their appropriate proportion of capital to acquire their carried interest.[2673] For instance, if the profits of the private equity fund are to be split in terms of the typical 80:20 profit split between the fund's investors and the fund managers after the contracted hurdle

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[2667]See Prassl, J. (2015), 'The Employment Impact of Private Equity Investors: A Return of the Barbarians?', Industrial Law Journal, 44(1), at pages 150-157.
See Spangler, T. (2012), 'The Law of Private Investment Funds', Second Edition, Oxford University Press, at chapter 6, paragraphs A-I. See also Spangler, T. (2012), 'The Law of Private Investment Funds', Second Edition, Oxford University Press, at chapter 6, paragraphs A-I.

[2668]See Clarysse, B., Knockaert, M. and Wright, M. (2009), 'Benchmarking UK Venture Capital to the US and Israel: What lessons can be learned?', Report prepared for the British Private Equity and Venture Capital Association (BVCA).

[2669]See Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc.

[2670]See Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc.

[2671]HM Revenue and Customs (2003), 'HMERSM30520-Restricted Securities: Memorandum of Understanding between the BVCA and HM Revenue and Customs on the income tax treatment of managers' equity investments in venture capital and private equity backed companies', 25th July 2003. Available at www.hmrc.gov.uk/manuals/ersmmanual/ersm30520.htm., accessed in June 2015.

[2672]See Cumming, D.J. (2012), 'The Oxford Handbook of Private Equity', Oxford Handbooks in Finance Oxford Handbooks, Oxford University Press. See also Cornelius, P. (2011), 'International Investments in Private Equity: Asset Allocation, Markets, and Industry Structure', First Edition, Elsevier Publishing. See also McFall, J. and Walker, D. (2007), 'Private equity: oral and written evidence', By Great Britain Parliament, House of Commons, Treasury Committee, 11th December 2007.

[2673]See Demaria, C. (2013), 'Introduction to Private Equity: Venture, Growth, LBO and Turn-Around Capital', Second Edition, John Wiley and Sons. See also McFall, J. and Walker, D. (2007), 'Private equity: oral and written evidence', By Great Britain Parliament, House of Commons, Treasury Committee, 11th December 2007.

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rate has been attained, the MOU requires that the private equity fund managers contribute 20 percent of the private equity fund's investable capital. In practice, however, this will be a nominal amount on the basis that the majority of investor capital commitments to the private equity fund will be made by way of loan.[2674] The private equity fund managers must receive their normal full arm's length remuneration for their employment as managers by the private equity fund management company. The carried interest must be acquired on the establishment of the private equity fund and the carried interest must be structured as 'whole fund' carry and not on a deal by deal basis.[2675] A further restriction created by the 2003 MOU is that MOU compliance must be attained before the carried interest is acquired and/or subsequently increased.[2676] It will be impossible to achieve MOU compliance after the initial set up of the private equity fund in all cases. In addition, the MOU only applies to private equity funds and excludes property, infrastructure, hedge and other types of funds.[2677]

The central debate at hand pertains to the taxation of carried interest as a profit-sharing scheme within the private equity business model. This profit-sharing scheme is a fundamental characteristic of the private equity business model and it allows the private equity firm to reward its managers. The fund managers determine a private equity fund's investment strategy. On the other hand the fund's investors provide the capital with limited control and liability. In addition, the managers invest only a small amount in the private fund themselves, however they get to keep a fifth of the overall profits above the hurdle rate. It is evident from the discussions of the three previous jurisdictions,[2678] that there is a concerted shift away from the historical approach of taxing carried interest on capital account towards taxing carried interest on revenue account. For instance, if the legislative proposals in the US gets legislated into US law, carried interest income would be taxed at the higher ordinary income tax rates. However, current in US the private equity fund will recognise capital gain income

[2674]See Wetherly, P. and Otter, D. (2014), 'The Business Environment: Themes and Issues in a Globalizing World', Third Edition, Oxford University Press, at pages 113-142. See also Spangler, T. (2013), 'One Step Ahead: Private Equity and Hedge Funds After the Global Financial Crisis', Oneworld Publications.
[2675]See Bishop, M. (2012), 'The Future of Private Equity: Beyond the Mega Buyout', First Edition, Palgrave Macmillan, at pages 1-235. See also Spangler, T. (2013), 'One Step Ahead: Private Equity and Hedge Funds After the Global Financial Crisis', Oneworld Publications.
[2676]See Prassl, J. (2015), 'The Employment Impact of Private Equity Investors: A Return of the Barbarians?', Industrial Law Journal, 44(1), at pages 150-157. See also Moore, C.B., Payne, G.T., Bell, R.G. and Davis, J.L. (2015), 'Institutional Distance and Cross-Border Venture Capital Investment Flows', Journal of Small Business Management, 53(2), at pages 482-500. See also Snieska, V. and Venckuviene, V. (2015), 'Venture Capital Impact on the Region's Competitiveness', Economics and Management, (14), at pages 961-967. See also De Cock, C. and Nyberg, D. (2014), 'The possibility of critique under a financialized capitalism: The case of private equity in the United Kingdom', Organization, 21, 1350508414563526. See also McFall, J. and Walker, D. (2007), 'Private equity: oral and written evidence', By Great Britain Parliament, House of Commons, Treasury Committee, 11th December 2007.
[2677]HM Revenue and Customs (2003), 'HMERSM30520-Restricted Securities: Memorandum of Understanding between the BVCA and HM Revenue and Customs on the income tax treatment of managers' equity investments in venture capital and private equity backed companies', 25th July 2003. Available at www.hmrc.gov.uk/manuals/ersmmanual/ersm30520.htm., accessed in June 2015.
[2678]Namely, the US, Canada and Australia.

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on the disposition of its investment and, therefore, the fund manager generally receives capital gain treatment on its allocable share of that income resulting from the carried interest.[2679]

It is submitted that the Canadian tax rules so far seem to follow the more measured approach as to the determination as to whether the fund manager's carried interest should be taxed on capital or revenue account, which is ultimately a question of fact that can be determined only on a case-by-case basis. The Australian Government on the other hand has legislated that carried interest should be taxed on revenue account with the exception being the venture capital limited partnership structures, the rules of which will allow carried interest to be treated on capital account. In essence the UK tax regime also applies a similar approach to that of Australia. For instance, the UK Finance Act of 2003 has broadened the circumstances in which investment gains are treated as employment related and therefore taxed as income, provided the carried interest of a specific private equity fulfills the requirements of the 2003 MOU.

(e) South Africa

One of the key characteristics of the private equity business model discussed in chapter one is the remuneration of the private equity firm. Central to the latter is the private equity firm's profit share, which is commonly referred to as the 'carried interest'. This was extensively discussed throughout the first three chapters[2680] and the preceding paragraphs[2681] of this chapter. It is evident that the taxation of carried interest in the jurisdictions discussed above has historically been treated as capital gains. However there is a definitive shift towards a more measured approach whereby the capital versus revenue determination is either applied on a case by case basis or determined strictly in accordance with the applicable legislation.[2682]

For South African tax policymakers carried interest arrangements raise two significant tax issues: the timing and the character of the income earned by the private equity firm. Both of those issues involve the same underlying question, which is whether a private equity firm's carried interest should be treated as a quasi-investment in the private equity fund by the other investor participants, with the result that the carried interest would be subject to the same tax rules as apply to the other investor participants' interests, or some form of contractual undertaking by the other investor participants (or

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[2679]See paragraph 2.3(a) of this chapter above.
[2680]Specifically paragraph 4.1.1 of chapter one.
[2681]Specifically paragraphs 2.3(a) to (f) of chapter four.
[2682]See earlier paragraph 2.1(e) of this chapter, more specifically 'Capital Gains Tax' section, in relation to possible policy concerns.

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the private equity fund) to compensate the founding member for management services.[2683] The first tax issue involves the timing of a private equity firm's tax liability for the carried interest that it receives for managing the private equity fund. In terms of the Income Tax Act 58 of 1962 carried interest is not taxed at the time the right to the future profits is granted (for example, when the private equity fund is created) but rather when the private equity fund realises profits that are allocated to the private equity firm.[2684] At one level, deferral is a specific example of a more pervasive phenomenon, which is the Income Tax Act 58 of 1962's reliance on realisation events, the sale of an investment, for example to determine the timing of income from investments. Other investor participants in a private equity fund also enjoy the benefits of deferral because they do not pay tax on unrealised gains, but only on gains that have been recognised through a sale or similar event.[2685]

However, deferral as applied to a private equity firm's carried interest effectively assumes the resolution of the underlying technical and policy issue as to (a) whether the private equity firm's carried interest should be treated as a simple investment by the private equity firm (albeit one that has no claim to the current capital of the fund but only to the future appreciation thereof), or (b) whether, at least to some degree, the carried interest is in substance a form of compensation paid by the other investor participants to the private equity firm for services in managing the private equity fund.[2686] The second issue is the character of the income received as carried interest. Under the Income Tax Act 58 of 1962, carried interest is treated in the same way as all other profits from the private equity fund for tax purposes.[2687] In particular, carried interest flows through to the private equity firm on the basis of the nature of the income from the underlying investments. Thus, if the carried interest arises from realisations of capital gains on the investments held by the private equity fund, the private equity firm is taxed on the carried interest at the prevailing capital gains tax rate. In the paradigmatic private equity case, most profits arise from capital gains, so the profit allocated to the private equity firm's carried interest will be taxed as capital gains.[2688]

This means that carried interest in South Africa is typically derived in the form of a share of the gains from the disposal of shares by the private equity fund. Capital gains tax and taxes on the disposal of an asset are regulated in terms of the Eighth Schedule to the Income Tax Act 58 of 1962, which primarily centre on the question South African courts would ascertain, namely whether the applicable

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[2683]See Batchelder, L. (2008), 'Business Taxation: What is carried interest and how should it be taxed?', Tax Policy Center, updated 7th February 2013 by Rosenthal, S. Available at www.taxpolicycenter.org/briefing-book/key-elements/business/carried-interest.cfm., accessed in June 2015.
[2684]Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023. See also Haupt, P. (2015), 'Notes on South African Income Tax', Thirty Fourth Edition, H and H Publications.
[2685]See discussion under paragraphs 2.1(e) and 2.2(e) of this chapter above.
[2686]Burke, K.C. (2010), 'Sound and Fury of Carried Interest Reform', Columbia Journal of Tax Law, 1(1), at pages 1-44.
[2687]See discussion under paragraphs 2.1(e) and 2.2(e) of this chapter above.
[2688]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.

