

A CASE FOR REFORM:

**IS THE KENYAN REGULATORY FRAMEWORK FOR PRIVATE EQUITY
ADEQUATE?**

BY

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DECLARATION

I **PAMELLAH ORATA** declare that this dissertation is my original work and has not been presented to any other institution for the purpose of obtaining a degree.

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This dissertation has been submitted with my approval as a University of Nairobi supervisor.

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“Talent is a universal gift, but it takes a lot of courage to use it. Don't
be afraid to be the best.”

Paulo Coelho, *The Winner Stands Alone*

Table of Contents

List of abbreviations	9
List of statutes	12
Kenya	12
United Kingdom.....	12
India	12
List of cases.....	13
Abstract	14
Overall objective of the research study	14
Justification for the research study.....	14
Hypothesis	15
Literature review	15
Chapter breakdown	20
CHAPTER ONE: AN INTRODUCTION TO PRIVATE EQUITY	22
1.1. Private Equity: The Concept.....	22
1.2. The definition of Private Equity.....	23
1.3. Private Equity as distinguished from Public Equity, Venture Capital and Unit trusts.....	24
2. The Historical Development of Private Equity from a Global Perspective	27
2.1 The Humble Beginnings of Private Equity and the Historical development of private equity in USA	27
2.1 b Comparative analysis between US and Kenyan Regulatory Frameworks	32
2.2. Historical development of and legal framework for the private equity in UK	33
2.3 Historical development of and legal framework for private equity in India.....	38
2.3 b Comparative analysis between private equity in Kenya and India	41
2.4 Historical development of and the legal framework for private equity in Australia.....	42
2.4. b Comparative Analysis between Private Equity in Kenya and Australia.....	44
2.5 Historical Development of Private Equity in Kenya.....	44
2.6. The structure of the Kenyan private equity market:.....	45
2.7. The socio-economic role private equity plays in the Kenyan economy	47
3. Conclusion	48
CHAPTER TWO: THE LEGAL FRAMEWORK FOR PRIVATE EQUITY REGULATION IN KENYA	49
2.1 Introduction.....	49

2.2. Private Equity Funds in Kenya	50
2.2. a. Venture capital funds	50
2.2. b. Collective investment schemes	53
2.2. c. Retirement Benefit Scheme Funds	54
2.2. d. Limited liability partnership funds.....	56
2.2. e. Funds owned by quoted investment companies	57
2.3. The Capital Structure of Private Equity Funds in Kenya.....	57
2.4. Private equity transactions	59
2.5. Corporate Governance	62
Venture Capital Funds	62
i. Conduct of business requirements	62
ii. Prudential business requirements.....	62
iii. Financial Reporting Requirements	63
Continuing Obligations.....	64
Conflicts of interest.....	64
Multiple Directorships	64
2.5 Exit Options	67
Trade sales	68
Re purchase.....	68
IPOs	68
2.6. The Regulator.....	69
2.7 Conclusion	70
CHAPTER 3: PRIVATE EQUITY REGULATION: THE UK EXPERIENCE.....	72
3.1 Private Equity in the UK.....	72
a. The structure of the market	72
b. Fundraising for private equity funds.....	73
c. The investment cycle.....	74
d. Types of Private Equity Funds.....	74
i. Limited Liability Partnerships	74
ii. Venture capital trusts	75
e. Private Equity Transactions	76
f. Exit options.....	77
g. Conflicts of interest.....	78

