



**PARLIAMENT**  
OF THE REPUBLIC OF SOUTH AFRICA

**RESEARCH UNIT**

PO Box 15 Cape Town 8000 Republic of South Africa  
Tel: 27 (21) 403 8273 Fax: 27 (21) 403 8118  
www.parliament.gov.za

## **MINERAL RESOURCES**

### **ANALYSIS OF THE ANNUAL REPORT 2012/13 OF THE STATE DIAMOND TRADER (SDT)**

16 January 2014

#### **1. Introduction**

The State Diamond Trader's main business is to buy and sell rough diamonds in order to promote equitable access to beneficiation of diamond resources. The main aim of the SDT is to address distortions in the diamond industry and correct historical market failures to develop and grow South Africa's diamond cutting and polishing industry.<sup>1</sup>

The SDT continued to go through difficult times in 2012 and 2013.

It has been described by analysts as "an organisation that is struggling financially and unable to achieve its aims"<sup>2</sup> and the Minister of Mineral Resources Ms Susan Shabangu has stated that a "radical overhaul of the State Diamond Trader" is needed.<sup>3</sup> This will be part of a review of the entire regulatory framework for the precious metals and diamond jewellery industries.

In October 2013, Ms Shabangu told *Mining Weekly* that "The creation of a State-enabled precious metals and gemstone bourse was under consideration to replace South Africa's State Diamond Trader, which had failed to deliver as a standalone entity".<sup>4</sup> She was quoted as saying that: "The State Diamond Trader indeed has weaknesses, which we have identified. That's why what we are looking at is how to reposition the State Diamond Trader in a way that will make it viable."<sup>5</sup>

The purpose of this research brief is to analyse the *Report and Financial Statements of the State Diamond Trader for 2012-13*<sup>6</sup>, as tabled in Parliament on 26 September 2013.<sup>7</sup>

<sup>1</sup> DMR (2012).

<sup>2</sup> Antwerp Facets (2010); Gleason (2013). The problems are acknowledged by government - in late 2013, *Business Day* reported that "President Jacob Zuma tacitly acknowledged ... that the Diamonds Amendment Act introduced more than five years ago had failed to achieve its objectives." (Mathews 2013).

<sup>3</sup> Creamer (2013a).

<sup>4</sup> Creamer (2013b).

<sup>5</sup> Ibid.

<sup>6</sup> State Diamond Trader (2013a).

<sup>7</sup> ATC No 126-2013.



## 2. Background

The term of office of the first Board of the SDT ended in September 2012. Mrs Dolly Mokgatle, who was not previously on the Board, was appointed the new chairperson. Mrs Mokgatle is an executive director of Peotona, a 26 per cent shareholder in De Beers.

The new Board has reviewed and substantially changed the strategic business targets – and performance measures – of the SDT for 2013 to 2016. These were presented to the Portfolio Committee on 31 July 2013.<sup>8</sup>

There is considerable continuity within the new Board – nine out of ten board members were re-appointed (including the former chair Adv Linda Makatini – who is now the chair of Mintek). Six new board members were appointed.

In July 2013, the Committee was told that the SDT had forecasted a sales drop of about 20 per cent for 2012/13 and a loss of about R10-million for the financial year.<sup>9</sup> In fact, audited results show that sales fell by less than 1 per cent, and that a profit of R5.2-million was earned in 2012/13. (2011/12 profit was R12.9-million).

Despite the radical changes in the strategic management of the SDT since the decisions of the new Board, the main point of reference for this analysis has to be the *State Diamond Trader Strategic Plan 2012-2015* which was presented to the Portfolio Committee on 23 May 2012. Where appropriate, however, aspects of the new strategy will be referred to.

## 3. Reported performance of the SDT compared with the Strategic Plan 2012/13

<i>SDT Strategic Plan 2012-2015</i>	<i>SDT Strategic Plan 2013-2016*</i>
<b>Goal 1:</b> To ensure continued sustainability of the State Diamond Trader	SDT Outcome: Objective 1: A sustainable, growing and transformed diamond beneficiation industry
<b>Goal 2:</b> Be an efficient and professionally managed organization	SDT Outcome: Objective 3: Be an efficient, innovative and development oriented organisation
<b>Goal 3:</b> Promote and uphold efficient governance	
<b>Goal 4:</b> Ensure constant and suitable supply and access to rough diamonds	SDT Outcome: Objective 2: Be the leading and innovative rough diamond trader for the local beneficiation industry

\* The right column of the table above shows the adjustments in the structure of the Strategic Plan made by the new Board for 2013-16.