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gains are of a revenue or capital nature.[2689] In addition, if such gains qualified under the safe-harbour provisions of section 9C of the Income Tax Act 58 of 1962 and did not fall within the scope of the provisions of section 8C of the Income Tax Act 58 of 1962, would they generally be taxed at capital gains tax? At this point in the discussion, it is important to note that the latter question has been extensively discussed under paragraphs 2.1(e) and 2.2(e) of this chapter. There is uncertainty in South Africa regarding the tax treatment of the carried interest. For instance, some observers view carried interest as a mixture of compensation for management services and capital returns. These tax issues and those described under paragraphs 2.1(e) and 2.2(e) of this chapter, all have given rise to proposals to change the tax treatment of carried interest. The first draft of the Explanatory Memorandum to the Revenue Laws Amendment Bill, 2007 contained the following statement:

> 'It has come to Government's attention that a number of private equity deals involve management 'carried interests'. These carried interests represent a form of services, which should be taxed at ordinary rates. However, these carried interests are often arranged so that they are instead taxable as a capital gain. One mechanism for disguising these interests may be through the use of shares. The proposed 3-year deemed capital rule may accordingly be adjusted at a later date to eliminate this potential for arbitrage. Any changes in this regard will be subject to further analysis.'

At the time of writing this section of this thesis, the above statement has not been incorporated into South African tax law. However, it is an indication that the South African Revenue Service ('SARS') will in future scrutinize carried interest payments. Policymakers considering such proposals may want to weigh the underlying substance of the tax issue at hand with various other considerations. For example, changes in tax policy that have significant and potentially unexpected effects on particular industries should generally be approached with caution, because a broader policy objective may be served by stability and an associated perception of fairness.[2690] Furthermore, as noted above, carried interest arises not just within private equity funds; it is also a common feature of other sectors.[2691] Many of the underlying tax issues that arise with regard to the taxation of carried interest in the financial services sector arise in those other sectors as well, and policy makers interested in changing the tax treatment of carried interest therefore need to evaluate the costs and

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[2689]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023.

[2690]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023. See also Vargo, C.M. (2012), 'Carried Interest Taxation and Private (and Horizontal) Equity', Tax Notes, 22nd October 2012. See also Winchester, R. (2014), 'Carried Interest for the Common Man', Tax Notes, 142(11), at 1250.

[2691]See Stiglingh, M., Koekemoer, A.D., Van Zyl, L., Wilcocks, J.S. and De Swardt, R.D. (2017), 'Silke: South African Income Tax', LexisNexis, Volume 2, January 2017, paragraph 28, at pages 902-1023. See also Vargo, C.M. (2012), 'Carried Interest Taxation and Private (and Horizontal) Equity', Tax Notes, 22nd October 2012. See also Stoff, I. and Braun, R. (2014), 'The Evolution of Private Equity Fund Terms Beyond 2 and 20', Journal of Applied Corporate Finance, 26(1), at pages 65-75. See also Cochran, W.G. (2014), 'Searching for Diamond in the Two-and-Twenty Rough: The Taxation of Carried Interests', Stanford Law Review, 66, at 953.

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benefits of changing that treatment for all carried interest relative to restricting the change to the financial services industry.[2692]

It is submitted that carried interest represents a performance-based compensation for services undertaken by the private equity firm. This is supported by two important themes. First, a private equity firm that manages a private equity fund undertakes a fundamentally different economic role from that of the other investor participants, because the private equity firm is responsible for managing the fund's assets on a day-to-day basis.[2693] Second, the carried interest is not principally based on a return to the private equity firm's own financial assets being at risk. If the purpose of the preferential tax rate on capital gains in South Africa is to encourage investors to put financial capital at risk, there is little reason for that preference to be made available to the private equity firm, whose risk involves time and effort rather than financial capital.

(f) Analysis

South African policymakers should consider the background of carried interest as the primary incentive for the fund management firm before they decide to adjust the 3-year deemed capital rule. As discussed above, carried interest does not simply represent a form of services, which should be taxed as ordinary income. Instead South African policymakers should maintain their current approach with regard to the taxation of carried interest and should be cautious when considering current legislative proposals being considered in the US, including the radical approach adopted in Australia (discussed above). On the other hand, the UK and Canada have followed a more measured approach, with Canada dealing with the capital versus revenue determination on a case by case basis, coupled with the *prima facie* position that carried interest is of a capital nature until established otherwise. In the UK, the taxation of carried interest is treated on capital account in terms of the UK Income Tax Act of 2003 as amended by the Finance Act of 2003.

Carried interest in South Africa has traditionally and should continue to be treated as capital gains income taxed at favourable capital gains rates. However, any proposed amendment to the Income Tax Act 58 of 1962 aimed at adjusting the current 3-year deemed capital rule and tax carried interest on income account would disproportionately impact the South African private equity industry because it forms a vital component of the local private equity industry's business model. The latter may not in itself represent a strong enough reason not to implement the aforementioned legislative consideration, however then it should not be intended solely as a revenue-raising measure or as a

[2692]See Field, H.M. (2012), 'The Return-Reducing Ripple Effects of the Carried Interest Tax Proposals', Florida Tax Review, 13(1), at pages 1-40. See also Field, H.M. (2014), 'The Real Problem with Carried Interests', Hastings Law Journal, 65(2). See also Borden, B.T. (2014), 'Notable Partnership Articles from 2013', Tax Notes, 143, at 1513.
[2693]Basically by virtue of its expertise, contacts, experience and talent.

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punitive attack on the private equity industry alone. Adjusting the current 3-year deemed capital rule, ignores the negative impact it would have on the South African private equity market and could potentially slow the flow of investment capital to the local private equity market. Any such legislative change to the Income Tax Act 58 of 1962 should only be undertaken in the context of overall comprehensive reform of the South African tax rules, where the total impact of the changes on the private equity market can be balanced. It is submitted:

(i) Firstly, carried interest is not a guaranteed salary income to the private equity firm. The private equity firm's management fees for services received by the private equity firm are already taxed as ordinary income. In addition, it is virtually impossible to quantify a private equity firms carried interest monetary value at the time it is granted because the payment thereof is dependent on the final performance of the applicable private equity fund. This makes carried interest in the nature of a long term investment that should treated as capital gains.

(ii) Secondly, the private equity firm's carried interest is received in return for the risks taken by fund management firm in managing the private equity fund and its underlying portfolio investments. The private equity firm is responsible for all the affairs of the private equity fund on a day to day basis.

(iii) Thirdly, taxing carried interest on the higher revenue account basis will increase tax on carried interest which would undermine the socio-economic objectives of the South African Government. For instance, it would undermine the entrepreneurial activity in the small to medium size private equity market and in those areas of the South African economy where high risk investing is most required. Therefore, the appetite by private equity firms to undertake higher risk private equity investments would be reduced by higher taxes on the ultimate return, which would mean that job-creating investments will not be undertaken or at least significantly reduced.

(iv) Fourthly, taxing carried interest on the higher revenue account basis will negatively impact the flow of capital to the private equity industry because private equity firms could demand different forms of compensation structures before they undertake the risk of managing a private equity fund. This could make the local private equity market unattractive to potential investors.

(v) Fifthly, if the 3-year deemed rule discussed above is adjusted then the tax increase based on revenue account will apply to any legal structure that has a carried interest component in terms of South African law.

Nevertheless, whether a private equity firms' carried interest should be taxed at a higher or lower rate, is not a matter of substantial critical analysis in this thesis, other than to submit that it should continued to be taxed at the lower capital gains tax rates. To this end, changing the way private

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equity firms, *bewind* trusts and *en commandite* partnerships in general are taxed is a policy consideration that should only be undertaken after careful consideration of the real and potential consequences.

3. Private Equity Exit Alternatives

As mentioned earlier, this chapter will critically analyse how the lack of exit alternatives in South Africa is an impediment to the growth of the local private equity industry. The objective of a private equity fund is to realise the return on its investment in each underlying portfolio investee company after a period of time once the initial transaction was concluded. The private equity fund achieves this objective by exiting the underlying portfolio investee companies and this process is an integral part of the private equity business model.[2694] In addition, the ultimate success of a private equity fund is reflected by the number of successful exits it has achieved, which in turn has a direct impact on the ability of such a private equity firm to attract investors and raise more funds.[2695] Therefore, the various potential exit routes in a private equity market also directly impacts on an investor(s) decision as to whether or not it will commit to invest in a particular private equity fund.[2696] Although fund raising and investment activity in South Africa seems reasonably consistent, exiting alternatives remain a challenge for the local industry.[2697] In order for a private equity market to flourish, private equity firms must have clear exit strategy alternatives that enable them to realise the gains on their investments. According to the South African Venture Capital and Private Equity Association ('SAVCA'), stock market listings and trade sales are the main exit strategies in South Africa. Thus, perhaps the most challenging aspect of private equity investing in South Africa has been the difficulty of exit.[2698]

In broad terms, there are four methods used by private equity funds to exit from their underlying portfolio investee companies, namely trade sales, stock market listings, recapitalisation and secondary buyouts.[2699] According to Lerner *et al*, these represent the most widely used exits routes

[2694]Cumming, D.J. (2010), 'Private Equity: Fund Types, Risks and Returns, and Regulation', Kolb Series in Finance, Essential Perspectives, John Wiley and Sons.
[2695]Lerner, J., Hardymon, F. and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', Fifth Edition, Wiley and Sons.
[2696]See Broere, M. (2013), 'Decision-Making in Private Equity Firms: An Empirical Study of Determinants and Rules', Springer Science and Business Media, at pages 113-150. See also Cumming, D.J., and Johan, S.A. (2007), 'Regulatory Harmonization and the Development of Private Equity Markets', Journal of Banking and Finance, 31, pages 3218-3250.
[2697]KPMG and SAVCA (South African Venture Capital Association), (2013), 'Private Equity and Venture Capital Industry Performance Survey of South Africa covering the 2012 calendar year', Survey, 2013.
[2698]KPMG and SAVCA (South African Venture Capital Association), (2013), 'Private Equity and Venture Capital Industry Performance Survey of South Africa covering the 2012 calendar year', Survey, 2013, at page 2.
[2699]Most of the leading authors in the field suggest that these four methods are the main methods of exiting. Lerner, J., Hardymon, F. and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', Fifth Edition, Wiley and Sons. See also Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc. See also Gilson, R.J., and Milhaupt, C.J. and (2004), 'Choice as Regulatory Reform: The Case of Japanese Corporate Governance', Columbia Law and Economics Working Paper No. 251; Stanford Law and Economics Olin Working Paper No. 282.

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in the US, Canada, Australia and the UK.[2700] At this point it is important to note that it is not the purpose of this discussion to provide a detailed analysis of the various exit alternatives in each of the above mentioned jurisdictions. Instead, this discussion has commenced by stating why the availability of exit routes is important and the lack thereof represents an impediment to the growth of a country's private equity market. The discussion on exiting will comprise of a general description of the most widely used exits routes mentioned above and secondly, the state of exiting in the South African private equity market.