3.2 The UK Regulatory Framework for Private Equity	79
3.3. The Institutions that Regulate Private Equity	81
3.3. a The Financial Services Authority (FSA).....	81
3.3. b The British Venture Capital Association (BVCA).....	84
3.4 The Legal Regime for Private Equity in UK	86
3.4. a. High level standards	86
3.4. b. Prudential standards	88
3.4. c. Business standards	89
3.2. d. Conduct of business	90
3.2. e. Conflicts of interest	91
3.4. f. Fund Management: The Alternative Investment Fund Managers Directive (AIFMD).....	92
i. Alternative Investment Funds (AIFs)	93
ii. Scope of the AIFMD.....	94
iii. Capital requirements under the AIFMD	94
iv. Marketing passports	94
v. Notification of the acquisition of major holdings and control of non-listed companies.....	95
v. Implementation of AIFMD in the UK	96
3.5 Comparative analysis between Kenyan and UK approaches to regulating private equity.....	96
3.6 Conclusion	98
CHAPTER 4: THE WAY FORWARD: RECOMMENDATIONS	99
4.1 A summary of the preceding chapters.....	99
4.2 A ‘More’ versus ‘less’ approach to the regulation of private equity	99
4.4 Structural reforms	101
4.4. a The Capital Markets Authority	101
4.4. b The Kenya Venture Capital and Private Equity Association	101
a. The Council.....	102
b. Committees:	102
i. The Venture Capital Committee	102
ii. The Legal and Advisory Committee	103
iii. Research committee	103
iv. Members committee	104
4.5 Legal reforms	104
4.5 Conclusion	106

BIBLIOGRAPHY.....	106
Books	106
Journals	107
Publications.....	107
Articles.....	107
Thesis.....	109

LIST OF ABBREVIATIONS

1. AIF- Alternative Investment Fund
2. AIFM- Alternative Investment Fund Managers
3. APRA-Australian Prudential Authority
4. ARD-American Research and Development Cooperation
5. ARROW-Advanced Risk Response Operating Framework
6. ASIC- Australian Securities Exchange
7. BES- Business Expansion Scheme
8. BITS- Building on IT Strengths
9. BoE-Bank of England
10. BVCA-British Venture Capital Association
11. CMA-Capital Markets Authority
12. CRD- Capital Requirements Directive
13. COBS-Conduct of Business Services
14. EVCA-European Venture Capital Association
15. ESMA-European Securities and Markets Authority
16. ESRB-European Systemic Risk Board
17. FCA-Financial Conduct Authority
18. FCI-Finance Corporation for Industry
19. FEMA-Foreign Exchange Management Act
20. FAIF-Funds of Alternative Investment Funds
21. FFI-Finance For Industry
22. FSA-Financial Services Authority
23. FSMA-Financial Services and Markets Act
24. FTSE100- Financial Times share Index
25. GDP-Gross Domestic Product

26. GP-General Partner
27. ICDC-Industrial and Commercial Development Corporation
28. ICFC-Industrial and Commercial Finance Corporation
29. IIF-Innovation Investment Fund
30. IPO-Initial Public Offering
31. ISD-Investment Services Directive
32. IT-Information Technology
33. KES-Kenya Shillings
34. LBO-Leveraged Buy Out
35. LLP-Limited Liability Partnership
36. LSE-London Stock Exchange
37. M&A-Mergers and Acquisitions
38. MBO-Management Buy Out
39. MIC-Management Investment Company
40. MiFID-Market in Financial Instruments Directive
41. MLRO-Money Laundering Reporting Officer
42. NSE-Nairobi Securities Exchange
43. NURS-Non- UCITS Retail Schemes
44. PE-Private Equity
45. PEIT-Private Equity Investment Trusts
46. PDF-Pooled Development Fund
47. PLC-Private limited Company
48. PRA- Prudential Regulation Authority
49. PRIN- Principles for Business Source Book
50. PwC-Price Waterhouse Coopers
51. QIS-Qualified Investment Schemes

52. RAO-Regulated Activities Order
53. RBA-Retirement Benefit Authority
54. RBS-Retirement Benefit Scheme
55. REIT-Real Estate Investment Trust
56. SBIC-Small Business Investment Company
57. SBIR-Small Business Investment Research
58. SEBI-Securities Exchange Board of India
59. SEBI FVCI-Securities Exchange Board of India (Foreign Venture Capital Investments)
60. SME- Small-Medium size Enterprise
61. SYSC-Senior Management Arrangements Systems and Control Sourcebook
62. TDC-Technical Development Capital
63. UK-United Kingdom
64. USD-US Dollars
65. USM-Unlisted Securities Market
66. VCTs- Venture Capital Trusts

