

A GUIDE ON

RECOGNISING AND PREVENTING

FRONTING

BUSA CONTACT DETAILS

Third Floor, South Block, 9 Fredman Drive, Sandton
P O Box 652807, BENMORE, 2010
Tel: (011) 784 8000/1/2/3 Fax: (011) 784 8004/8
E-mail: busa@busa.org.za
Website: www.busa.org.za



BUSA
BUSINESS UNITY SOUTH AFRICA

VISION

BUSA aims to be a unified and fully representative organisation that contributes to a vibrant, transforming and growing economy in South Africa.

MISSION

BUSA aims to ensure that organised business plays a constructive role, within the context of the country's economic growth, development and transformation goals, in achieving an environment in which businesses of all sizes and in all sectors can thrive, expand and be competitive both nationally and internationally.

OBJECTIVES

BUSA operates on a non-profit basis and represents the collective interests of business in South Africa by:

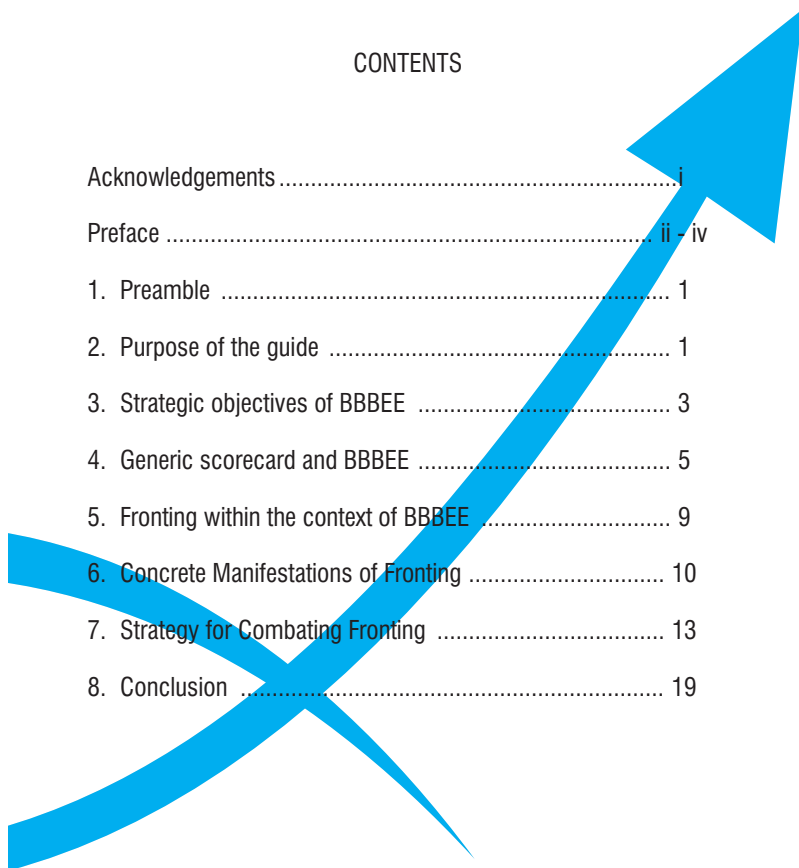
- Acting as the principal representative of business in South Africa in its national, sub-continental, continental and international spheres of activity, so as to ensure a primary and consistent representation of the views of the South African business community;
- Promoting Broad-Based Black Economic Empowerment (BBBEE);
- Advancing and promoting initiatives aimed at job creation and the alleviation of poverty;
- Acting for and representing the views of its members at national, sub-continental, continental and international levels; and
- Enabling business to play a meaningful strategic role in South Africa's overall development.