3.1 Exiting Defined

A critical characteristic of the private equity business model is the pre-determined, fixed life period of a private equity fund. In addition, private equity investments are by their very nature illiquid investments that cannot be sold as readily, say for instance, as listed shares trading on a stock exchange. This, coupled with the limited investment period highlights the crucial nature of private equity exiting, which involves the private equity firm ensuring the ultimate redemption of the investor's capital and investment returns.[2701] The pre-determined, fixed life period of a private equity fund basically requires that the investment relationship of the parties thereto, namely between the private equity firm, the investors and the underlying investee companies has to be terminated after a period of time.[2702] This creates the situation that the private equity firm and its investors are contractually 'forced' to exit from the underlying portfolio investee companies. Gompers and Lerner defines exiting as the disinvestment process whereby the private equity fund sells its stake in an underlying portfolio investee company in full or in part, aiming to reduce the fund's exposure.[2703]

Stock Market Listing

A stock market listing and initial public offering ('IPO') which is interchangeable used, refers to the method whereby a company's shares are listed on a stock exchange and where the investor will be able to sell its shares to the public.[2704] This is one of the most common forms of exit used by private

[2700]See Meyer, T. (2014), 'Private Equity Unchained: Strategy Insights for the Institutional Investor', First Edition, MacMillan Publishers Ltd, at pages 149-160 and 259-270. See also Lerner, J., Hardymon, F. and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', Fifth Edition, Wiley and Sons.
[2701]Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc. See also Popov, A. (2014), 'Venture Capital and Industry Structure: Evidence from Local US Markets', Review of Finance, 18(3), at pages 1059-1096.
[2702]See Demaria, C. (2013), 'Introduction to Private Equity: Venture, Growth, LBO and Turn-Around Capital', Second Edition, John Wiley and Sons.
[2703]Gompers, P.A. and Lerner, J. (1999), 'The Venture Capital Cycle', MIT Press, Cambridge.
[2704]A financial instrument that is traded through an exchange such as the Johannesburg Stock Exchange. When a private company decides to go public and issue shares, it will need to choose an exchange on which to be listed. To do so, it must be able meet that exchange's listing requirements. Listing requirements vary by

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equity firms. According to Lerner *et al*, studies of the US market suggest that the most profitable private equity investments have, on average, been exited by way of stock market listing.[2705] Private equity investors in South Africa cannot rely on these offerings, and even in a bull market where large capital inflows are occurring on the Johannesburg Stock Exchange ('JSE'), institutional funds are usually concentrated in a few of the largest corporations.[2706] Smaller and new firms typically do not attract significant institutional holdings, and have much less liquidity. By contrast, the fortunes of private equity investors in the US and UK have been largely linked to those of the market for stock market listing and there has been a strong link between the health of the market for stock market listing and the ability of private equity funds to raise more capital.[2707]

Despite a stock market listing being an attractive exit route, it still has noticeable disadvantages compared to other common forms of exit routes. For instance, the complexities of the financial markets and the high costs of stock market listings, coupled with it being a lengthy process puts it at a distinct disadvantage to the other common forms of exiting. According to Lerner *et al*,[2708] the public offering of shares in itself does not mean an exit. The private equity fund will only be able to exit its investment when its shares are eventually sold on the stock market, which in practice does not happen at the time of the listing. According to Caselli, the investors who have undertaken a listing as an exit will be exposed to the stock market risk factors and its fluctuations for a period of time after the listing.[2709] Nonetheless, compared to the other exit options, a stock market listing provides a company with a fresh injection of capital via its new shareholders and also provides shareholders with a higher degree of liquidity.[2710]

Trade Sale

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exchange. Exchanges have listing requirements to ensure that only high quality securities are traded on them and to uphold the exchange's reputation among investors. Available at www.investopedia.com/terms/l/listedsecurity.asp., accessed in June 2015.

[2705]Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', Fifth Edition, Wiley and Sons. See also Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', Second Edition, John Wiley and Sons.

[2706]KPMG and SAVCA (South African Venture Capital Association), (2014), 'Private Equity and Venture Capital Industry Performance Survey of South Africa covering the 2013 calendar year', Survey, 2014. See also Leeds, R. (2015), 'Private Equity Investing in Emerging Markets: Opportunities for Value Creation', First Edition, Palgrave Macmillan, at page 43.

[2707]Povaly, S. (2007), 'Private Equity Exits: Divestment Process Management for Leveraged Buyouts', Springer Science and Business Media Publishers, at pages 36-41. See also Demaria, C. (2013), 'Introduction to Private Equity: Venture, Growth, LBO and Turn-Around Capital', Second Edition, John Wiley and Sons.

[2708]Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', Fifth Edition, Wiley and Sons. See also Demaria, C. (2013), 'Introduction to Private Equity: Venture, Growth, LBO and Turn-Around Capital', Second Edition, John Wiley and Sons.

[2709]Caselli, S. (2009), 'Private Equity and Venture Capital in Europe: Markets, Techniques, and Deals', Elsevier Publishing, at pages 41-66. See also Gaughan, P.A. (2015), 'Mergers, Acquisitions, and Corporate Restructurings', Sixth Edition, John Wiley and Sons, at pages 349-370.

[2710]Stowell, D.P. (2012), 'Investment Banks, Hedge Funds, and Private Equity', Second Edition, Academic Press.

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The trade sale is another widely used exit route which involves the private equity fund selling its shares in an underlying portfolio investee company to a third party trade buyer, which is often a company operating in the same industry as the investee company.[2711] This method entails a complete and an immediate exit of the investment by the private equity fund from the underlying portfolio investee company. Compared to a stock market listing, a trade sale's negotiations are subject to less regulatory restrictions and occur with a single buyer allowing for a more efficient exit process. In addition, the private equity firm can exercise greater control over the negotiations and in certain instances might even obtain a better price for the investee company's shares compared to the other exit alternatives.[2712] However, the investee company's management could be unsupportive to a trade sale because it could for instance imply a change in management control. In addition, a trade sale may result in a business risk to the investee company because the potential buyer would in all likelihood gain access to valuable confidential business information during the negotiation stage, albeit subject to the typical non-disclosure agreements.[2713] According to SAVCA, the sale of a portfolio company to a third party industry peer is the most common exit route for the South African private equity industry.[2714] According to Demaria, a trade sale represents a complete exit which is basically the sale of the entire investee company for a cash consideration to a third party.[2715]

Secondary Buyout

According to Povaly, a secondary buyout occurs when a private equity fund sells its interest in an underlying portfolio investee company to another private equity fund.[2716] The secondary buyout method is typically used by the management of the underlying investee company when they want to replace the private equity fund backing the investee company with another private equity fund.[2717] The secondary buyout method is attractive to the private equity fund exiting the investment because

[2711]Povaly, S. (2007), 'Private Equity Exits: Divestment Process Management for Leveraged Buyouts', Springer Science and Business Media Publishers. See also Gaughan, P.A. (2015), 'Mergers, Acquisitions, and Corporate Restructurings', Sixth Edition, John Wiley and Sons, at pages 349-370.
[2712]Demaria, C. (2013), 'Introduction to Private Equity: Venture, Growth, LBO and Turn-Around Capital', Second Edition, John Wiley and Sons. See also Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', Second Edition, John Wiley and Sons.
[2713]Demaria, C (2013), 'Introduction to Private Equity: Venture, Growth, LBO & Turn-Around Capital', John Wiley & Sons.
[2714]KPMG and SAVCA (South African Venture Capital Association), (2013), 'Private Equity and Venture Capital Industry Performance Survey of South Africa covering the 2012 calendar year', Survey, 2013. See also KPMG and SAVCA (South African Venture Capital Association), (2014), 'Private Equity and Venture Capital Industry Performance Survey of South Africa covering the 2013 calendar year', Survey, 2014. See also Leeds, R. (2015), 'Private Equity Investing in Emerging Markets: Opportunities for Value Creation', First Edition, Palgrave Macmillan, at pages 1-245.
[2715]Demaria, C. (2013), 'Introduction to Private Equity: Venture, Growth, LBO and Turn-Around Capital', John Wiley and Sons. See also Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', Second Edition, John Wiley and Sons.
[2716]Povaly, S. (2007), 'Private Equity Exits: Divestment Process Management for Leveraged Buyouts', Springer Science and Business Media Publishers. See also Gaughan, P.A. (2015), 'Mergers, Acquisitions, and Corporate Restructurings', Sixth Edition, John Wiley and Sons, at pages 349-370.
[2717]Povaly, S. (2007), 'Private Equity Exits: Divestment Process Management for Leveraged Buyouts', Springer Science and Business Media Publishers. See also Gaughan, P.A. (2015), 'Mergers, Acquisitions, and Corporate Restructurings', Sixth Edition, John Wiley and Sons, at pages 349-370.

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it involves a complete and immediate exit. In addition, the entire exit process can be implemented relatively quicker than a trade sale and a stock market listing.[2718]

According to Achleitner *et al*, secondary buyouts can also reduce the investment period with which a private equity fund holds an underlying portfolio investee interest.[2719] For instance, the private equity fund that made the initial investment into an investee company may no longer be willing to invest further cash into the investee company despite the investee company not being ready for a trade sale or stock market listing. Therefore, the sale of the investee company by the initial private equity fund to another private equity fund, that sees the further investment potential of the investee company, is the logical exit.[2720] This in itself has become important for private equity firms which has made secondary buyouts popular in the US and UK.[2721]

Recapitalisation

According to Yong, a leveraged recapitalisation represents a partial exit route for a private equity firm in that the private equity fund is able to realise a portion of its initial investment from an underlying portfolio investee company without having to completely exit from the investee company.[2722] This is done by leveraging the company, for instance by substituting part of the investee company's equity with additional debt.[2723] In practice, the investee company will raise money by borrowing from a bank, which amount is then used to repurchase the company's own shares from the investor. According to Yong, a leveraged recapitalisation is not a true form of exit, as it does not reduce a private equity fund's interest in an investee company.[2724] Partial exits through leveraged recapitalisations are used in most jurisdictions including the US, UK, Australia, South Africa and Canada where the main methods of exiting are either not available or not attractive enough at the time in the respective private equity markets. For instance, in the US, UK and Canadian private equity markets, leveraged recapitalisations often provide the sole source of liquidity and return of capital for private equity funds because the climate for stock market listings were either not favourable or strategic buyers for trade

[2718]Demaria, C. (2013), 'Introduction to Private Equity: Venture, Growth, LBO and Turn-Around Capital', John Wiley and Sons. See also Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc.
[2719]Achleitner, A.K. and Figge, C. (2014), 'Private Equity Lemons? Evidence on Value Creation in Secondary Buyouts', European Financial Management, 20(2), at pages 406-433.
[2720]Achleitner, A.K. and Figge, C. (2014), 'Private Equity Lemons? Evidence on Value Creation in Secondary Buyouts', European Financial Management, 20(2), at pages 406-433.
[2721]Achleitner, A.K. and Figge, C. (2014), 'Private Equity Lemons? Evidence on Value Creation in Secondary Buyouts', European Financial Management, 20(2), at pages 406-433.
[2722]Yong, K.P. (2012), 'Private Equity in China: Challenges and Opportunities', John Wiley and Sons. See also Caselli, S., Ippolito, F. and Garcia-Appendini, E. (2013), 'Contracts and Returns in Private Equity Investments', Journal of Financial Intermediation, 22(2), at pages 31-38.
[2723]See Demaria, C. (2013), 'Introduction to Private Equity: Venture, Growth, LBO and Turn-Around Capital', Second Edition, John Wiley and Sons. See also Cumming, D.J., and Johan, S.A. (2013), 'Venture Capital and Private Equity Contracting: An International Perspective', Second Edition, Elsevier Inc.
[2724]Yong, K.P. (2012), 'Private Equity in China: Challenges and Opportunities', John Wiley and Sons. See also Caselli, S., Ippolito, F. and Garcia-Appendini, E. (2013), 'Contracts and Returns in Private Equity Investments', Journal of Financial Intermediation, 22(2), at pages 31-38.