LIST OF STATUTES

KENYA

1. The Capital Markets Authority Act (Cap 485 A)
2. The Retirement Benefits Act, 1997 and Schedule G to the Act
3. The Proceeds of Crime and Anti-money Laundering Act No. 9 of 2009
4. The Competition Act No.12 of 2010
5. The Companies Act
6. The Limited Partnership Act
7. The Capital Markets (Registered Venture Capital Companies) Regulations, 2007,
8. The Capital Markets (Collective Investment Schemes Regulations) 2001
9. The Capital Markets (Securities) (Public Offers, Listing and Disclosures) (Amendment) Regulations 2008.

UNITED KINGDOM

1. Pensions Act 1995
2. The Financial Services and Markets Act (FSMA) 2000
3. The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001
4. Financial Services Authority Handbook Rules and Guidance
5. Money Laundering Regulations, 2007
6. Occupational Pension Schemes (Investment) Regulations 2005 (the “Investment Regulations”)
7. The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009
8. Markets in Financial Instruments Directive (MiFID)
9. AIFMD- Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments

INDIA

1. The Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996
2. The Securities and Exchange Board of India (Foreign Venture Capital Investors) Regulations, 2000 (SEBI FVCI Regulations)

3. The Foreign Exchange Management (Transfer of Issue of Security by a Person Resident Outside India) Regulations, 2000 (The FEMA Regulations 2000)
4. Income-Tax Act, 1961

LIST OF CASES

1. Salomon v Salomon [1897] AC 22
2. Standard Bank Ltd v Mehotoro Farm Ltd & 2 Others CC 54 [1972] CA
3. Azim Virjee & Two Others v Glory Properties Limited [2007] eKLR, CC559/1999 (HC)
4. Thermascan Ltd v Norman [2009] EWHC 3694 (Ch)
5. London and Mashonaland Exploration Co. Ltd v New Mashonaland Exploration Co. Ltd [1891] WN 165
6. Balston v Headline Filters [1990] FSR 385
7. Bristol and West Building Society v Mothew [1998] Ch 1 18 CA
8. Helmet Integrated Systems v Tunnard [2007] CA
9. Learoyd v Whiteley [1887] LR 12 App Cas 727
10. Shepherds Investments Ltd v Walters [2007] 2 BCLC 202
11. Kalashian v Advent VI Limited Partnership (Sup. Ct. Calif., No. CV-739278)

ABSTRACT

The private equity industry in Kenya, though young, continues to show a lot of promise in terms of high returns and is likely to experience tremendous growth. This growth can be attributed to increased lending and investment in various sectors of the economy such as agriculture, health and energy.¹ Over the years, private equity has gained wide acceptance among many investors as a preferred alternative investment class. It is very important that the Kenyan legal regime regulating private equity be equipped to support and deal with these changes. It should not only protect the investors but it should also promote market efficiency and not unnecessarily constrain its market operations.

OVERALL OBJECTIVE OF THE RESEARCH STUDY

The sole objective of carrying out this research is to determine whether the legal regime regulating private equity in Kenya is adequate enough to promote efficient market operation, sustain the growth of the private equity industry and safeguard the interests of the country as well as investors.

JUSTIFICATION FOR THE RESEARCH STUDY

Private equity capital plays a huge role in the Kenyan economy. It has been injected into various sectors including education, agriculture, energy and transport. It has contributed immensely to the country's socio-economic development. As the private equity market in continues to experience a steady growth curve, one of the most important market conditions that investors will consider is the regulatory regime.