8 Conclusion

- 8.1 The strategy for combating fronting outlined in this guide neither claims to be exhaustive, nor a final, solution to the complex challenges posed by fronting and misrepresentation in BBBEE processes and transactions.
- 8.2 Rather, the strategy is presented as one of many concrete steps that could be undertaken by a business to minimise incidents of BEE fronting and misrepresentation in the market place.
- 8.3 Needless to say, the effective implementation of the strategy calls for enterprises' greater commitment to ethics and integrity, as collusion on deceptive practices are difficult to detect until there is a fall-out between or among the colluding parties.
- 8.4 It is essential that all social partners, including business, work together with authorities to expose incidents of fronting so that we can stamp out a practice that is detrimental to the objectives of BBBEE and the transformation of the South African economy into a dynamic and globally competitive economy.
- 8.5 In doing so, it is important to understand that those involved in fronting practices will not, in the normal course of events, come forward and own up to their activities. Parties to fronting always seek to hide their activities, as they know that their actions are unacceptable and against the law.
- 8.6 Finally, most of the measures proposed to prevent fronting are likely to add to the cost of doing business in the country. However, this is a price the country should be prepared to pay to ensure that transformation and empowerment succeed, in the interests of the long-term sustainability of our democracy.

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PREFACE

This **"GUIDE ON RECOGNISING AND PREVENTING FRONTING¹ AND MISREPRESENTATION IN BROAD-BASED BLACK ECONOMIC EMPOWERMENT (BBBEE) PROCESSES AND TRANSACTIONS"** is intended to assist Business Unity South Africa (BUSA) member organisations and other interested parties to detect and prevent the occurrence of fronting incidents in BBBEE processes and transactions. In particular, the guide is designed to clarify and answer some of the 'frequently asked questions' about the meaning and manifestation of fronting within the context of BBBEE. The guide is neither meant to be a substitute for, nor an alternative to, Code 910: Practice Note on Fronting, to be released as part of phase 2 of the Codes of Good Practice on BBBEE.

BUSA is always concerned about incidents of fronting, as these incidents impact adversely on the effective implementation of BBBEE. As a result, BUSA, in its quest to help its member organisations and other interested parties to deal effectively with the challenges posed by fronting, has commissioned research to investigate the nature and extent of fronting in the market place.

In particular, the research has sought to accomplish two interrelated objectives: firstly, to unearth the various forms in which fronting


1. For a definition and meaning of fronting within the context of BBBEE, see clause 5 below.

manifests itself; and secondly, to propose strategies to reduce incidents of fronting and misrepresentation in BBBEE transactions. The research, which extended over a period of four months from the end of 2004 to the beginning of 2005, relied on information and anecdotal evidence gathered mainly from newspaper articles and interviews with select role-players in the market place.

In contrast with the popular view on fronting, which presumes that fronting occurs only at the level of equity ownership, the findings of the research have indicated that fronting can manifest itself in many guises affecting any one of the seven elements of the BBBEE scorecard. This suggests that our strategy for combating fronting needs to focus on the seven elements of the BBBEE scorecard. The recommendations for combating fronting presented in the guide are a product of the research described above and, accordingly, attempt to address fronting practices that impact on the various elements of the BBBEE scorecard.

The guide is divided into eight sections. **Preamble** argues for a strategic partnership among the social partners and other interested parties in combating fronting in the market place. **Purpose of the guide** explains how fronting undermines the objectives of BBBEE and articulates the specific objectives that the guide seeks to achieve.

As a background to understanding the phenomenon of fronting, **Strategic objectives of BBBEE** examines the interplay between the objectives of BBBEE and broad socio-economic transformation and empowerment. **Generic scorecard and BBBEE** explains how compliance



with the objectives of BBBEE is measured using the generic scorecard. **Fronting within the context of BBBEE** discusses the meaning of fronting within the context of BBBEE. **Concrete manifestations of fronting** describes the various ways in which fronting practices manifest themselves in the market place. **Strategy for combating fronting** describes practical steps that could be undertaken to combat fronting and misrepresentation in BBBEE transactions.

Conclusion encourages social partners, including business, to work together with the authorities to expose incidents of fronting so that we can stamp out a practice that is detrimental to the objectives of BBBEE and the transformation of the South African economy into a dynamic and globally competitive economy.