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sales were not available or secondary buyouts were just not available.[2725] Nevertheless, it is submitted that despite the latter a leveraged recapitalisation is not a true form of exit for the purpose of this discussion because it does not reduce a private equity fund's interest in an investee company. Instead it is nothing more than financial engineering aimed at creating liquidity for private equity investors.

3.2 Exiting in South Africa

As mentioned in chapter one, South Africa's capital markets are generally characterised by a lack of liquidity, especially for private equity investments.[2726] This lack of liquidity negatively impacts the private equity industry because a private equity firm's success is gauged by the number of successful exits it has achieved.[2727] For example, the more favourable the environment for stock market listing is as an exit route for private equity investments, the more favourable the environment is for private equity firms to raise more capital.[2728] In addition, it has a direct impact on the ability of such a private equity firm to raise more funds.[2729] For example, studies of the US market suggest that the most profitable private equity investments have, on average, been exited by way of stock market listing.[2730] Nevertheless, while trade sales and secondary buyouts are important exit methods available to the South African market, it is submitted that the stock market listing method remains critical to the long term success of the local private equity industry. As Lerner states:

> '…the types of environments where private equity funds have thrived in the US are quite similar to developing nations: the investors have specialized in financing illiquid, difficult-to-value firms in environments with substantial uncertainty and information asymmetries. In short, it would not be surprising if the private equity industry in developing nations slowly matures, with the investment cycle becoming increasingly similar to that of developed nations…'[2731]

[2725]Stowell, D.P. (2012), 'Investment Banks, Hedge Funds, and Private Equity', Academic Press.

[2726]See Leeds, R. (2015), 'Private Equity Investing in Emerging Markets: Opportunities for Value Creation', First Edition, Palgrave Macmillan, at pages 1-245.

[2727]See Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', Second Edition, John Wiley and Sons.

[2728]See Demaria, C. (2013), 'Introduction to Private Equity: Venture, Growth, LBO and Turn-Around Capital', Second Edition, John Wiley and Sons. See also See Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', Fifth Edition, Wiley and Sons.

[2729]See Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', Fifth Edition, Wiley and Sons.

[2730]Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', Fifth Edition, Wiley and Sons.

[2731]Lerner, J. (1999), 'Venture Capital and Private Equity: A Casebook', John Wiley and Sons, at page 257. Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', Fifth Edition, Wiley and Sons. See also Demaria, C. (2013), 'Introduction to Private Equity: Venture, Growth, LBO and Turn-Around Capital', Second Edition, John Wiley and Sons.

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The 2011 SAVCA report on exit data for the 2010 calendar year indicates that funds returned to investors[2732] increased by R15.3 billion from R2 billion during 2009 to R17.3 billion during 2010.[2733] According to the report there were no stock market listings during 2009 and 2010 as an exit mechanism by private equity funds.[2734] Earlier SAVCA reports highlighted the above trend of the lack of liquidity for exiting in the South African private equity market. In fact, there were only twenty-nine liquidity events for private equity investments in South Africa in 2000 and twenty-one in 1999, and of these, only two were through stock market listings.[2735] The value of disposal proceeds increased from R3.1 billion in 2012 to R5.4 billion during 2013.[2736] The 2014 SAVCA report on exit data for the 2013 calendar year indicates that secondary buyouts, namely a sale to another private equity firm was the most popular exit route.[2737] The 2013 SAVCA report on exit data for the 2012 calendar year indicates that trade sales was the most popular exit route.[2738] Similar to the earlier SAVCA reports, the exit patterns highlight the lack of liquidity (especially the JSE) for exiting in the South African private equity market. In addition, this shows that because of a depressed market for stock market listings, the vast majority of private equity firms exit investments primarily via trade sales in South Africa. Interestingly secondary buyouts, namely the sale to another private equity firm, was the second most preferred method of returning funds to investors in the calendars years 2010 to 2013.[2739]

In the long term, sustained growth in the South African private equity market will be difficult to achieve unless there is an improvement in the demand for new listings. An initiative between the Johannesburg Stock Exchange ('JSE') and the Department of Trade and Industry ('DTI') has been the introduction of an alternative exchange for small to medium sized companies, called AltX.[2740]

[2732]Which are the proceeds on exit of investments through disposals, repayments of loans and dividend receipts.
[2733]KPMG and SAVCA (South African Venture Capital Association), (2011), 'Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2010 calendar year', Survey, 2011.
[2734]KPMG and SAVCA (South African Venture Capital Association), (2011), 'Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2010 calendar year', Survey, 2011.
[2735]KPMG and SAVCA, (2000), 'Private Equity and Venture Capital', Survey, 2000.
[2736]KPMG and SAVCA (South African Venture Capital Association), (2014), 'Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2013 calendar year', Survey, 2014.
[2737]KPMG and SAVCA (South African Venture Capital Association), (2014), 'Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2013 calendar year', Survey, 2014.
[2738]KPMG and SAVCA (South African Venture Capital Association), (2013), 'Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2012 calendar year', Survey, 2013.
[2739]See KPMG and SAVCA (South African Venture Capital Association), (2014), 'Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2013 calendar year', Survey, 2014. See also KPMG and SAVCA (South African Venture Capital Association), (2013), 'Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2012 calendar year', Survey, 2013. See also KPMG and SAVCA (South African Venture Capital Association), (2012), 'Private Equity and Venture Capital Industry Performance Survey of South Africa covering the 2011 calendar year', Survey, 2012.
See also KPMG and SAVCA (South African Venture Capital Association), (2011), 'Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2010 calendar year', Survey, 2011.
[2740]AltX was launched in October 2003. AltX, the alternative exchange, is a division of the Johannesburg Stock Exchange ('JSE'). It is a parallel market focused on small and medium sized high growth companies. AltX provides smaller companies not yet able to list on the JSE Main Board with a clear growth path and access to capital. Available at www.jse.co.za/How-To-List/AltX.aspx., accessed in June 2015.

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AltX aims to give smaller companies the opportunity to issue new shares, raise capital, widen their investor base and have their shares traded in a regulated market.[2741] AltX is differentiated from the main board at the JSE, for instance both exchanges have separate listing requirements. One of the AltX's aims is for companies that list on AltX to become large companies in the future, which will eventually migrate to the JSE main board.[2742] AltX has reduced listing fees, but is supported by the full range of JSE services, including the trading of shares on the same system as the main board, market surveillance to eliminate irregularities and settlement of AltX securities through the JSE's electronic system, STRATE.[2743] AltX has listing requirements appropriate for small and medium companies, placing emphasis on initial and ongoing disclosure of company information. There is also a focus on the enhancement of the skills of directors of AltX companies, with a compulsory four-day directors' induction programme.[2744] Companies require no profit history to list, but a minimum share capital of R2 million is required, as well as a minimum of one hundred shareholders, fifteen percent free float and it needs to appoint an AltX-designated adviser.[2745]

There exists no real data to make the claim that the AltX and the local private equity industry will complement each another in that the former will provide an exit platform for the latter. However, since its inception in October 2004, one hundred and eleven companies have listed on the AltX and at the time of writing this section appropriately sixty remain listed on the AltX, twenty four have migrated to the JSE main board and twenty seven companies have delisted from AltX.[2746] According to a 2011 study, the lack of liquidity is the main reason why many institutional investors have not invested in AltX listed companies.[2747] Typically, the co-founders of many companies listed on the AltX hold the majority of shares in issue, making it difficult for investors, such as institutional fund managers, to acquire shares in these companies. The lack of liquidity is believed to be a key factor

[2741]See Sokołowska, E. (2015), 'The Principles of Alternative Investments Management: A Study of the Global Market', Springer Publishers, at page 142. See also Best, M. and Soulier, J.L. (2010), 'International Securities Law Handbook', Kluwer Law International, World Law Group Series, Volume 9, at pages 521-538.

[2742]See Sokołowska, E. (2015), 'The Principles of Alternative Investments Management: A Study of the Global Market', Springer Publishers, at page 142. See also Best, M. and Soulier, J.L. (2010), 'International Securities Law Handbook', Kluwer Law International, World Law Group Series, Volume 9, at pages 521-538.

[2743]As South Africa's Central Securities Depository (CSD), Strate is licensed to be the independent provider of post-trade products and services for the financial markets. Strate provides electronic settlement of equities and bonds transactions concluded on the Johannesburg Stock Exchange. It also settles transactions in money market securities and have introduced a collateral management service. Available at http://www.strate.co.za., accessed in August 2014.

[2744]Niemann, M. (2012), 'Perceived Constraints to Investments in the JSE Alt-X by Professional Portfolio Managers', University of the Witwatersrand, Faculty of Commerce, Law and Management, Graduate School of Business Administration.

[2745]Niemann, M. (2012), 'Perceived Constraints to Investments in the JSE Alt-X by Professional Portfolio Managers', Wits University, Faculty of Commerce, Law and Management, Graduate School of Business Administration.

[2746]Peters, F. (2014), 'AltX: springboard to capital or liquidity trap?', Business Day Report, 8th MAY 2014. Available at www.bdlive.co.za/markets/2014/05/08/altx-springboard-to-capital-or-liquidity-trap., accessed in August 2014.

[2747]BDO (2011), 'BDO research project into JSE listing', Southern African Coordination (Pty) Ltd, March 2011. Available at www.bdo.co.za/documents/jse-listings-research-project.pdf., accessed in August 2014.