<sup>8</sup> State Diamond Trader (2013b) and (2013c).

<sup>9</sup> State Diamond Trader (2013c). The forecast in slide 23 is different from that in State Diamond Trader (2013b:19), but was presumably the more current forecast at the time.



### Goal 1: To ensure continue sustainability of the SDT

Ten target areas were described in the Strategic Plan related to Goal 1. Six targets (60%) were not achieved in 2012/13.<sup>10</sup> Information provided did not allow a judgement to be made on two targets. Two targets were achieved. Poor trading conditions and a weak economic climate meant that none of the growth goals were achieved. The number of HDSA (Historically Disadvantaged South Africans) clients fell from 26 to 16 and their share in the value of all the diamonds sold by the SDT fell from 3 per cent to 2 per cent. Businesses have closed due to the economic situation, or they have been excluded from trading with the SDT due to non-compliance with conditions, such as holding a Diamond Beneficiation License and a certificate of good standing from SARS (SA Revenue Service). It is a disappointing trend that after five years only 2 per cent of the diamonds obtained by the SDT are going to HDSA beneficiaries.

The SDT does not get any regular funding from government. It finances its budget from selling diamonds. The law allows the SDT to purchase up to ten per cent of the run of mine from all diamond producers, for onward sale to the local diamond beneficiation sector and to companies that make use of the bulk of diamonds (by weight) that are too small or flawed for beneficiation. In 2012/13 only four per cent of the diamonds mined in South Africa was purchased by the SDT (down from an historic high point of nine per cent in 2010/11). The SDT reduced its purchases in response to weak demand from local diamond beneficiaries.

The SDT continues to have a clean audit and to make a modest profit – R5.2-million in 2012/13, compared with R12.9-million in 2011/12. But for the first time since its establishment, it sold stones below cost to the “Mandate client segment” – these are HDSA clients with fewer than five employees. This was a small quantity, resulting in a relatively small loss of R113,846. It did not impact drastically on the 2.83 per cent gross margin on sales for the year, but contributed to missing the target for a minimum of 4 per cent gross margin rate per trading cycle.

**Table 1: State Diamond Trader - historical performance figures over five years**

Year	Revenue (R-m)	Administrative expenses (R-m)	Admin expenses as % of revenue	Inventory at year end (R-m)	Net assets (R-m)	Profit (loss) (R-m)	Gross Margin on trading	Number of clients
2008 /09	117.2	12.3	10.5%	0.3	(4.2)	(5.2)	1.50%	68
2009 /10	330.9	10.1	3.0%	-	4.4	8.6	3.87%	34
2010 /11	810.4	12.3	1.5%	6.5	28.0	23.6	4.46%	60
2011 /12	433.1	14.2	3.3%	6.7	40.9	12.9	5.22%	58
2012 /13	411.4	15.9	3.9%	15.2	46.1	5.2	2.83%	42

<sup>10</sup> This marks a significant deterioration. Two targets in this section were not achieved in the previous 2011/12 period.



Key Activities for Goal 1	Target 2012/13	Performance 2012/13
Improve stock turnaround time in terms of SDT Stock Holding Policy	Reduce turnaround times on stocks to below a weighted average of 14 days	<b>Not achieved:</b> average was 21 days
Maintain gross margin rates	Gross margin maintained at minimum of 4% per trading cycle	<b>Not achieved:</b> 2.83%
Review and streamline operational expenditure	Improve efficiencies - Operating expenses not exceeding budget	<b>Not achieved:</b> operating expenses R600,000 greater than budget
Ensure that trading policies create an enabling environment to deliver required profit	A review of trading policies to ensure an environment to deliver required profit	<b>ACHIEVED</b> – policies were reviewed, if not in a manner that delivered the required profit
Increase number of and value of sales to HDSA clients	Increase number of and percentage value of sales to HDSA clients by 20% for 2012-2014	<b>Not achieved:</b> fall in both indicators
Maintain cordial relations with the IDC	Reduce cost of funding to prime minus 1-2% by 2013	Unclear – “improved interest rate” achieved but amount not stated
	Improved funding arrangements – R50-m for 2012/13	<b>ACHIEVED</b> – remains at R50-m
Facilitate technical and business management training	Train 10 HDSA clients per annum (p.a.)	Unclear – number not given
Provide market intelligence	Quarterly Market Intelligence briefings	<b>Not achieved:</b> Two briefings held
Facilitate access to finance	Increase number of trading clients by 10% p.a.	<b>Not achieved:</b> fall in number of trading clients