Siyabonga Ndabezitha
Chief Officer: Transformation
Business Unity South Africa
November 2005

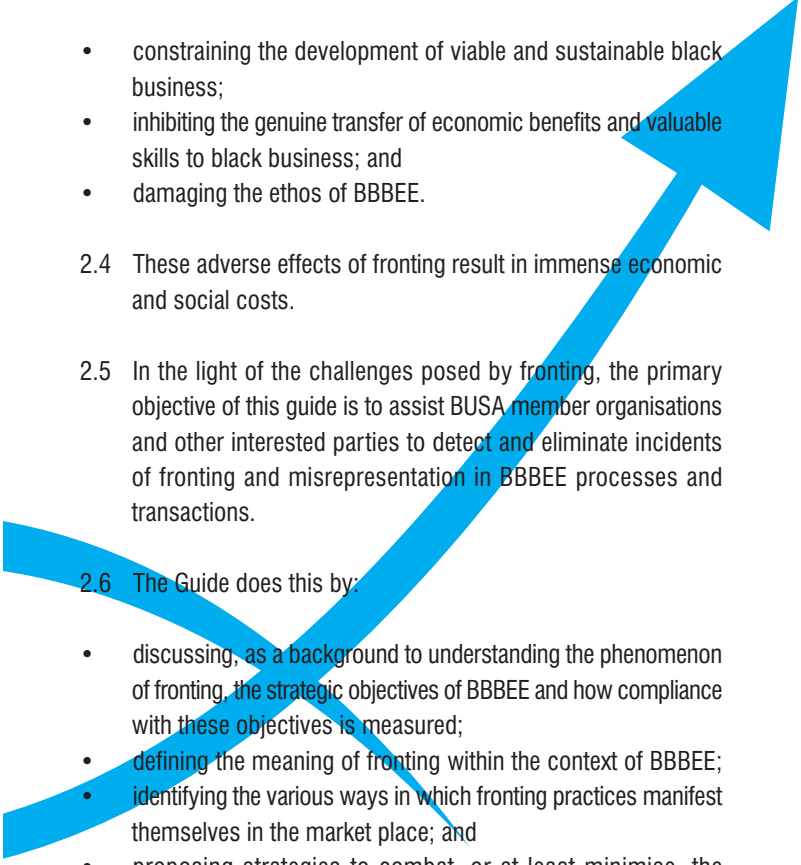
Sindi Zilwa
Chairperson: TRANSPOL
Business Unity South Africa
November 2005

1. Preamble

- 1.1 One of the strategic objectives of Business Unity South Africa (BUSA) is to promote the effective implementation of the objectives of BBBEE by engaging government, corporate South Africa and other stakeholders on issues of empowerment and transformation.
- 1.2 In line with this objective, BUSA seeks to work in partnership with government, corporate South Africa, verification agencies and other interested parties to eliminate fronting and other obstacles to the implementation of BBBEE.
- 1.3 It is BUSA's considered view that strategic partnerships among social partners represent the most effective way to address fronting and other challenges of mutual concern in the market place.

2. Purpose of the Guide

- 2.1 Fronting is one of the greatest impediments to the effective implementation of the objectives of BBBEE.
- 2.2 As a result, fronting has become a source of grave concern to the public in general, and the business community in particular.
- 2.3 This is so because fronting undermines the objectives of BBBEE by, inter alia:

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- constraining the development of viable and sustainable black business;
 - inhibiting the genuine transfer of economic benefits and valuable skills to black business; and
 - damaging the ethos of BBBEE.

2.4 These adverse effects of fronting result in immense economic and social costs.

2.5 In the light of the challenges posed by fronting, the primary objective of this guide is to assist BUSA member organisations and other interested parties to detect and eliminate incidents of fronting and misrepresentation in BBBEE processes and transactions.

2.6 The Guide does this by:

- discussing, as a background to understanding the phenomenon of fronting, the strategic objectives of BBBEE and how compliance with these objectives is measured;
- defining the meaning of fronting within the context of BBBEE;
- identifying the various ways in which fronting practices manifest themselves in the market place; and
- proposing strategies to combat, or at least minimise, the occurrence of fronting practices and misrepresentation in BBBEE processes and transactions.