The regulatory regime sets the tone for the market's investment climate. It indicates to investors what to expect should they choose to invest. If regulatory measures are very stringent, investors will shy away from investing in the private. On the other hand, lack of regulation or clarity of existing regulation will not promote market operations and efficiency. Recent cases of dishonest trade practises at the Nairobi Securities Exchange are but a

¹ Emmanuel Were, 2009, Business Daily, "Kenya's new capitalists go big on private equity". <<http://www.businessdailyafrica.com/-/539552/606824/-/552vni/-/index.html>>. Date Accessed 1 March 2012

A survey conducted by Deloitte and Touché Kenya, 'Private equity news, New frontiers, More growth' <<http://www.deloitte.com/assets/Dcom-Kenya/Local%20Assets/Documents/Deloitte%20-%20Private%20Equity%20News.pdf>>. Date Accessed 1 March 2012

demonstration of the impact of a bad regulatory system. Among the lessons from the failures of the public equity regime learnt apart from investor losses is that prevention is better than cure. It is better to implement a system that works from an early stage and subject it to review so as to accommodate new developments in the market. It is also high time that Kenya develops a strong culture of efficient business regulation.

HYPOTHESIS

This research paper will test two main hypotheses:

1. Is the existing legal regime regulating private equity in Kenya adequate?
2. Does Kenya need a new legal regime to regulate private equity?

LITERATURE REVIEW

The regulatory debate on private equity continues to move forward at a global level. Many authors have raised the issue as to whether private equity creates value to society and if that is the case should there be some form of more stringent regulation to the industry following events such as the credit crunch of 2007 which proved to be a significant factor in the dynamics of the regulatory debate; to the extent that it limits the possibility of completing buyouts or the degree to which deals can be leveraged.²

Peter Morris and Ludovic Phalippou (2010)³ are of the view that private equity has never been a crowd pleaser. They say that over the years, politicians, unions and journalists have called buyout bosses locusts, tax avoiders and asset strippers. These authors highlight some of the negative publicity that private equity has received over the years. In as much as private equity has been painted in bad light there are some positive contributions it has made to economies worldwide.

According to the **Financial Services Authority (FSA)**⁴, private equity has significantly enhanced capital market efficiency by widening the availability of capital, increasing the effectiveness of company valuations, identifying companies with growth potential and

²Oliver Smidy and Toby Lewis. (2009) 'Crunch Time for Private Equity Regulation'. Retrieved on 1 March 2012 from <<http://www.efinancialnews.com/story/2009-02-23/crunch-time-for-private-equity-regulation>>

³Duisenberg School of Finance Policy Paper Series (2010) 'Regulating Private Equity' p.2. Retrieved 1 March 2012 from <<http://www.dsf.nl/assets/cms/File/Research/DSF%20Policy%20Paper%20No%209%20Regulating%20Private%20Equity%20November%202010.pdf>>

⁴ The Financial Services Authority (FSA) is the financial services regulator in the United Kingdom.

facilitating their transformation.⁵ **Geoffrey Colvin and Ram Charan (2006)**⁶ share similar sentiments to those of the **FSA**. Following an analysis of the growth of private equity as against that of public equity; they have concluded that companies, in which private equity investors have invested in and later go public, generally outperform the market. They attribute the successes of private equity to the theory that it is built on advantages that public firms just have not figured out how to adopt yet.

The rapid growth in private equity in recent years, and in particular the scale and consequences of large-scale buyouts of public companies, has led to calls from many quarters for some form of regulatory intervention. Despite its continued growth and positive contribution to global economies, private equity continues to have a poor public image which is attributed to a number of factors. Firstly, private equity is not well understood since the contracts between private equity firms and their investors have become too complex.⁷ For example private equity structures are often complex and it can be difficult to identify who ultimately owns the assets and bears the economic risk associated with LBOs.⁸

R.K. Jain and Indrani Manna (2009)⁹ attribute the complexity of the private equity industry to its highly secretive in nature. They assert that private equity firms do not provide accounts of what it does and how it does it. **Brendan Scandrett**¹⁰ shares a similar view. He asserts that the criticism against private equity will continue because by taking companies private they drastically reduce the public disclosure requirements that are normally associated with the demands of shareholders. As a result of there being no adequate information

⁵ Jeremy Cooper. (2010) 'Corporate & Market Regulation: An Australian Securities and Investments Commission (ASIC) Update'. Retrieved on 1 March 2012 from <[http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/SDIA%20_speech_jun_%202007.pdf/\\$file/SDIA%20_speech_jun_%202007.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/SDIA%20_speech_jun_%202007.pdf/$file/SDIA%20_speech_jun_%202007.pdf)>