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in the decline of new listings on the exchange. In 2013 only five companies listed on AltX compared with nineteen in 2006 and thirty seven in 2007.[2748]

It is clear that South Africa lacks a strong market for stock market listings, which is a critical component necessary for the development of the South African private equity market. Although the JSE is the largest stock exchange in Africa, it is still not considered a well developed stock market for private equity-backed companies.[2749] Furthermore, the question as to how the current state of the JSE will progress to create a favourable market for stock market listing (namely, exit strategy) for private equity investments is difficult to assess. However, this is only one component of developing a private equity market and with the appropriate legislative reform the JSE could receive greater portfolio allocations from money managers in the short term. In addition, one must note that a depressed JSE automatically creates a greater level of private equity activity and opportunities, and the economic importance of the asset class will over time positively contribute to enhancing the overall performance of the JSE. A depressed stock market yields opportunities for later-stage buy-outs, whereby the delisting of South African companies with poor performing stocks on the JSE also presents attractive buyout opportunities.[2750] It is a widely believed and accepted proposition in private equity literature that a public listing of a private equity portfolio company is the ultimate and most successful form of exit.[2751]

3.3 Analysis

At this point it is important to note that it is very difficult to submit a specific recommendation as to how policymakers can improve exit routes or improve the liquidity of South Africa's capital markets. However, it is evident that one of the main challenges for South African private equity firms is finding a profitable way to exit from underlying portfolio companies. From the SAVCA industry data discussed above, it is clear that stock market listings feature very little as an exit route. Trade sales and secondary buyouts have become the predominant method of exiting for private equity firms in South Africa. According to Barth *et al*, a well functioning stock market plays an important role in a

[2748]Peters, F. (2014), 'AltX: springboard to capital or liquidity trap?', Business Day Report, 8th MAY 2014. Available at www.bdlive.co.za/markets/2014/05/08/altx-springboard-to-capital-or-liquidity-trap., accessed in August 2014.
[2749]See Sokołowska, E. (2015), 'The Principles of Alternative Investments Management: A Study of the Global Market', Springer Publishers, at page 142. See also Best, M. and Soulier, J.L. (2010), 'International Securities Law Handbook', Kluwer Law International, World Law Group Series, Volume 9, at pages 521-538. See also Leeds, R. (2015), 'Private Equity Investing in Emerging Markets: Opportunities for Value Creation', First Edition, Palgrave Macmillan, at pages 1-245.
[2750]See Cendrowski, H., Petro, L.W., Martin, J.P., Wadecki, A.A. (2012), 'Private Equity: History, Governance, and Operations', Second Edition, John Wiley and Sons. See also Demaria, C. (2013), 'Introduction to Private Equity: Venture, Growth, LBO and Turn-Around Capital', Second Edition, John Wiley and Sons.
[2751]See Lerner, J., Hardymon, F., and Leamon, A. (2012), 'Venture Capital and Private Equity: A Casebook', Fifth Edition, Wiley and Sons. See also Gaughan, P.A. (2015), 'Mergers, Acquisitions, and Corporate Restructurings', Sixth Edition, John Wiley and Sons, at pages 349-370.

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private equity market, especially as an exit route.[2752] The question as to how South African policymakers can develop policy aimed at promoting the local stock market to improve its attractiveness as an exit route is beyond the scope of this discussion. Trying to answer this question would be complex and too wide ranging and would include a analysis of all the legal, regulatory, accounting, tax and supervisory systems that influence stock market liquidity.[2753] In addition, the prevailing political and macroeconomic conditions also have a direct impact on stock markets liquidity.[2754] Nonetheless, the South Africa stock market plays a crucial role in the long term development of the economy and the local private equity market. The ability to trade listed shares with maximum ease should encourage greater investment and hopefully promote the efficient allocation of capital for private companies that intend listing on the stock exchange which would stimulate long term economic growth. However, it is submitted that South African policy makers should not adopt an interventionist approach, for instance by introducing tax incentives aimed at artificially trying to improve South Africa's capital market's liquidity. Also interventionist schemes underpinned by tax incentives such as the Venture Capital Company (discussed under paragraph 2.1(e) of this chapter) and AltX discussed above are two examples of an interventionist approach that has not succeeded. According to Levine:

> 'The available information suggests that policymakers should remove impediments, tax, legal, and regulatory barriers to stock market development. But there is not strong evidence to support interventionist policies like tax incentives that artificially boost stock market size and activity.'[2755]

In addition, Claessens *et al* studied how local stock market development and listing, trading, and capital raising in international exchanges are related to economic fundamentals.[2756] They argued that higher income economies with sounder macro policies, more efficient legal systems, greater openness, and higher growth opportunities have more developed local markets.[2757] Importantly, these fundamentals also relate to internationalisation, and actually more so, since the better the

[2752]Barth, J.R., Caprio, G. and Levine, R. (2012), 'Guardians of Finance: Making Regulators Work for Us', Cambridge MA, MIT Press. See also Gorton, G. and Metrick, A. (2012), 'Getting up to speed on the financial, crisis: A one-weekend-reader's guide', Journal of Economic Literature, 50(1), at pages 128-150.

[2753]See Laeven, L., and Levine, R. (2009), 'Bank governance, regulation and risk taking', Journal of Financial Economics, 93, at pages 259–275.

[2754]Barth, J.R., Caprio, G. and Levine, R. (2012), 'Guardians of Finance: Making Regulators Work for Us', MIT Press.

[2755]Levine, R. (1996), 'Stock Markets: A Spur to Economic Growth', Finance and Development Division, the World Bank's Policy Research Department, 33, at 7-10.

[2756]Claessens, S., Klingebiel, D. and Schmukler, S.L. (2006), 'Stock market development and internationalization: Do economic fundamentals spur both similarly?' Journal of Empirical Finance, 13, at 316–350. Barth, J.R., Caprio, G. and Levine, R. (2012), 'Guardians of Finance: Making Regulators Work for Us', Cambridge MA, MIT Press.

[2757]Claessens, S., Klingebiel, D. and Schmukler, S.L. (2006), 'Stock market development and internationalization: Do economic fundamentals spur both similarly?' Journal of Empirical Finance, 13, at pages 316–350.

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fundamentals, the higher the ratio of internationalisation to local market activity.[2758] Therefore, easing restrictions on international capital flows would be a good starting point for South African policymakers. Nevertheless, private equity firms should become more innovative in seeking liquidity in light of the challenges surrounding all three of the established exit routes in South Africa.[2759] Private equity firms should also look for alternative buyers for their underlying portfolio investee companies. For instance, sources of capital that provide a broader range of exit alternatives could be sovereign wealth funds, public market fund managers willing to bridge the pre-listing stage for an investee company and international companies.

4. Conclusion

South African policymakers have a key role to play in creating the framework which will enhance the human and financial resources needed for a dynamic private equity sector. The framework must improve the potential for capital formation via private equity funding from South African investors and individuals; encourage the development of entrepreneurship; and remove practical impediments to private equity investing. As mentioned at the beginning of this chapter, in order for the private equity market to flourish, there should be as little legal, tax and regulatory impediments as possible. Two key lessons emerged from reviewing the reforms in the above jurisdictions.

Firstly, an appropriate tax regime is critical to the private equity industry. Investment vehicles that are not subject to double taxation are the norm. Tax incentives have been widely used worldwide to stimulate private equity investments and all of the countries discussed above provide some form of tax incentives. For instance, the reduction of capital gains taxes in the US as an incentive is viewed as having made a significant contribution to the growth of private equity investments. Another important event that contributed to the success of the private equity industry in the US was the Stock Options Law of 1981 discussed above. It provided that taxes on share options are to be paid when shares are sold, instead of when the options were exercised. In addition, South African policymakers should maintain its current approach with regard to the taxation of carried interest, namely dealing with the capital versus revenue determination on a case by case basis, and should be cautious when considering current legislative proposals being considered in the US aimed at taxing carried interest as ordinary income.

[2758]Claessens, S., Klingebiel, D. and Schmukler, S.L. (2006), 'Stock market development and internationalization: Do economic fundamentals spur both similarly?' Journal of Empirical Finance, 13, at pages 316–350. See also Gorton, G. and Metrick, A. (2012), 'Getting up to speed on the financial, crisis: A one-weekend-reader's guide', Journal of Economic Literature, 50(1), at pages 128-150.
[2759]Namely trade sales, secondary buyouts and stock market listing.

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Secondly, in order for a private equity market to flourish, private equity firms must have clear exit alternatives that enable them to realise the gains on their investments. Stock market listings and trade sales are the main exit strategies in South Africa. Thus, perhaps the most challenging aspect of private equity investing in South Africa has been the difficulty of exit. It is clear that South Africa lacks a strong market for stock market listings, which is a critical component necessary for the development of the South African private equity market. Private equity reforms aimed at improving exit options have not attempted to change the JSE, but rather focus on the creation of new, minimally regulated exchanges (such as AltX) in which smaller companies can be actively traded.

Based on the analysis of the key issues in South Africa and lessons learned from international experience, the next chapter will submit several policy considerations aimed at contributing to a more progressive South African private equity industry.

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Chapter Five: Policy Considerations for Private Equity in South Africa

1. Introduction

The development of regulatory policy in South Africa needs to recognise the unique South African context and should attempt to balance the competing interests of the economic actors and of society at large.[2760] South Africa has made significant strides over the past twenty years of democratic government in terms of development; socially, politically and economically.[2761] However, 'two economies' appear to exist in South Africa. The first is an advanced, sophisticated economy, based on skilled labour, which is becoming more globally competitive. The second is a mainly informal, marginalised, unskilled economy, populated by the unemployed and those unemployable in the formal sector.[2762] Despite the impressive gains made in the first economy, the benefits of growth have yet to reach the second economy, and with the enormity of the challenges arising from the social transition, the second economy risks falling further behind if there is no decisive government intervention. These sentiments were echoed more than ten years ago by the authors of a Department of Trade and Industry corporate law reform paper.[2763] Ten years later and twenty years into South Africa's 'new' democracy, government has still not been able to decisively address the problems of the 'second' economy.

In South Africa, the Minister of Finance is primarily responsible for the policy framework for the regulation of the South African financial system. According to former Minister Pravin Gordhan:

> '... South Africa is committed to the highest standards for regulating the financial sector. This is because the financial sector affects all people and companies who transact through the financial system, including those who do so outside South Africa's borders. It affects pensioners, workers, depositors, employers, businesses, as all receive, invest, or send money via a financial institution. The 2008 global financial crisis has demonstrated the weaknesses of a light-touch financial regulatory system. Even though our financial system weathered the storm, South Africa lost nearly a million jobs as a result of the global contagion that originated from the crisis in the banking and financial systems of the developed world. Had South Africa experienced a financial crisis, many more jobs would have been lost ... The dilemma that faces most countries is that the financial sector is globally integrated, but regulated nationally. For this reason, there needs

[2760] See International Monetary Fund ('IMF'), (2013), 'South Africa: 2013 Article IV Consultation', International Monetary Fund African Department, Issues 13-303 of IMF Staff Country Reports.
[2761] See OECD (2013), 'OECD Economic Surveys: South Africa 2013', OECD Publishing.
[2762] See Saul, J.S. and Bond, P. (2014), 'South Africa: the Present As History: From Mrs Ples to Mandela and Marikana', Boydell and Brewer Ltd.
[2763] Department of Trade and Industry (2004), 'South African Company Law for the 21st Century: Guidelines for Corporate Law Reform', Report presented by the Department of Trade and Industry, South Africa.