3. Strategic objectives of BBBEE

- 3.1 To appreciate the harmful effects of fronting on empowerment and transformation initiatives, it is important to understand the objectives of BBBEE.
- 3.2 BBBEE is government's policy to redress the legacy of racial and gender-based economic inequalities induced by South Africa's past colonial and apartheid policies of socio-economic exclusion.¹
- 3.3 The implementation of these socio-economic policies of exclusion has resulted in the domination of mainstream economic and business activities (First economy) by whites and the relegation of most blacks to peripheral business activities (Second economy) and menial jobs in the labour market.
- 3.4 Against this background, the principal objective of BBBEE is to:
 - promote economic transformation to enable meaningful participation of black people in the mainstream economy;
 - achieve a substantial change in the racial composition of ownership and management structures and in the skilled occupations of existing and new enterprises;

1. For a detailed discussion of this point, see *South Africa's Economic Transformation: A strategy for broad-based Black Economic Empowerment (2002)*.

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- increase the extent to which communities, workers, cooperatives and collective enterprises own and manage existing and new enterprises;
 - increase the extent to which black women own and manage existing and new enterprises;
 - promote investment programmes that lead to broad-based and meaningful participation of black people in the mainstream economy;
 - empower rural and local communities by facilitating their access to economic opportunities, land, infrastructure, ownership and skills; and
 - promote access to finance for black economic empowerment.²

3.5 The strategic objectives of BBBEE outlined in 3.4 above are intended to counter measures that invariably underpinned the colonial and apartheid policies of racial exclusion.

3.6 In the economic sphere, colonial and apartheid policies of exclusion meant that blacks were, inter alia, stripped of and denied opportunities to accumulate assets, denied opportunities to develop and acquire certain technical skills, prevented from playing any controlling role in major companies and prohibited from starting their own enterprises in certain areas of the economy.

² The strategic objectives of BBBEE are set out in section 2 of the *BEE Act No. 53 of 2003*.

4. Generic scorecard and BBBEE

4.1 The government uses a generic scorecard, which identifies seven elements (indicators) of empowerment and transformation, to measure enterprises' compliance with the strategic objectives of BBBEE outlined in 3.4 above.

4.2 To ensure uniformity in the measurement of compliance, as well as comparability among the various economic sectors, the generic scorecard assigns weightings and targets on the seven elements of BBBEE.³

4.3 The seven elements of BBBEE that are measured by the scorecard are:

- **equity ownership**, which measures the economic benefits that accrue to black people as a result of their participation in the ownership of enterprises;
- **management control**, which measures the effective control of enterprises by black people as a result of their participation in the key decision-making structures;

3. For the weightings and targets attached to each element of the BBBEE scorecard, see the draft amended *Codes of Good Practice on Broad-Based Black Economic Empowerment*, p.18.

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- **employment equity**, which measures the equitable representation of black people in all occupational categories and levels within an enterprise;
 - **skills development**, which measures the financial resources an enterprise spends on developing the core competencies and technical skills of black people to facilitate their meaningful incorporation into mainstream economic activities;
 - **preferential/affirmative procurement**, which measures the extent to which an enterprise widens market access for BEE entities;
 - **enterprise development**, which measures an enterprise's initiatives aimed at assisting and accelerating the development of the operational and financial capacity of entities that contribute towards BBBEE;
 - **residual element**, which includes sector specific empowerment and social development initiatives that measure the extent to which these sector specific initiatives directly or indirectly facilitate the access of black people into the economy.