Several of the indicators are not well specified as indicators of the performance of SDT as an institution because they rely upon factors that are beyond the control of the SDT – such as the economic climate and the profitability of the diamond sector. One infers from the report that the SDT was not able to find even ten HDSA clients who were able to take up an offer of training. The over-spending on the budget was caused by under budgeting on travel, expenses for participating in the Mining Indaba trade show and the introduction of benefits for SDT employees. This was not noted as being material by the Auditor General.



**Goal 2: Be an efficient and professionally managed organization**

All four of the indicators for Goal 2 appear to have been achieved.

Key Activities for Goal 2	Target 2012/13	Performance 2012/13
Implement HR policy	Compliant HR processes, on going	ACHIEVED: HR policy manual approved and implementation is ongoing.
Review HR Plan	HR Plan responding to SDT requirements	ACHIEVED: HR Plan provided for appointment of critical staff [not clear if the identified staff were in fact appointed – but that is not part of the indicator].
Ensure continuous capacity building for all personnel	Relevant training for all diamond trainee personnel	ACHIEVED: training is ongoing and included 5 diamond sorting and valuing trainees.
Review and monitor training provided to ensure appropriateness	Skills gaps identified and relevant courses/ training initiated	ACHIEVED: trainees appointed in line with the gaps that were identified.

**Goal 3: Promote and uphold efficient governance**

All fifteen of the indicators for Goal 3 appear to have been achieved.

Key Activities for Goal 3	Target 2012/13	Performance 2012/13
Improve the use of admin processes	All approved procedures implemented and monitored	ACHIEVED: positive internal audit reports
Ensure quarterly Internal Audits are conducted	Tested internal controls and systems	ACHIEVED
Training staff on all policies and business processes	Implementation of and compliance with all policies and procedures	ACHIEVED
Develop and get approval of Asset Management Policy	Compliant legislative framework on assets	ACHIEVED
Maintain asset register	Secured assets	ACHIEVED
Develop and approve IT Policies and Procedures	Secured IT environment	ACHIEVED
	Appropriate IT support for SDT business	ACHIEVED



Key Activities for Goal 3	Target 2012/13	Performance 2012/13
Acquire and maintain adequate insurance for diamond stock and SDT assets	Sufficient insurance for all stock and assets	ACHIEVED
Review and maintain compliant procurement procedures in line with SDT Supply Chain Policy	Compliant procurement procedures	ACHIEVED
Ensure Audit and Risk Management Committee meetings are held	Compliance monitoring and guidance to Board – 4 meetings minimum	ACHIEVED
Preparation and approval of Statutory reports	Submission of quarterly and annual reports	ACHIEVED: [whether the reports are submitted on time is not part of the indicator]
Address All Audit findings	Improved performance on systems and controls	ACHIEVED: [Measure not given – In 2012/13 the Auditor General found information technology controls to be inadequate and specific remedial actions were recommended. <sup>11</sup> ]
Conduct annual Risk Assessment	Frequently assessed risk profile	ACHIEVED
	Risk appropriate mitigation plans	ACHIEVED

#### Goal 4: Ensure constant and suitable supply and access to rough diamonds

Five of the nine indicators for Goal 4 (56 per cent) were not achieved. The remaining four were achieved. In 2012/13 SDT purchased all of its diamonds from 6 producers, so the target for ten additional producers to be added was ambitious. SDT has been involved in court proceedings, where its actions have been challenged by the SA Diamond Producers Organisation (SADPO), a representative of many small diggers.