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to be minimum international standards and greater co-ordination among different national regulators.'[2764]

Taking into account the vision of the economy and the particular challenges that South Africa faces, it is proposed that policy reform within the areas of capital formation, capital gains tax and legislation fostering small business development within the context of South Africa's existing regulatory environment, would foster the development of South Africa's financial markets. However, the primary objective of such policy reform is to promote the competitiveness and development of the South African economy, by providing a predictable and effective regulatory environment that recognises the broader social role of companies.

Nevertheless, South African policymakers cannot with certainty predict how the South African financial markets will react to the introduction of policy reform mentioned above and often the introduction of new laws and regulations have unintended consequences. For instance, in paragraph 3.1 of chapter one, the rationale for the introduction in the US of the Sarbanes-Oxley Act of 2002 was discussed. Namely, that the Sarbanes-Oxley Act of 2002 was introduced in response to the accounting scandals in the early 2000s; and required that public companies put in place costly internal financial controls; and that the chief executive and chief financial officers of public companies personally attest to the veracity of their companies' financial statements.[2765] Since the law raises the cost of running a public company and makes senior management legally liable for the accuracy of the financial information it provides, fewer companies have an incentive to be public in the US.[2766] It was argued in chapter one of this thesis, that the law was designed to deal with financial fraud experienced at companies like Enron and Worldcom, but has had the unintended consequence of negatively impacting the private equity industry.

According to Wang, the Sarbanes-Oxley Act of 2002 *inter alia* has contributed to the decline in the number of private equity backed companies going public since its promulgation in the US.[2767] The provisions of the Sarbanes-Oxley Act of 2002 have made public companies in the US more costly to

[2764]Department of National Treasury of the South African Government (2013), 'Implementing a Twin Peaks Model of Financial Regulation in South Africa', Published for public comment by the Financial Regulatory Reform Steering Committee, 1st February 2013, Pretoria, South Africa, at page 2.

[2765]Wang, J. (2008), 'The Unintended Consequences of the Sarbanes-Oxley Act on Small Business', Chapter 3, Public Policy in an Entrepreneurial Economy, Volume 17 of the Series International Studies in Entrepreneurship, at pages 67-93.

[2766]Howell, E.C. (2013), 'Two Essays on the Unintended Consequences of Sarbanes-Oxley on Small Banks and Small Businesses', Dissertations, Theses and Capstone Projects. Paper 554. Available at http://digitalcommons.kennesaw.edu/etd/554, accessed in April 2016.

[2767]Wang, J. (2008), 'The Unintended Consequences of the Sarbanes-Oxley Act on Small Business', Chapter 3, Public Policy in an Entrepreneurial Economy, Volume 17 of the Series International Studies in Entrepreneurship, at pages 67-93.

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run and have reduced the incentive to list companies on a stock exchange.[2768] The decline in stock market listings is problematic to private equity backed companies as discussed in paragraph 3 of chapter four. Howell argues that the decline in stock market listings has reduced private equity firm's earnings, which, in turn, has reduced the amount of private equity funding available to entrepreneurs.[2769] Nevertheless, it is accepted that the law was introduced to curb financial fraud experienced at companies like Enron and Worldcom. However it has had the unintended consequence of negatively impacting the private equity industry and entrepreneurship. Neverthless, the proposals submitted in paragraph 3 of this chapter cannot definitively anticipate the potential adverse effects for the South African financial system and the private equity industry. Furthermore, the proposals submitted in paragraph 3 of this chapter are aimed at shaping the South African economic system to fit the designs of policy makers and could possibly result in unintended consequences. This means that laws designed to solve unrelated problems often end up imposing unnecessary and counterproductive burdens on entrepreneurs and their businesses.

The development of a regulatory framework for the South African private equity industry is a fundamental part of the latter process. Saxenian and Sabel examined the creation of private equity industries in emerging economies and highlighted the ways in which public and private sector stakeholders, such as investors, private equity firms, government, regulators, the management of investee companies and the like, build on networks they 'find' and how the day to day activities associated with the private equity business model can construct an institution that systematically creates further networks to foster and monitor the progress of new companies and industries.[2770] The above mentioned authors conclude that the development of a private equity industry in an emerging economy:

> 'can serve as a powerful search network in developing economies when the investors have global as well as local connections. By supporting a diverse portfolio of ventures and combining hands-on monitoring and mentoring with market selection, investors are institutionalizing a process of continuous economic restructuring—and learning about how to improve the institutions of restructuring—that transforms the domestic economy by linking it to the most demanding and capable actors in global markets.'[2771]

[2768]Wang, J. (2008), 'The Unintended Consequences of the Sarbanes-Oxley Act on Small Business', Chapter 3, Public Policy in an Entrepreneurial Economy, Volume 17 of the Series International Studies in Entrepreneurship, at pages 67-93.

[2769]Howell, E.C. (2013), 'Two Essays on the Unintended Consequences of Sarbanes-Oxley on Small Banks and Small Businesses', Dissertations, Theses and Capstone Projects. Paper 554. Available at http://digitalcommons.kennesaw.edu/etd/554, accessed in April 2016.

[2770]Saxenian, A., and Sabel, C. (2008), 'Venture Capital in the "Periphery": The New Argonauts, Global Search, and Local Institution Building', Roepke Lecture in Economic Geography, 84(4), at page 381. Available at www2.law.columbia.edu/sabel/EG_84401-Saxenian.pdf., accessed in August 2014.

[2771]Saxenian, A., and Sabel, C. (2008), 'Venture Capital in the "Periphery": The New Argonauts, Global Search, and Local Institution Building', Roepke Lecture in Economic Geography, 84(4), at page 392. Available at www2.law.columbia.edu/sabel/EG_84401-Saxenian.pdf., accessed in August 2014.

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The growth of the South African private equity industry will depend on creating an environment in which investors and regulators alike clearly see the advantages and disadvantages of private equity. Private equity as an asset class has clear and demonstrable benefits for the South African economy, but also poses several dangers, such as limited liquidity, conflicts of interest, excessive fees charged by private equity firms and lack of transparency. In addition, private equity risk management by investors of private equity funds lags that of other asset classes. For instance, because of the private nature of the industry, relationships between investors and private equity managers, and long time horizon and illiquid nature of these investments, private equity creates some challenges relative to other asset classes with regard to monitoring investments and risk.[2772] Nevertheless, it is submitted that the development of South Africa's private equity industry will not only serve the country's economic goals, but also its crucially important social goals.

2. Current Financial Services Regulatory Framework

At the outset it is important to note that the purpose of this paragraph is to provide a broad analysis of the current financial services regulatory framework solely aimed at contextualizing the considerations being proposed.[2773] The current supervision and financial regulation framework in South Africa consists of several regulators, however the main regulators are the FSB and Bank Supervision Department of the South African Reserve Bank ('SARB'). SARB regulates and supervises banks whereas the FSB regulates and supervises non-bank financial institutions and the securities markets.[2774] The FSB relies on self-regulatory organisations such as the JSE and STRATE with regard to the regulation and supervision of the securities markets.[2775] SARB has a direct reporting line to the Minister of Finance on legislative issues and the FSB is subject to the general authority of the Minister of Finance.[2776]

In 2007, the South African government undertook a formal review of the South African financial regulatory system and as a result it was proposed that South Africa move towards a 'twin peaks'

[2772]D'Angelo, E. (2008), 'Limited Partners' Perceptions and Management of Risk in Private Equity Investing', Kellog School of Management, Zell Center for Risk Research, at page 2.

[2773]See paragraph 4 of chapter 2.

[2774]Pretorius, D. (2014), 'Beyond Play', Xlibris Corporation Publishers, at pages 193-251. See Lamprecht, I. (2015), 'Four regulatory reforms you should know about: legislation', Personal Finance Newsletter, (409), at pages 8-9.

[2775]As South Africa's Central Securities Depository, Strate is licensed to be an independent provider of post-trade products and services for the financial markets. Strate provides electronic settlement of equities and bonds transactions concluded on the Johannesburg Stock Exchange ('JSE'). It also settles transactions in money market securities and have introduced a collateral management service. Strate offers an asset servicing product range which augments the services it offers to issuers in terms of the Companies Act 71 of 2008 and the Financial Markets Act 19 of 2012. Available at www.strate.co.za/about-strate/our-company, accessed in June 2015.

[2776]Department of National Treasury of the South African Government (2011), 'A Safer Financial Sector to Serve South Africa Better', National Treasury Policy Document, 23 February 2011, Pretoria, South Africa.

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model of financial regulation.[2777] The above mentioned review led to the Minister of Finance releasing a 2011 policy document,[2778] that become the precursor to a subsequent policy document released by the Financial Regulatory Reform Steering Committee[2779] in February 2013.[2780] Before the release of the last mentioned policy document, the previous Minister of Finance during his 2012 Budget Speech stated:

> 'As announced last year, we intend to shift towards a twin peaks system for financial regulation, where we separate prudential from market conduct supervision of the financial sector. Consultations will continue this year, with a view to tabling legislation in early 2013.'[2781]

The move to a 'twin peaks' model is an effort to address the inefficiencies in the current regulatory structure.[2782] The shift to the 'twin peaks' model is also aimed at causing the least amount of disruption to the financial industry and the current regulators.[2783] The introduction of the 'twin peaks' model will see the establishment of two regulators namely be the 'prudential regulator' and the 'market conduct regulator'.[2784] The prudential regulator will form part of SARB.[2785] It will enhance financial stability by promoting safety and soundness of regulated institutions. The market conduct regulator will form part of a restructured FSB.[2786] The proposed reforms to the current financial services regulatory system is aimed at maintaining and enhancing several policy objectives; namely: [2787]