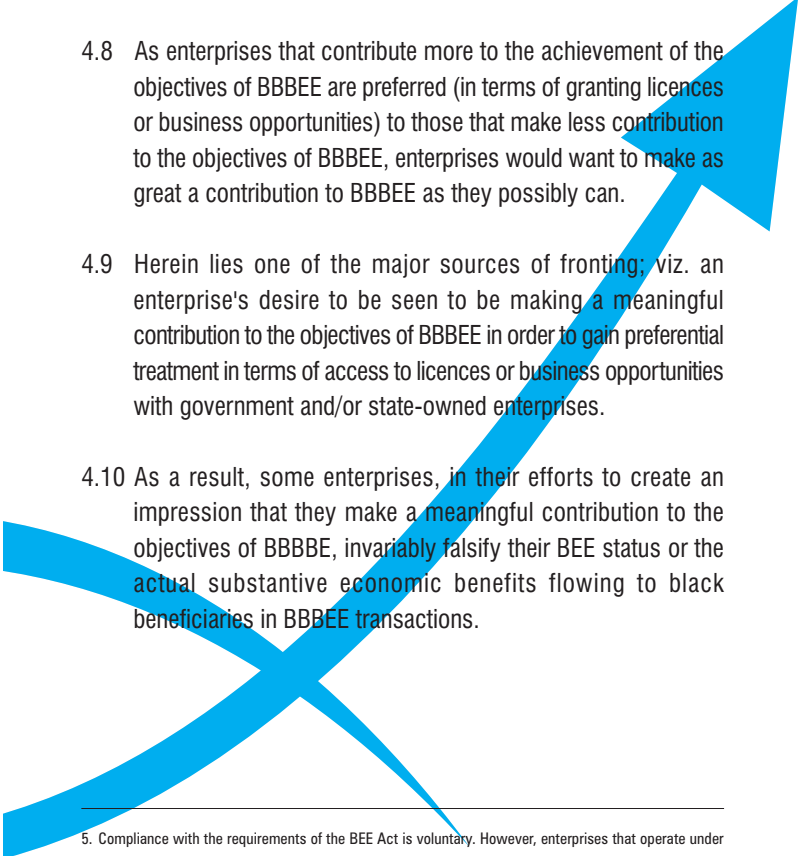
4.4 The scorecard operates on the basis of a weighted average and the overall weighted average score that an enterprise obtains determines the BBBEE status of that business undertaking.

- 4.5 This may vary from **Level One Contributor** (overall weighted score of 100 points on the generic scorecard) to **Non-Compliant Contributor** (overall weighted score of less than 30 points on the generic scorecard).⁴
- 4.6 An enterprise's level of contribution to BBBEE represents that enterprise's competitive advantage, as an enterprise's BBBEE status (i.e. level of contribution to BBBEE) becomes critical in the enterprise's commercial and economic dealings with the government and state-owned enterprises.⁵
- 4.7 The more an enterprise contributes to the achievement of the objectives of BBBEE, the better chances that enterprise stands vis-a-vis less-empowered enterprises in securing business from government, state-owned enterprises and other enterprises.

4. Nine levels of contribution to BBBEE are delineated, as follows:

- level one contributor (overall weighted score of 100 points on the generic scorecard)
- level two contributor (overall weighted score from 85 to less than 100 points on the generic scorecard)
- level three contributor (overall weighted score from 75 to less than 85 points on the generic scorecard)
- level four contributor (overall weighted score from 65 to less than 75 points on the generic scorecard)
- level five contributor (overall weighted score from 55 to less than 65 points on the generic scorecard)
- level six contributor (overall weighted score from 45 to less than 55 points on the generic scorecard)
- level seven contributor (overall weighted score from 40 to less than 45 points on the generic scorecard)
- level eight contributor (overall weighted score from 30 to less than 40 points on the generic scorecard)
- non-compliant contributor (overall weighted score of less than 30 points on the generic scorecard)

The more an enterprise contributes to the achievement of the objectives of BBBEE, the more points an enterprise gains on the scorecard.



4.8 As enterprises that contribute more to the achievement of the objectives of BBBEE are preferred (in terms of granting licences or business opportunities) to those that make less contribution to the objectives of BBBEE, enterprises would want to make as great a contribution to BBBEE as they possibly can.

4.9 Herein lies one of the major sources of fronting; viz. an enterprise's desire to be seen to be making a meaningful contribution to the objectives of BBBEE in order to gain preferential treatment in terms of access to licences or business opportunities with government and/or state-owned enterprises.