Key Activities for Goal 4	Target 2012/13	Performance 2012/13
Ensure all producers declare their production cycles	10 additional producers trading with SDT by end 2013	<b>Not achieved:</b> no new producers registered

<sup>11</sup> Auditor-General of South Africa (2013:14 to 17). But the AG noted 'some improvement' in IT Controls.



Key Activities for Goal 4	Target 2012/13	Performance 2012/13
Inspect rough diamonds produced in SA	90% by 2013	ACHIEVED
Purchase up to 10% of total SA production (volume and value)	9% target for 2012/13	<b>Not achieved:</b> 4% - amount purchased determined by market conditions
Update client demand analysis	Report produced annually in December	ACHIEVED
Engage producers on suitability of supply per SDT Producer Engagement strategy	50% reduction in disputes [baseline not given]	ACHIEVED: only 2 disputes, both resolved by independent diamond valuation (IDV) process
Test purchasing with 3 African countries producing diamonds	Costs and sales analysis of purchases made from 3 countries	<b>Not achieved:</b> no purchases yet made
Negotiate supply agreements with 3 selected diamond producing countries	One country agreement by 2012/13	<b>Not achieved:</b> no agreement made
Contribute to Kimberley Process Certification Scheme (KPCS) development and in RSA KPCS compliance processes	One KPCS compliant purchase of rough diamonds by March 2013	<b>Not achieved:</b> no agreement in place allowing purchase.
Attend KPCS meetings as part of RSA team	June and November 2012	ACHIEVED

As indicated above, the SDT failed to achieve eleven of the targets it set for itself in 2012/13. The Auditor general identified a total of 36 targets in the strategic plan<sup>12</sup> and stated that this represents 31 per cent of total planned targets that were not achieved. The reported performance of the SDT was therefore only partly in line with its strategic plans and budgets.

#### 4. Challenges faced by the SDT in 2012/13

In mid 2013, commenting on the weak performance of the SA diamond sector since 2008, the *Mail and Guardian* reported that “The diamond manufacturing sector, which forms a key part of the government’s beneficiation plan, has decreased dramatically in size. In just three years it has gone from 3 000 polishers to about 300.”<sup>13</sup> Mr Ernie Blom, president of the World

<sup>12</sup> State Diamond Trader (2013a:52). The Research Unit counted 38 measurable targets in the Strategic Plan 2012/13, of which eleven were not achieved – this represents a 29 per cent non achievement rate. In 2011/12, the Research Unit calculated a 24 per cent non achievement rate for the SDT, with 8 out of 33 targets not being achieved.

<sup>13</sup> Benjamin (2013).



Federation of Diamond Bourses, citing similar figures, told *Mining Weekly* that the South African diamond -cutting and -polishing industry is in distress.<sup>14</sup>

His view was that globally, the industry has fully recovered from the 2008 recession. "India's cutting industry is currently the largest, with one-million cutters, while China's industry has grown from having no cutters 20 years ago to having 60 000 cutters, and Botswana's cutters increased over the past years from 300 to 3 000".

While Mr Blom believes that the biggest potential for growth in the diamond sector in South Africa lies in beneficiation (as opposed to mining or research), the binding constraint is skills. Training facilities, he states, are mostly in-house and are not equipped to provide marketable skills that can be used worldwide. China and the Asian Rim countries, by contrast, have excellent training facilities.

Mr Blom states that the industry in South Africa is not globally competitive and steps need to be taken to reintroduce the industry to the international arena.<sup>15</sup>

## **5. Liquidation of African Romance**

Although not mentioned specifically in the Annual Report, the liquidation of diamond-cutting beneficiation company African Romance in early 2013 gives an insight into the difficulties faced by new entrants into the diamond beneficiation business and to the high risk of investing public money.

African Romance was launched in 2007 with 120 employees. It obtained R97-million from the Industrial Development Corporation (IDC) and more than R50-million from the Gauteng Enterprise Propeller, a company owned by the Provincial government.<sup>16</sup>

African Romance set out to add value to diamonds that would be sourced directly from local mines. Its aim was to provide, in the long term, African competition for brands such as Cartier and Gucci. According to press reports "the operation had modern machines that were said to be able to do in minutes what conventional processing took hours to do and a barcode inscription system tracking every diamond from mine to manufacture."