[2777]Department of National Treasury of the South African Government (2013), 'Implementing a Twin Peaks Model of Financial Regulation in South Africa', Published for public comment by the Financial Regulatory Reform Steering Committee, 1 February 2013, Pretoria, South Africa.
[2778]Department of National Treasury of the South African Government (2011), 'A Safer Financial Sector to Serve South Africa Better', National Treasury Policy Document, 23 February 2011, Pretoria, South Africa.
[2779]The Financial Regulatory Reform Steering Committee is a task team that is co-chaired by Lesetja Kganyago, Deputy Governor of the South African Reserve Bank; Ismail Momoniat, Deputy Director-General: Tax and Financial Sector Policy of the National Treasury; and Dube Tshidi, Chief Executive Officer of the FSB.
[2780]Department of National Treasury of the South African Government (2013), 'Implementing a Twin Peaks Model of Financial Regulation in South Africa', Published for public comment by the Financial Regulatory Reform Steering Committee, 1 February 2013, Pretoria, South Africa. See also Godwin, A. (2015), 'The Financial Sector Regulation Bill In South Africa: Lessons From Australia', CIFR Paper, (52).
[2781]Department of National Treasury of the South African Government (2012), '2012 Budget Speech', 22 February 2012, Pretoria, South Africa, at page 28.
[2782]Pretorius, D. (2014), 'Beyond Play', Xlibris Corporation Publishers, at pages 193-251. See also Lamprecht, I. (2015), 'Four regulatory reforms you should know about: legislation', Personal Finance Newsletter, (409), at pages 8-9.
[2783]Department of National Treasury of the South African Government (2011), 'A Safer Financial Sector to Serve South Africa Better', National Treasury Policy Document, 23 February 2011, Pretoria, South Africa.
[2784]Department of National Treasury of the South African Government (2013), 'Implementing a Twin Peaks Model of Financial Regulation in South Africa', Published for public comment by the Financial Regulatory Reform Steering Committee, 1 February 2013, Pretoria, South Africa.
[2785]Pretorius, D. (2014), 'Beyond Play', Xlibris Corporation Publishers, at pages 193-251. See also Lamprecht, I. (2015), 'Four regulatory reforms you should know about: legislation', Personal Finance Newsletter, (409), at pages 8-9.
[2786]See Bosch, R. (2012), 'Banking Regulation: Jurisdictional Comparisons', Sweet and Maxwell Publishers.
[2787]Department of National Treasury of the South African Government (2013), 'Implementing a Twin Peaks Model of Financial Regulation in South Africa', Published for public comment by the Financial Regulatory Reform Steering Committee, 1 February 2013, Pretoria, South Africa. See also Pretorius, D. (2014), 'Beyond Play', Xlibris Corporation Publishers, at pages 193-251.

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(i) transparency with regard to regulators' decisions, actions and approaches;
(ii) principles and rules based regulation to achieve regulatory outcomes;
(iii) appropriate, intensive and intrusive supervision;
(iv) comprehensive coverage of financial services activities and consistent principles and rules for comparable activities;
(v) risk-based and proportional regulatory and supervisory approaches;
(vi) pre-emptive and proactive frameworks that enable regulators to identify and mitigate emerging risks;
(vii) reliable methods that allow regulators to possess and use the authority to enforce adherence to principles and rules; and
(viii) appropriate alignment with international standards.

By way of the proposed 'twin peaks' model, South Africa is aiming to improve consumer confidence thereby hoping to increase employment, development and economic growth, and ultimately creating a more sustainable financial sector.[2788] Both SARB and the FSB will base their regulatory framework on the same comprehensive set of principles however each of these regulators will place varying degrees of significance onto each principle.[2789] This model differs significantly from the current financial regulatory framework in which the responsibility of prudential regulation and market conduct regulation is shared by both SARB and the FSB.[2790]

The prudential regulator will operate within the SARB and be subject to the SARB's governance arrangements. The market conduct regulator will be governed by a fulltime commissioner and executive management team appointed by the Minister of Finance.[2791] Independent audit, remuneration and risk committees will have administrative oversight. The 'twin peaks' model of financial regulation separates regulatory functions by objectives, thereby allowing each regulator to focus on a single core mandate.[2792] According to the National Treasury, the introduction the 'twin peaks' model in South Africa has two broad objectives. Firstly, it is aimed to strengthen South Africa's approach to consumer protection and market conduct in financial services and secondly it is aimed at creating a more robust and stable financial system.[2793]

[2788]See Bosch, R. (2012), 'Banking Regulation: Jurisdictional Comparisons', Sweet and Maxwell Publishers.
[2789]See Oxford Business Group (2012), 'The Report: South Africa 2012', Oxford Business Group.
[2790]Department of National Treasury of the South African Government (2013), 'Implementing a Twin Peaks Model of Financial Regulation in South Africa', Published for public comment by the Financial Regulatory Reform Steering Committee, 1 February 2013, Pretoria, South Africa.
[2791]Pretorius, D. (2014), 'Beyond Play', Xlibris Corporation Publishers.
[2792]Pretorius, D. (2014), 'Beyond Play', Xlibris Corporation Publishers.
[2793]Department of National Treasury of the South African Government (2011), 'A Safer Financial Sector to Serve South Africa Better', National Treasury Policy Document, 23 February 2011, Pretoria, South Africa.

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The imminent introduction of the 'twin peaks' model to the South African financial services regulatory framework creates a unique opportunity for the South African private equity industry. The South African private equity industry has the opportunity to consult more effectively with Government and key stakeholders, not only on the proposed reforms discussed above, but on industry specific regulations required to foster a better private equity market. It is hereby submitted that the private equity industry has not always been effective in communicating its business model, as well as the socio-economic benefits of its business model. It is therefore an imperative that the formal representatives of the South Africa private equity industry, albeit via the relevant industry bodies, show commitment to engage more effectively with policy makers and key stakeholders moving forward and contribute to the creation of a regulatory environment that supports a competitive and robust South African economy.

3. Proposed Regulatory Reform Relating to Private Equity

In this paragraph three, specific policy proposals are made. Regulatory reform in South Africa should be driven by the goals for creating a transparent, sustainable, sound and efficient financial system for the future. The South African private equity industry (as represented by either SAVCA and/or ASISA)[2794] should co-operate closely with Government, the Financial Services Board ('FSB') and other related institutions in developing an appropriate and proportionate regulatory framework. This framework should consist of enhanced unified professional standards and an effective enforcement regime with oversight thereof by the appropriate national bodies. The South African private equity industry can be part of the solution to help overcome the current lack of liquidity of the local capital market and thereby play an active role contributing to the recovery of the South African economy. The industry is an important source of long term capital throughout all stages of a company's growth strategy, namely from seed capital to larger scale corporate restructurings. The private equity industry employs a hands-on approach to working with management teams to develop more successful businesses. In this way, the private equity industry also makes an important contribution to South African employment, competitiveness and innovation.

However, the development of the above mentioned regulatory framework will only be successful if the private equity industry participants themselves acknowledge and actively address the disadvantages and real risks posed by the private equity industry on the South African financial system. In paragraph 5 of chapter one, these disadvantages are summarised as:

> 'Conflicts of interest, because private equity partners involved in the running of companies may have different priorities from other investors in the private equity fund; Shorter investment

[2794]Industry bodies are the Association for Savings and Investment South Africa ('ASISA') and the South African Venture Capital and Private Equity Association ('SAVCA').

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horizons, because the aim is usually to sell the company after a few years, rather than focusing on long-term growth; Lack of transparency, making them less accountable to the public and their workforces; Greater leverage, making companies more vulnerable to economic downturns and with the potential to pose risks to lenders and the financial system; Risk of job destruction through seeking to extract value; Risk to pensions, through selling assets and loading companies with debt.'[2795]

If the introduction of new laws and regulations is required to addressing these disadvantages, then South African policymakers should be cognizant of their unintended consequences as highlighted in paragraph 1 of this chapter. As Scott so aptly states:

> 'What is the lesson here? Policy makers need to recognise ... No matter how benevolent, intelligent, and farsighted policy makers might be, they cannot anticipate how markets will react to laws and regulation. Efforts to shape the economic system to fit the designs of policy makers inevitably result in unintended consequences. In the case of small business, this means that laws designed to solve unrelated problems often end up imposing unnecessary and counterproductive burdens on entrepreneurs and their businesses.'[2796]

Nevertheless, it is submitted that a private equity fund's aim is to increase the stability and value of the business it acquires, which in turn would be beneficial for both employees and wider civil society as the company's stability increases and more employment is created.[2797] Many investors in private equity funds are pension funds that typically require adherence to high ethical standards. They expect the private equity firm to have the same standards. For example, a breach of legal obligations in a portfolio company or publicity around inappropriate behaviour towards workers will be damaging to the private equity firm's ability to raise future private equity funds.[2798] While there is conflict in all businesses between maximizing the rewards to workers and employees and maximizing profitability and return to investors, employees are a key part of increasing the value of a private equity fund's investment, and there is no incentive for a private equity fund to behave inappropriately towards workers or employees.[2799] Therefore clear governance structures ensure an alignment of interests.

The detailed description and analysis of existing laws, regulations and professional standards throughout this thesis demonstrates that the private equity industry is already highly-regulated at

[2795]See House of Commons Treasury Committee, (2007), 'Private Equity', Tenth Report of Session 2006-07, Volume 1, Ordered by House of Commons, July 2007, at chapter 3, pages 11-18.
[2796]Scott, S. (2010), 'Born Entrepreneurs, Born Leaders: How Your Genes Affect Your Work Life', 1st Edition, Oxford University Press, at pages 1-182.
[2797]Civil Society, is the collection of individuals and classes of individuals as determined by their sense of belonging (together with their official and unofficial representative groupings) which taken as a whole compete and collaborate to form the system of interaction between people that is the world in which we live.
[2798]See Fraser-Sampson, G. (2011), 'Private Equity as an Asset Class', John Wiley and Sons.
[2799]See Fraser-Sampson, G. (2011), 'Private Equity as an Asset Class', John Wiley and Sons.

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national level, and does not pose systemic risks either through its funding model or the companies in which it invests. Moreover, this thesis's assessment shows that the current practices in terms of contractual agreements between sophisticated investors and private equity firms are characterised by a high level of understanding among parties on how contractual clauses should be structured in relation to the underlying investment strategies, their risk and the compensation of managers. Retail investors play an insignificant role in the market and, in the few cases they are engaged, are protected by the laws covering public offerings. As a customer of financial services, the private equity industry is no different from other investors and is not immune from the financial turmoil. The private equity industry should support appropriate changes in capital market regulation which could help to revitalise capital markets, provided that it maintains the level playing field between the private equity industry and other users of financial services. The important recommendations of this thesis in the areas of industry standards and supervision for private equity are intended to contribute to this objective.

The starting point in considering the broad regulatory framework aimed at 'reforming' the South African private equity market should be with the main 'actors' themselves. On the one hand this would consist of the private equity industry which would be represented by the two central figures, namely the private equity firms via their representative industry bodies, such as ASISA and/or SAVCA and investors such as pension funds. On the other hand will be the policy makers and relevant regulators such as the FSB, National Treasury and the other relevant government agencies. As stated above, the South African private equity industry should co-operate closely with Government, the FSB and other related institutions in developing an appropriate and proportionate regulatory framework.