4.10 As a result, some enterprises, in their efforts to create an impression that they make a meaningful contribution to the objectives of BBBEE, invariably falsify their BEE status or the actual substantive economic benefits flowing to black beneficiaries in BBBEE transactions.

5. Compliance with the requirements of the BEE Act is voluntary. However, enterprises that operate under licence from the government and enterprises that source their business from the government and state-owned enterprises are expected to contribute to the achievement of the objectives of BBBEE. Private enterprises that seek to get involved in private-public partnerships (PPP) are also expected to contribute to the achievement of the objectives of BBBEE.

5. Fronting within the context of BBBEE

- 5.1 At the risk of over-simplification, fronting may be described as a set of adverse business practices designed to circumvent the implementation of BEE, thereby undermining the effective implementation of the objectives of BBBEE.
- 5.2 The Codes of Good Practice on BBBEE released in December 2004 for public comment define fronting as 'any entity, mechanism or structure established in order to circumvent the BEE requirements as required under various policy instruments. Fronting structures generally claim a higher BEE status than the actual substantive economic benefits flowing to black beneficiaries. The claims can be in the form of direct ownership, human resource development and indirect ownership components as per the balanced scorecard.'
- 5.3 At the core of fronting is the desire to circumvent the BEE requirements in order to make a commercial or an economic gain.
- 5.4 Viewed in this context, fronting is tantamount to a fraudulent activity as it relies on false representation to obtain a gain, to which the company so misrepresenting the facts would otherwise not be entitled.

5.5 It is generally assumed that fronting is limited to matters of ownership. This is not the case, as BEE is intended not only to promote asset ownership among blacks, but is also concerned with increasing the skills of blacks by a variety of means, including amassing on-the-job experience so that the workforce broadly represents the demographic profile of the country. It is also concerned with increasing control by blacks over significant assets. As is demonstrated below, fronting can, and indeed does, take place in all these areas.

6. Concrete Manifestations of Fronting

6.1 While circumvention takes many different forms, the main form of circumvention employed in BEE fronts entails concealing, misrepresenting or exaggerating the white business's true equity ownership status, the extent of employment equity, the degree of management participation by blacks and women, as well as procurement from empowered entities.

6.2 In practice this assumes different forms. One way in which this finds expression is the inclusion of blacks among directors of the company without intending to accord them the standing of white directors. This can happen both in the case of non-executive as well as executive directors. A question that arises is why would black people make themselves available for appointment into what are, in reality, phantom positions?

While in some cases the victims are not aware of the full meaning of their actions, in other cases those appointed to such positions are aware of the fact that there is no intention to ever let them play the role that their white counterparts play. In cases where black people are aware that their role is not meant to be identical to that of their white counterparts, this is usually done for a fee.

6.3 Another form of fronting, unlike instances already outlined, takes the form of simply changing the name of the company and changing the racial composition of the company's frontline staff. This change might be accompanied by all sorts of cosmetic changes that do not go to the heart of the changes intended by empowerment legislation. The rest of the practices of the company are left intact.

6.4 In the area of employment equity, fronting might assume the guise of employing people in positions for which they are never given the authority that goes with the job.

6.5 A simple yet increasingly used form of fronting is that of a white company creating a BEE company and entering their existing company into a relationship with 'their BEE Company'. Black employees of the company are made to sign documentation that gives the spurious 'BEE Company' the correct racial profile and they are appointed as directors of the company. This may be done without the full appreciation of the

people who are thus owners of the new empowered company.

6.6 Another form of fronting used, which appears rife in the construction industry, involves black contractors selling contracts to white companies. Black contractors tender on the basis they will do the work. However, upon being awarded a tender, they sell it to a white company for an amount significantly less than the contract is worth. Various reasons are advanced for this practice. One reason could be that the contractor in question was unable to raise the necessary bank loan to do the work. Faced with the prospect of an inability to complete the work, he/she sells the contract to a company that can deliver on the contract to his/her client.