The owner of the company, Mr Mohseen Valli Moosa said that African Romance had been only a year old when the 2008/9 financial crisis took hold and it had been unable to recover from this setback.

<sup>14</sup> Vermeulen (2013). Mr Blom said that "20 years ago, the industry had 4 500 polishers – currently, there are fewer than 600."

<sup>15</sup> Ibid.

<sup>16</sup> Creamer (2013) – the main source for the information below, unless otherwise noted.





The absence of a dependable supply of rough diamonds was stated to be a major cause of the closure of the company. African Romance was unsuccessful in becoming a De Beers sightholder and had to rely upon the State Diamond Trader. The SDT had not been able to supply polishable rough diamonds at competitive prices.<sup>17</sup> Mr Moosa “accused the SDT of being too expensive and of failing to function in the manner that Parliament had laid down.”<sup>18</sup> He was reported to say that the SDT sold “run of mine” packets of diamonds, which meant that good and flawed diamonds had to be bought together. “But African Romance wanted to use only good-quality stones because it was not operating in the industrial diamond space.”<sup>19</sup>

Other factors that contributed to the failure of the business included the lack of adequate funding for marketing, trading and retail development and the high cost structure of funding and operating diamond-cutting businesses in South Africa compared with India and China.<sup>20</sup>

Mr Moosa told *Mining Weekly*: “Unfortunately, beneficiation will only succeed if there is a pipeline of raw materials that is guaranteed and if the funding is able to support a long-term time horizon which allows for the development of marketing and retail strategies alongside production and beneficiation. In the absence of such support, despite all the best intentions of government agencies and development funders, beneficiation is unlikely to succeed,”

When it ceased operations (still with 69 employees), the African Romance board was chaired by a sector divisional executive of the IDC, Ms Katinka Schumann. Ms Schumann said that in addition to the macro factors, “the company had faltered because of a lack of understanding of the diamond business. She blamed ‘an inexperienced operator and management team’”<sup>21</sup>. After a forensic audit, the CEO of the IDC, Mr Geoffrey Qhena, also apportioned some of the blame to Mr Moosa’s management, “saying he had proven to be inexperienced and slow to change operational direction when the going got tough.”<sup>22</sup>

#### Issues for the Committee to consider

The reported performance of the SDT in 2012/13 was only partly in line with its strategic plans and budgets, but the operating environment has been difficult and the new Board has responded to the weaknesses in the performance of the SDT by revising the strategic plan for the future.

Does this ‘new start’ provide for sufficient change and role clarity for the SDT, which has budgeted for a R10.3-m loss in 2013/14, a R 1.3-m profit in 2014/15 and a R0.1-m loss in 2015/16?<sup>23</sup>

<sup>17</sup> Creamer (2013).

<sup>18</sup> Mining Weekly Online (2013). Also see Benjamin (2013).

<sup>19</sup> Weavind (2013).

<sup>20</sup> Creamer (2013).

<sup>21</sup> Weavind (2013).

<sup>22</sup> Ibid.

<sup>23</sup> State Diamond Trader (2013b:19, 20 and 21).



## 6. Forward-looking commentary

In response to the challenges it faced in the first five years of its operation, the SDT made significant adjustments in its strategic objectives after the 2012/13 financial year.

As is appropriate, the management of the SDT prepared its responses to the results of the SDT in 2012/13 even before the annual report for the year to March 2013 had been produced. The new Board held strategic planning sessions on 22 and 23 January 2013 and later approved a strategic plan and budget for the 2013/14 Financial Year<sup>24</sup> that is significantly different from the strategic plan previously prepared covering the period from 2012 to 2015.<sup>25</sup>

In most respects, the performance indicators for the SDT have been totally changed.

The apparent focus is less on the SDT as a successful business in its own right and more on its role in assisting the local diamond beneficiation industry. In its revised strategic thrust “the SDT will align its goals and outcomes with those of the approved Beneficiation Strategy of SA.” One concern is that clear performance baselines are not given in the strategic plan for the percentage increases planned for 2013 to 2016.