⁶ Geoffrey Colvin and Ram Charan (2006) 'Private Equity, Private Lives'. Retrieved on 1 March 2012 from <http://money.cnn.com/magazines/fortune/fortune_archive/2006/11/27/8394344/index.htm>

⁷ Morris and Phalippou (2010) 'Duisenberg School of Finance Policy Paper Series- Regulating Private Equity' Retrieved on 1 March 2012 from <<http://www.dsf.nl/assets/cms/File/Research/DSF%20Policy%20Paper%20No%209%20Regulating%20Private%20Equity%20November%202010.pdf>>

⁸ Jeremy Cooper. (2010) 'Corporate & Market Regulation: An Australian Securities and Investments Commission (ASIC) Update'. P7. Retrieved on 1 March 2012 from <[http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/SDIA%20_speech_jun_%202007.pdf/\\$file/SDIA%20_speech_jun_%202007.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/SDIA%20_speech_jun_%202007.pdf/$file/SDIA%20_speech_jun_%202007.pdf)>

⁹ R. K. Jain and Indrani Manna, 2009, "Evolution of global private equity market: Lessons, implications and prospects for India", p.118. Retrieved on 1 March 2012 <<http://rbidocs.rbi.org.in/rdocs/Content/PDFs/2RKSN010210.pdf>>

¹⁰ Brendan Scandrett. (2007) "Corporate governance in the shadows of private equity" Retrieved on 1 March 2012 from <<http://epublications.bond.edu.au/cgej/9>>

disclosure to the public, corporate governance issues such as conflicts of interest among private equity buyers or the directors are on the rise as regards private equity firms/funds.

Ian MacNeill,¹¹ has summarized the debate on private equity regulation as being, on the one hand private equity is seen as having a short-term focus on asset stripping and re-structuring without proper regard to the interests of employees, and on the other it is viewed as a means of transforming corporate governance, creating jobs and enhancing overall economic performance. Some proponents for regulation argue that it is the only way to address these issues. **Morris and Phalippou** suggest that the best way for private equity to deal with this issue is by improving its transparency. They propose that regulators should introduce standards that will promote information disclosure and market efficiency. They suggest that these standards should simply indicate whether the manager complied with agreed standards in terms of its contracts and data disclosure.¹² It is clear that they belong to the side of the private equity regulation debate which is pro- additional regulation to cater for the unaddressed risks.

Payne Jeniffer (2011)¹³ also argues in favour of the regulation of private equity. She opines that it is necessary to regulate the private equity industry when it comes to issues of disclosure and transparency. The author's assertion is that when it comes to disclosure matters, the difference between the reporting requirements for private equity-backed companies and public companies is rooted in the distinction between keeping a small group of private shareholders informed, and reporting to markets as a whole. Having observed the increasing tendency of some major companies moving from transparent public to opaque private markets, **Payne** is of the opinion that the regulation of a private equity portfolio company might not be needed to address shareholder concerns, but might be needed to address wider stakeholder issues.

MacNeill asserts that the rationale put forward for regulatory intervention in the private equity market varies from the elimination of specific regulatory advantages that are claimed to be available to participants in private equity to more broadly framed arguments that private equity is short term in its outlook and provides unjustifiably high returns to its participants

¹¹ Ian Mac Neill, 'Private Equity: The UK Regulatory Response' Retrieved on 25 March 2012 from <<http://cmlj.oxfordjournals.org/content/3/1/18.full>>

¹² Regulating private equity, 2009, p.8

¹³ Jennifer Payne, 2011, 'Private Equity and Its Regulation in Europe', *European Business Organization Law Review*

with the costs being largely borne by other stakeholders in the corporate sector among other reasons.¹⁴

According to **Steen Thomsen (2009)**¹⁵ the four factors that form the basis for the rationale for regulatory intervention in the private equity market can be summarised as: *a) Significant market failure, b) Failure of private remedies, c) Informed and well-intentioned policy makers and d) Low or moderate costs of intervention.* He argues that market failure is a necessary condition for welfare-enhancing government intervention. His assertion is that the market must fail in such a way that it produces negative returns to some stakeholders, which are significant relative to the value created by others and which can in principle be corrected by regulation that makes decision makers internalize these costs. Since rational actors will not engage in activities that reduce their welfare, this typically implies significant externalities for third parties which are not incorporated in market prices because of high transaction costs. If private actors can address market failures using their own means, there is gain no reason to intervene politically.