6.7 Cases of collusion between white and black participants are not unknown. For some reason the parties come to an agreement that they will structure a relationship geared to giving an impression that a company is empowered when it is not. Necessary fees are obviously paid in these circumstances. This form of deception is difficult to detect until there is a fall-out among the contracting parties.

6.8 Finally, in some BEE transactions, sophisticated corporate instruments are employed to obscure the true nature of the relationship between the parties in a situation that is presented as black empowerment. In such situations, white shareholders

might structure voting arrangements so that they maintain control and influence in a company that is otherwise presented as empowered.

7. Strategy for Combating Fronting

- 7.1 As can be seen from the above account, fronting manifests itself in many guises, which can range from outright misrepresentation of an enterprise's BEE status to more sophisticated corporate structures designed to hide the true nature of business relationships between a company and its BEE partners.
- 7.2 To discourage fronting and other forms of BEE circumvention, verification agencies and other role players are required to report fronting practices to the Minister of Trade and Industry, who may blacklist such enterprises.
- 7.3 The effectiveness of blacklisting as a sanction aimed at preventing people from circumventing the BBBEE requirements resides in the potential loss of business. Business people are more likely to avoid fronting and dealing with anyone who engages in the practice if they know that, should they be found out, their businesses will be hurt. To a person seeking the continued success of a business, this is admittedly a severe sanction. Enterprises aspiring to promote BBBEE must therefore avoid being blacklisted, as this may result in loss of business and cause incalculable damage to the reputation of an enterprise.

7.4 In particular, key policy/decision-makers of such enterprises (i.e. Boards of Directors) must identify fronting as a risk, and devise, in conjunction with their management teams, a risk-management system. The possibility of inadvertent fronting needs to be managed with the same diligence as all other potential risks facing an enterprise.

7.5 Managing the fronting risk effectively requires key policy/decision-makers of enterprises to pay special attention to both policy and operational aspects of eliminating fronting.

7.6 At the policy level, enterprises must develop manuals that detail the procedures to be followed to ensure that their BBBEE processes and transactions are in line with the parameters set by the BEE Act and the Codes of Good Practice on BBBEE.

7.7 It is recommended that these policy manuals, which must be written in clear, concise and unambiguous language, should, inter alia:

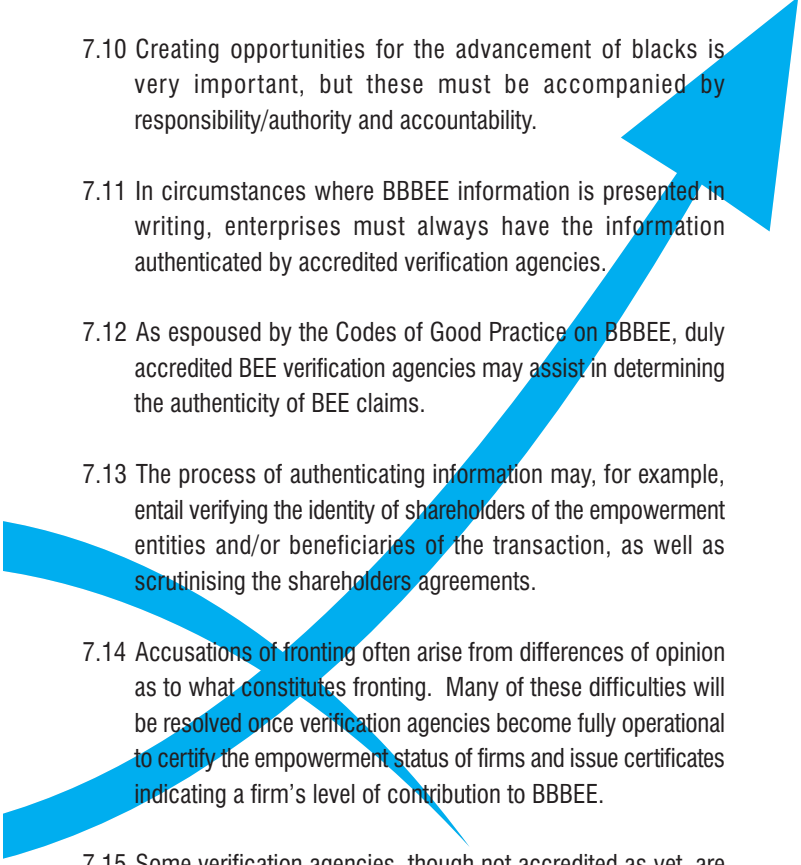
- explain the social and economic benefits of embracing and implementing BBBEE;
- discuss the meaning of fronting within the context of BBBEE and explain how fronting undermines the objectives of BBBEE;
- explain an enterprise's procedure for complying with the seven pillars of the BBBEE scorecard; and