For example, the strategic plan sets a 2013/14 target of a 25% increase in the “amount and value of rough diamonds beneficiated” following the SDT’s activity to “supply rough diamonds to local beneficiaries”.

In 2012/13, 290,449 carats were sold to local beneficiaries, valued at R411,462,599. The apparent target for 2013/14 is therefore 363,061 carats and a value of R514.3-million. But the budgeted sales in the SDT strategic plan for 2013/14 are R331.4-m, suggesting that a different baseline of R257.4-m was used for calculating the target.

### Issues for the Committee to consider

The 2012-15 performance targets included a measure of the profitability of the SDT. This was to maintain a gross margin on sales of a minimum of 4 per cent per trading cycle. The new 2013-16 performance targets encourage the management to pursue increased purchases and sales, but without a performance measure for profitability, and sustainability, of the SDT.

<sup>24</sup> State Diamond Trader (2013b). This document is signed, but not specifically dated.

<sup>25</sup> State Diamond Trader (2012).



# Comparison of SDT strategic objectives up to 2012/13 and thereafter

<i>[same]</i>	<i>[same]</i>	<i>As stated in the SDT 2012/13 Annual Report</i>	<i>As revised in the Strategic Plan of 2013 - for 2013/16</i>
National Outcome	DMR Programme	SDT Strategic Objectives	SDT Strategic Objectives
	<b>SDT Mandate</b>	<b>Promote the diamond beneficiation industry through research and development</b>	<b>Promote the diamond beneficiation industry through research and development over the next phase of State Diamond Trader's existence</b>
Create a better South Africa and contribute to be a better and safer Africa	Mineral Policy and Promotion		
	Promote investment in the Mining Sector	Improve profitability of SDT operations to ensure its sustainability; Facilitate support to SDT clients; Increase the number of and value of sales to HDSDA clients	Contribute to the growth of the local diamond beneficiation industry
	Mineral Policy and Promotion		
	Promote sustainable resource use and Management	Enforce compliance with legislation on trading matters; Develop and maintain trading relations with other African diamond producing countries.	Develop efficient means to market diamonds not suitable for local beneficiation.
Effective, efficient and development orientated Public Service	Corporate Services		
	Contribute to skills development	Develop and acquire appropriate Human Resource capacity ; Facilitate support to SDT clients.	Develop and acquire appropriate Human Resource capacity

Strategic objectives are set at a high level of generalisation. It is not clear why the new, very relevant, objectives on Mineral Policy and Promotion introduced in 2013 were not added to the existing, historical objectives, but have rather replaced them.



## **7. Conclusion: Issue for the Committee to consider**

In its first five years of operation, the SDT has not succeeded in addressing distortions in the diamond industry to any discernible degree, nor has it successfully corrected historical market failures to develop and grow South Africa's diamond cutting and polishing industry.

On the contrary, the diamond industry employs fewer people than it did in 2008 and the SDT sells barely 2 per cent of its diamonds to the targeted "mandate segment" of its clients – HDSA companies with fewer than five employees. Despite the acknowledged need for training, the SDT was unable to claim achievement of its performance target for just ten HDSA clients to receive technical and business management training in 2012/13. (15 HDSA clients were trained in 2011/12 but the target was then reduced from 20 to 10 for 2012/13 – and it was not reported as being achieved.)

The Minister's statement in November 2013 that a "radical overhaul of the State Diamond Trader"<sup>26</sup> is needed is clearly justified. This needs to take into account both the international economic climate and the fact that, despite the best of intentions, South Africa has been out-competed by other countries (including Botswana) in building a diamond cutting and beneficiation industry.

The question is raised whether the present, new, strategic effort of the SDT board (with its nine old and six new members appointed in 2012) marks a sustainable re-direction for the SDT that can realistically be expected to yield results, or whether the entire environment created for the diamond sector with the 2005/6 amendments to the Diamonds Act (No 56 of 1986) needs to be reconsidered.

### **Note:**

This analysis has drawn on the National Treasury's *Guideline for Legislative Oversight through Annual Reports* of January 2005. This 46 page document – which is directed at Members of Parliament and Provincial Legislatures – states that annual reports "must deal with every aspect of performance to which an entity has committed itself in its strategic plan."

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<sup>26</sup> Creamer (2013a).



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