PRIVATE EQUITY

Substance over form: Structuring black private equity funds under the B-BBEE framework: The importance of active management

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1. Introduction

1.1. The growth of black-managed private equity ("**PE**") funds in South Africa is a significant development in the transformation of our financial sector.

1.2. Sector Codes issued under the B-BBEE Act 53 of 2003 ("**B-BBEE Framework**"), provide a framework intended to grow the black fund management industry and the regulatory incentives offered to portfolio companies whose shares are owned by private equity funds managed by qualifying black fund managers are substantial.

1.3. Yet this opportunity also introduces serious legal risks as the structuring of these transactions is complex. The law, as enforced by the B-BBEE Commission, demands substance and where substance is absent, the consequences range from loss of B-BBEE status to criminal prosecution.

1.4. This article focuses on a risk that is, in our experience, most commonly misunderstood and most frequently encountered in practice, which is the failure to ensure that the black fund manager actively manages the private equity fund.

2. The Regulatory Framework: What is Required

2.1. The B-BBEE Framework creates a powerful incentive for portfolio companies to seek investment from black-managed private equity funds. Where a qualifying Black Management Company (the "**Black Management Company**") manages a private equity fund, the portfolio companies in which that fund invests are entitled to treat the entire equity stake held by the private equity fund as being held by black persons — irrespective of whether the underlying investors in the fund are themselves black.

2.2. This is a deliberate policy choice. The B-BBEE Framework recognises that if black fund managers were required to raise capital exclusively from black investors, the growth of the black fund management industry would be severely constrained. By decoupling the racial profile of the investors from the B-BBEE ownership recognition at portfolio company level, the B-BBEE Framework allows black fund managers to compete for capital in the institutional market.

2.3. But this recognition is conditional. For a fund to qualify, the Black Management Company must satisfy all of the following requirements —

1. at least 51% of the exercisable voting rights in the Black Management Company must be held by Black People;
2. at least 51% of the executive and senior management of the Black Management Company must be Black People;
3. at least 51% of the profits — after realising investments — must accrue to Black Persons by written agreement; and
4. the Black Management Company must be structured as a company (not a trust, partnership or other entity) owned by black persons.

2.4. In addition, the Black Management Company must progressively invest a growing proportion of its funds under management in companies with at least 25% black shareholding, starting at 5% in year one and escalating to 51% by year nine.

2.5. On paper, these requirements are reasonably straightforward. In practice, the manner in which fund structures are actually implemented is where the risks arise and where, in our experience, many structures fall short.

3. The Key Problem: Ownership Without Control

3.1. The most pervasive risk we encounter in advising on black PE fund structures is what can be described as a "form without substance" problem.

3.2. The B-BBEE Framework defines fronting broadly as any transaction, arrangement or conduct which directly or indirectly undermines or frustrates the achievement of the objectives of the B-BBEE Act 53 of 2003. The definition captures, amongst other things, arrangements in which black people are appointed to roles that lack substance, in which economic benefits do not flow to black people in the ratios specified in the documentation, or in which a legal relationship with a black person is concluded for B-BBEE compliance purposes without conferring on that person the economic benefits reasonably expected to accompany their role.

3.3. This principle applies in the private equity fund context and it leads directly to what we regard as one of the most important and most misunderstood requirements in the structuring of a black PE fund, (a requirement not expressly stipulated in the B-BBEE Framework) namely that the Black Management Company must actively manage the fund.

4. The Importance of Active Management

4.1. The B-BBEE Framework's private equity provisions are designed primarily to grow the black fund management industry. This is not an incidental objective but it is the central purpose of the regulatory framework. A structure that claims B-BBEE recognition while effectively sidelining the Black Management Company from genuine fund management does not advance this purpose and arguably subverts it.