He believes that policy makers must have the right information and motivation to correct market failures. Finally, for government policy to increase welfare for society as a whole, the costs of policy intervention must not exceed the benefits.¹⁶ He is of the opinion that no market failures can fail to be remedied by private means. He opines that the costs of policy changes are high, and policy makers have insufficient information and inadequate incentives to regulate efficiently. Efficient regulation requires more convincing arguments, better information and less partisan views. He strongly insists that politicians who have a reform agenda should be obligated to show that their policies will pass the four criteria mentioned above.¹⁷

Those who argue against additional regulation of private equity industry deem it as that which is unnecessary to the industry since it is already regulated. **Cheffins and Armour (2007)** argue that since private equity is relatively new, it has yet to find its proper niche in society. In the long run, this will happen more or less automatically if markets are left to their

¹⁴ Ian Mac Neill, 'Private equity: The UK Regulatory Response'. Retrieved on 25th March 2012 from <<http://cmlj.oxfordjournals.org/content/3/1/18.full>>

¹⁵ Steen Thomsen, 2009, "Should Private Equity Be Regulated?" *European Business Organization Law Review*

¹⁶ Ibid.

¹⁷ Supra.

own devices.¹⁸ One **Philip Buscombe**¹⁹ asserts that increased regulation of the private equity sector will attract fewer industry executives to provide their expertise and fewer quality managers will agree to work in the private equity industry to implement their growth strategies. In light of the proposed regulation on private equity in the UK, he opines that this current is to increase the marketing restrictions on private equity funds in raising capital, raise the capital gains tax payable by the private equity industry that brings such capital to the UK and try to ensure that less debt capital will be made available to private-equity backed companies.

Although **Charlie McCreevy**²⁰ does not share the exact same sentiments as those of **Buscombe**, he is of the view that private equity is not systemically relevant and therefore should not be lumped together with other categories of leveraged financial institutions. According to him, the private equity industry must not be shackled with regulatory constraints that are neither necessary nor productive.²¹ I agree with his view to the extent that any regulatory measures introduced to the private equity industry ought to serve two functions promote the market efficiency and protect investors, since at the end of it all the failure of private equity funds will lead to huge pecuniary losses for investors.

Notwithstanding the above arguments for and against regulation, I am of the opinion that additional regulation of the private equity sector ought to be geared towards ensuring more information disclosure, adherence to corporate governance standards and ensure clarity in operations so as to protect investors.

THEORETICAL FRAMEWORK

A review of the existing literature on private equity regulation reveals that the whole notion on financial regulation is as a result of market failures. Following the 2008 financial crisis there have been calls for a more sophisticated financial regulatory framework, capable of effectively monitoring and providing stability of the (global) financial system.²² Regulation is

¹⁸ Thomsen p

¹⁹ Chairman, Lyceum Capital, UK

²⁰ The European Commissioner for the internal market and services

²¹ Oliver Smidy and Toby Lewis, 2009, 'Crunch Time for Private Equity Regulation'. Retrieved on 1 March 2012 from <<http://www.efinancialnews.com/story/2009-02-23/crunch-time-for-private-equity-regulation>>

²² F. Amtenbrink and R.M. Lastra, 'Securing Democratic Accountability of Financial Regulatory Agencies – A Theoretical Framework' in R. V. De Mulder, Mitigating Risk in the Context of safety and security. How Relevant is a Rational Approach? (Rotterdam: Erasmus School of Law & Research School for Safety and

viewed as a means to an end. It is clear that the policy debate over financial market regulation however, is limited to a choice between complete deregulation or regulation.