- include examples of incidences of fronting, such as those contained in paragraph 7.9 below, so that such incidences are easily identifiable.

7.8 Relevant sections of the policy manuals should be freely available to staff via notice boards/intranet in order to educate staff about the negative effects of fronting on empowerment and transformation.

7.9 At a practical level, enterprises should avoid:

- the inclusion of blacks among directors of the company if there is no intention to accord them the same standing enjoyed by white directors;
- changing the name of the company and the racial composition of the company's frontline staff in order to create a false impression that the enterprise is black-owned or empowered;
- employing people in positions for which they are never given the authority that goes with the job;
- coming to agreements, through collusion between white and black participants, to structure business relationships geared towards giving an impression that a company is empowered when it is not; and
- creating spurious 'BEE Companies', with black employees of the company as directors, which are used to source business under the false pretext that the enterprise bidding for work is black-owned or empowered.

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- 7.10 Creating opportunities for the advancement of blacks is very important, but these must be accompanied by responsibility/authority and accountability.
- 7.11 In circumstances where BBBEE information is presented in writing, enterprises must always have the information authenticated by accredited verification agencies.
- 7.12 As espoused by the Codes of Good Practice on BBBEE, duly accredited BEE verification agencies may assist in determining the authenticity of BEE claims.
- 7.13 The process of authenticating information may, for example, entail verifying the identity of shareholders of the empowerment entities and/or beneficiaries of the transaction, as well as scrutinising the shareholders agreements.
- 7.14 Accusations of fronting often arise from differences of opinion as to what constitutes fronting. Many of these difficulties will be resolved once verification agencies become fully operational to certify the empowerment status of firms and issue certificates indicating a firm's level of contribution to BBBEE.
- 7.15 Some verification agencies, though not accredited as yet, are in business and have already performed work in this regard. Increasingly, in future, verification agencies will be called upon

to verify the empowerment claims of companies seeking contracts.

7.16 Verification agencies, which must be accredited by the South African National Accreditation System (SANAS), will have to be perceived to be, and factually, independent of the rated entities.

7.17 As a sign of their total commitment to all the seven pillars of the BBBEE scorecard, verification agencies will have to be 'superior contributors to BEE.'⁶

7.18 To provide an independent opinion on the BBBEE status of enterprises, verification agencies will be required to, firstly, assess, verify and validate both the disclosed and undisclosed BEE related information of entities and secondly, to evaluate the BEE transactions/scenarios to determine their effective creation and/or enhancement of economic wealth for the black people.

7.19 Another way of dealing with the problem of fronting might be to require existing auditing processes to specifically cover this aspect. Auditors are unlikely to mislead in reporting on this

6. Level One to Level Four contributors to BEE are considered 'superior contributors to BEE.'
See footnote number 4 on page 7.

aspect of their work on any company. Their reputation is their major asset.

7.20 Due diligence work could also be necessary to ascertain if what is claimed in writing is in fact the case. This is especially true if one is dealing with huge BBBEE transactions that involve a multiplicity of shareholders and beneficiaries.

7.21 In many cases it is difficult to conclude simply by looking at a transaction that there is fronting in it. Thus, as cases of fronting arise, further work would have to be undertaken to establish exactly what the practice is.

7.22 Finally, as some fronting practices arise from the ignorance of participants, there is an education process to be undertaken to ensure that people do not unintentionally subvert the objectives of government's empowerment policies.