4.2. Active management, in the context of a private equity fund, means that the Black Management Company should —

1. make investment decisions. The identification, evaluation, negotiation and approval of investments should be driven by the Black Management Company's team. This is the core function of any fund manager, and the B-BBEE framework requires that black managers exercise this function in substance, not merely on paper;
2. exercise ongoing portfolio oversight. Managing a PE fund does not always end at the point of investment, it typically encompasses active engagement with portfolio companies, monitoring of financial performance, participation in board governance, and the strategic management of exits. The Black Management Company should be involved in these functions;
3. hold real authority over fund governance. The key decisions of the fund, drawdowns, distributions, valuations, and material changes to investment strategy, should be subject to meaningful input by the Black Management Company; and
4. earn a market-related management fee. This is both a legal requirement and a practical indicator of genuine management. A fund manager that is not paid market-related fees is a fund manager whose role has been economically marginalised. The B-BBEE Framework's definition of fronting is alert to arrangements that strip economic benefits away from black participants. A black fund manager that is appropriately qualified, properly compensated, and genuinely in charge of day-to-day management decisions is not merely a regulatory requirement, it is the foundation on which a black PE fund's credibility rests.

5. The Problem with Investment Committees

5.1. One of the most common structural mechanisms that can undermine the role of the Black Management Company is the role of the investment committee.

5.2. Investment committees are a standard and entirely legitimate feature of private equity fund governance. They provide a structured forum for the collective review of investment opportunities, risk management and portfolio oversight and in well-run funds, they are a useful asset.

5.3. The problem arises when an investment committee is structured or operated in a manner that effectively displaces the Black Management Company as the decision-maker. We have seen fund structures, sometimes drafted with the best of intentions, in which —

1. the investment committee is constituted predominantly or entirely by individuals who are not part of the Black Management Company's team;
2. the Black Management Company's investment recommendations are subject to an investment committee veto that can be exercised without meaningful engagement with the Black Management Company;
3. the investment committee's composition and terms of reference give non-black participants effective control over all material investment decisions; and
4. the Black Management Company's role is reduced to implementing decisions already made by an investment committee on which it has no meaningful representation or influence.

5.4. In any of these scenarios, the risk of fronting is acute. The Black Management Company becomes, in substance, an administrator rather than a manager. It holds a title and receives a fee, but the actual management function, the core of what the B-BBEE Framework requires, has been transferred elsewhere.

5.5. This is precisely what the Courts have warned against generally when considering the B-BBEE Framework: black ownership and management in form, without the substance of genuine control and decision-making authority.

5.6. Any fund structure in which an investment committee plays a significant role must therefore be scrutinised carefully to ensure that the Black Management Company retains genuine decision-making authority. The investment committee should advise and review, it should not govern. The Black Management Company's team should either independently or by holding sufficient representation on the investment committee, ensure that its voice is not merely heard but is determinative. And the constitutional documents of the fund must reflect this in clear, unambiguous terms.

6. Conclusion

6.1. Fronting is a criminal offence under the B-BBEE Act, with penalties including —

1. fines of up to 10% of annual turnover;
2. imprisonment of up to 10 years;
3. severe reputational damage; and
4. loss of B-BBEE status across portfolio companies.

6.2. Beyond governance design, we frequently see private equity vehicles designed primarily for B-BBEE recognition, without the other true private equity characteristics, such as fundraising, an investment strategy or an exit strategy, which risk falling outside the B-BBEE Framework entirely.

6.3. A properly structured black private equity fund shows the same core features —

1. the Black Management Company is the true decision-maker across the investment lifecycle;
2. governance documents clearly reflect this authority;
3. economic participation is real, market-related, and aligned with performance;
4. investment committees are advisory, not determinative; and
5. the fund operates as a genuine, active private equity vehicle, encapsulating functions which are typical for a private equity fund, not merely as a compliance construct.

6.4. In short: substance should match form at every level. For fund managers, investors, and sponsors, the safest and most durable position is also the simplest which is to build structures where substance leads, and form follows.

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