3.1 The Private Equity Industry's Policy Considerations

The South African private equity industry should commit to a unified industry set of professional standards. These should be principle-based to allow national implementation of approved variations to fit with local practices and legislation. A good starting reference would be the King IV Code, in particular supplements 6.4 and 6.5[2800] thereof.[2801] Given the important national and international

[2800]Supplement 6.5 relates to small medium enterprises.

[2801]The King Report on Corporate Governance is a booklet of guidelines for the governance structures and operation of companies in South Africa. It is issued by the King Committee on Corporate Governance. Three reports were issued in 1994 (King I), 2002 (King II), and 2009 (King III) and a fourth revision (King IV) in 2016. The Institute of Directors in Southern Africa (IoDSA) owns the copyright of the King Report on Corporate Governance and the King Code of Corporate Governance. Compliance with the King Reports is a requirement for companies listed on the Johannesburg Stock Exchange. Available at https://en.wikipedia.org/wiki/King_Report_on_ Corporate_Governance, in December 2017.

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status of the King Codes,[2802] the relevance of these practices and principles cannot be ignored.[2803] For example, supplement 6.4 focuses specifically on the retirement fund industry given that such retirement funds play a significant role in the institutional investor industry.[2804] This applies to all retirement funds in accordance with their definitions in the Income Tax Act 58 of 1962.[2805] Supplement 6.4 recommends that Board of Trustees of retirement funds should consider the King IV Code principles in conjunction with the Code for Responsible Investing in South Africa ('CRISA'),[2806] as well as the Financial Services Board Circular PF 130, which King IV refers to being complementary to the Code.[2807] On the one hand, any improvement to the governance requirements that are in the best interests of the retirement fund members, are positive. On the other hand, guidelines should not become too onerous that it leads to an increase in costs, which essentially negates any benefit of what the guidelines are aiming to achieve. The reality is that as governance requirements increase, so do administrative costs, therefore innovative ways need to be implemented in order to balance the benefits with the unintended consequences.

The unified set of professional standards should be based on:

(a) a code of conduct;
(b) corporate governance guidelines in the management of private equity-held companies;
(c) reporting to investors;
(d) valuation guidelines;
(e) transparency and disclosure guidelines; and
(f) governing principles for the establishment and management of private equity funds.

In addition, the private equity industry should introduce and establish an enforcement regime for the industry professional standards in South Africa, and make it subject to oversight by the appropriate national supervisory bodies. The enforcement regime should create:

[2802]Increasingly recognised by South African courts.

[2803]King IV Code (2016), 'The King Code on Corporate Governance for South Africa', The Institute of Directors in Southern Africa, November 2016. The King IV Code was released on 1 November 2016 and was aimed to bring it up to date with international governance codes and best practice.

[2804]See King IV Code (2016), 'The King Code on Corporate Governance for South Africa', The Institute of Directors in Southern Africa, November 2016, supplement 6.4 at pages 95-102.

[2805]King IV Code (2016), 'The King Code on Corporate Governance for South Africa', The Institute of Directors in Southern Africa, November 2016, supplement 6.4 at pages 95-102.

[2806]The Code for Responsible Investing in South Africa ('CRISA') applies to institutional investors such as pension funds and insurance companies as the owners of assets and their service providers including asset managers and consultants. It encourages institutional investors and service providers to adopt its principles and practice recommendations on an "apply or explain" basis. The effective date for reporting on the application of CRISA was 1 February 2012.

[2807]CRISA has been endorsed by the Institute of Directors in Southern Africa (IoDSA), the Principal Officers Association (POA), and the Association for Savings and Investment South Africa (ASISA). The principles of CRISA are supported by the Financial Services Board (FSB) and the Johannesburg Stock Exchange (JSE).

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(a) accountability to the appropriate national supervisory bodies;
(b) protection of the process from conflicts of interest; and
(c) proportionality according to the risk posed by various industry participants.

3.2 The Government's Policy Considerations

Based on the analysis of the key issues in South Africa and lessons learned from international experience, this thesis recommends the following policy considerations, which are largely a summary of all the key points critically analysed and raised in the preceding chapters. These are:

a. The establishment of an appropriate regulatory framework for a local private equity investment vehicle to be regulated under the existing Collective Investment Schemes Control Act, 45 of 2002 ('CISCA').

   i. The investment vehicle must serve as a tax pass-through vehicle so that only the investor is subject to the assessment of taxes.
   ii. The proposed new flow through, closed-ended collective investment vehicle will be a South African domiciled onshore private equity vehicle, intended for investment by resident and non-resident investors.
   iii. The definition of the collective investment vehicle should encompass *en commandite* partnerships and *bewind* trusts and any future vehicle which meets the criteria, irrespective of whether it is aimed at larger and/or smaller private equity transactions.
   iv. The proposed closed-end unlisted collective investment vehicle must contain the following minimum features, namely allow flow through; complete transparency, including flow through of losses, so that there are equivalent tax results for direct investment and indirect investment through the collective investment vehicle; the regime should allow legal entities of different types to elect, irrevocably, to be collective investment vehicles; the new regime should have a specific designation that can be easily incorporated into future Double Tax Agreement negotiations; and allow accumulation and reinvestment for all investors.
   v. The 'private equity CIS' should enjoy certain exemptions with regard to paying capital gains tax, in that CIS investors will only incur capital gains tax (once) when they sell their units in the 'private equity CIS'.

b. A US and UK-style approach should be adopted and provision should be made that taxes on share options are to be paid when shares are sold, instead of when the options vest or is exercised. No tax is due when they are exercised and therefore the issuer is not entitled to a tax deduction.

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i. The counterintuitive provisions introduced by section 8C of the Income Tax Act 58 of 1962, furthermore should be repealed. A starting point in this regard is current section 10(1)(k)(i)(dd) of the Income Tax Act 58 of 1962 which states that a dividend will not be exempt from normal tax if such dividend is received or accrued in respect of a restricted equity instrument (as defined in section 8C). This section should be repealed.

c. Carried interest should continue to be treated as capital gains instead of ordinary income. Policymakers must consider the background of carried interest as the primary incentive for the private equity firm before it decides to adjust the 3-year deemed capital rule.

d. The legal duties of a private equity firm needs to be explicitly stated in a private equity regulatory framework. To this end, the framework must provide the expertise and resources for good governance; and these duties must be enforced by efficient regulation.

i. The regulatory framework should encourage the involvement of institutional investors. The participation of institutional investors in risk capital should be encouraged through legal authorisation, education, public information campaigns, and discussion forums. The participation of banks in a multi-faceted way in the risk capital industry should also be facilitated.

e. South African policy makers should not adopt an interventionist approach in trying to improve the liquidity of the local stock markets such as introducing tax incentives aimed at artificially trying to improve South Africa's capital market's liquidity.[2808] National Treasury, in conjunction with the FSB, ASISA and SAVCA should commission a detailed study aimed at developing policy that will improve the attractiveness of the local stock markets as viable exit routes for private equity funds. The study must extend beyond the private equity industry and should include an analysis of all the legal, political, macroeconomic, regulatory, accounting, tax and supervisory systems that influence capital market liquidity.

4. Conclusion

This thesis examined how the law affects the structure of a private equity industry, as well as the structure of private equity funds and the relationships between the various parties related to a fund, *inter alia* investors, the fund manager and underlying portfolio investments. It also examined how the

[2808]For example the South African Venture Capital Company ('VCC') intiative discussed under chapter 4, paragraph 2.1(e) at pages 355-359. Also see the discussion under chapter 4, paragraph 3.2 (titled 'Private Equity Exit Alternatives') at pages 414-425.

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law can be structured to promote business development. In addition, it examined the role of private equity in advancing social responsible investing in South Africa.

This thesis shows that private equity in South Africa is a major asset class. It is also important that policymakers understand the link between the stock market and the private equity market, because the two central characteristics of the US and UK private equity market have been the rapid exit by private equity funds from investments in portfolio companies, and the common practice of exit through a stock market listing. In addition, it is clear that private equity has a significant impact in fostering job creation and economic growth. Nevertheless, while private equity has been found to contribute to increased economic growth, it has also been argued that the studies analysing the interrelationship between private equity and economic growth have not clearly highlighted the influence of regulation on the impact of private equity on economic growth.[2809] In addition, some of the risks commonly associated with private equity investing mentioned in chapter one are conflicts of interest, lack of transparency and disclosure, high leverage and the allocation of fees and expenses by private equity firms. However, the growth of the South African private equity industry will depend on creating an environment in which investors and regulators alike clearly see the advantages and disadvantages of private equity. Private equity as an asset class has clear and demonstrable benefits for the South African economy, but also poses several dangers. Despite obvious weaknesses, private equity has become an attractive investment choice amongst investors and as a source of equity financing.

The decision as to the appropriate legal vehicle to structure a private equity fund depends on numerous factors, including the need for limited liability and tax transparency. This thesis discussed the *bewind* trust and *en commandite* partnership in South African law as two suitable legal vehicles. Furthermore, the favourable legal characteristics of collective investment schemes should be extended to private equity funds formed in South Africa. Compared to other investment vehicles, collective investment schemes are unique in terms of capital gains tax.

In addition, corporate governance plays an important role in a modern economy because the heart of it lies in affording efficient investor protection, together with the common law principles of fiduciary duties. Sound corporate governance is essential to the well being of an individual company and its stakeholders. It is also a critical ingredient in maintaining a sound financial system and a robust economy. This thesis shows that investor protection via legal rules and regulations is more effective in developing countries' financial markets than the traditional law and economics perspective of financial contracting.

[2809]As mentioned in chapter one, the relationship between private equity and economic growth could be in the reverse, that is, economic growth contributes to private equity activity. See Strömberg, P. (2009), 'The Economic and Social Impact of Private Equity in Europe: Summary of Research Findings', Stockholm School of Economics, Institute for Financial Research (SIFR), September 2009, at page 6.

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In conclusion, the thesis also reviewed reform policy in several jurisdictions and four key lessons emerged. Firstly, an appropriate tax regime is critical to the private equity industry. Secondly, private equity investments by pension funds have a significant impact on the private equity industry. Thirdly, corporate governance has played a significant role in shaping a private equity industry. Lastly, the various potential exit routes in a private equity market directly impact on an investor's decision as to whether or not it will commit to invest in a particular private equity fund. Therefore, in order for a private equity market to flourish, private equity firms must have clear exit strategy alternatives that enable them to realise the gains on their investments. Nevertheless, it is submitted that the current system can be improved and should be reformed in a manner that fosters economic and employment growth, but at the same time addresses the real risks that the private equity industry poses on the financial system.

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