Private equity revolves around the agency theory. The agency theory is relevant to private equity because it applies directly to fund management. This theory suggests that an agency relationship arises whenever principals hire agents to perform some service and then delegate decision-making authority to the agents. In the case of private equity, fund managers are appointed to manage funds on behalf of investors.²³ Therefore, a contract exists between the agent and principal. Corporate law, a branch of Private Law, governs the relationships between private persons. Therefore the law seeks to regulate the relationships between these persons.

CHAPTER BREAKDOWN

Chapter 1: Introduction

This chapter will introduce key private equity as a concept, some of the key descriptive terms that are unique to it and discuss the historical and development of private equity from a global perspective including the Kenyan one. It will also examine the structure of the Kenyan private equity market and its socio-economic contribution to the economy.

Chapter 2: Private Equity Regulation in Kenya

The following areas seek to give the reader an insight into the current legal regime governing equity in Kenya and some of the areas it falls short. This chapter tests the hypotheses of this research.

Chapter 3: Private Equity: The UK Experience

This chapter seeks to examine key aspects of the legal regime governing private equity in the UK and also look at the impact of EU law on the UK regulatory system. The UK will be used as a reference point while carrying out a comparative analysis between it and the Kenyan legal regime. UK will be used as a yard stick because it is one of the few countries in the world that have been recognised as having regulated their private equity industry. Secondly, Kenya borrows heavily when it comes to law making, it being a common law jurisdiction.

Security (OMV) 2008), pp. 115-132) (ISBN 987-90-5677-068-6). Retrieved on 31 July 2012 from <<http://ssrn.com/abstract=1330309>>

²³ Retrieved on 30th July 2012 from <<http://www.enotes.com/agency-theory-reference/agency-theory>>

Chapter 4: The Way Forward- Recommendations

This is the last chapter of this research paper. Its focus shall be to come up with ingenious ways to cure the defects in the current legal regime regulating private equity.

RESEARCH METHODOLOGY

The research will be through the analysis of secondary sources of data which include statutes. It will also involve an analysis of articles by Scholars in the field of corporate law as well as journals. Since private equity market in the UK is one of the most developed in the world, some of its courts decisions and reasoning will be analysed to help give clarity to some issues that are unique to private equity.

LIMITATIONS OF THE RESEARCH STUDY

While carrying out my research, I will not be able to carry out qualitative analysis and research on the topic area. I will not be able to conduct surveys or interviews with the various stakeholders in the private equity industry. This is due to a limitation in time and resources.

CHAPTER ONE: AN INTRODUCTION TO PRIVATE EQUITY

1.1. Private Equity: The Concept

The general idea behind private equity²⁴ is that of investing in companies. Companies need money to develop and expand. This money can either come from its profits or other investments. Sometimes this money is not enough and thus, the company has to source for capital elsewhere. These other sources include additional money raised from its shareholders, investors and loans from banks. More often than not it is easier for a listed company to use these options to raise money as compared to a small and unknown company. In the case of a small, unknown and private company the board of directors will turn to private individuals or organizations with money to invest to provide them with finance. This is where private equity funds step in.²⁵

A private equity fund is a "closed-end" vehicle in which investors commit to provide a certain amount of money to pay for investments in companies.²⁶ Private equity investors are 'financial sponsors' who acquire large ownership stakes and taking an active role in monitoring and advising portfolio companies.²⁷ The investors in these funds include pension schemes, banks, insurance companies and individuals. Private equity investors establish firms to run private equity funds that are institutional in nature dependent on the sector focus e.g.IT or real estate, stage or size of investment and the regulatory regime.²⁸ The private equity fund generally invests people's money.²⁹

Over time private equity has emerged as part of the new genre of alternative asset classes and financial intermediaries. Private equity has become an alternative to banks. It has contributed to financial globalization and innovation by creating links between the various global financial markets and has done so successfully in such seamless fashion.

²⁴ The term 'Private Equity' refers to the provision of medium to long-term finance to companies in return for an equity stake.

²⁵ Biggs, S, 2008, Private Equity: a Practical Guide p.247 Retrieved from <<http://journals.cambridge.org>> Downloaded: 24 Apr 2012

²⁶ Steven N. Kaplan and Per Strömberg, 'Leveraged Buyouts and Private Equity', The Journal of Economic Perspectives, Vol. 23, No. 1 (Winter, 2009), pp. 121-146 Published by: American Economic Association <<http://www.jstor.org/stable/27648297> .Accessed: 24/04/2012 05:26>

²⁷ R. K. Jain and Indrani Manna, 2009, "Evolution of global private equity market: Lessons, implications and prospects for India", p.118. Retrieved on 1 March 2012 <<http://rbidocs.rbi.org.in/rdocs/Content/PDFs/2RKSN010210.pdf>>

²⁸ Financial Services Authority "Private equity: A discussion of risk and regulatory engagement" p.16-17. Retrieved on from <http://www.fsa.gov.uk/pubs/discussion/dp06_06.pdf>

²⁹ Biggs, S, 2008 March, 'Private Equity: a Practical Guide', p.249-250 <<http://journals.cambridge.org>> Downloaded: 24 Apr 2012

1.2. The definition of Private Equity

An attempt to describe what Private Equity is would be fruitless if a definition of equity capital is provided and statement regarding its importance as a source of funding for companies, provided. The concept of equity capital was as a result of the landmark decision of the House of Lords in the case of **Salomon V Salomon**³⁰, in which the House of Lords recognised that a company is separate legal entity with certain powers and obligations. One of its powers included that one of borrowing. In exercise of its borrowing power, a company could raise capital to finance its activities through borrowing from a bank or the public by issuing debentures. A company could obtain debt capital from institutions such as banks, insurances companies or pension funds.

Where borrowed funds were not enough, the company could raise further funds through equity capital. Equity capital³¹ can be described as capital raised from owners in the company. The owners can choose to sell equity in their company by offering the public an opportunity to purchase securities in it for example shares. This is usually done through an Initial Public Offering (IPO) in the case of a company listed in the securities exchange or through an underwriter like an investment bank if the company is private. Some of the uses of equity capital at the initial stages include getting starting companies off the ground.

For a long time, the only form of equity that was recognised by many as a means of raising capital was public equity. Public equity³² is defined as an asset class where individuals and or organizations can buy ownership in shares of a company through a public market such as the Nairobi Securities Exchange (NSE). A good example is when Safaricom Limited, a telecommunications company in Kenya, floated its shares at the NSE in 2008 during its initial public offering. Members of the public who purchased its shares became its members otherwise known as shareholders. However, drawing from the definition on what Equity Capital is, one can rightfully conclude that apart from public equity there is another form of Equity Capital that can be used to finance a company's operations known as private equity.

³⁰ [1897] AC 22

³¹ 'Equity capital'. Retrieved on 3rd March 2012 from <<http://www.businessfinance.com/equity-capital.htm>>

³² 'Public equity.' Retrieved on 3rd March 2012 from <http://www.sib.wa.gov/financial/io_pue.asp>

Private equity is defined generally as a privately negotiated investment in a company aimed at achieving substantial added value.³³ Several other definitions that attempt to define what Private Equity is are:

The European Venture Capital Association³⁴ 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.

Drawing from the first two definitions, the general understanding is that private equity investors provide medium to long term finance to companies which have or show potential for high growth and performance in return for an equity stake in the same. Usually, the companies invested in are not listed on the securities exchange.

The International Financial Services, London³⁵ calls any type of equity investment in an asset in which the equity is not freely tradable on a public stock market as private equity. Private equities are generally less liquid i.e. they cannot be sold easily at the securities exchange than publicly traded stocks for example shares and are thought of as a long term investment.

Private equity organizations have been defined broadly as partnerships specializing in venture capital, leveraged buyouts (LBOs) and other related investments.³⁶ These terms shall be discussed shortly.

1.3. Private Equity as distinguished from Public Equity, Venture Capital and Unit trusts

The distinction between public and private equity is a straightforward one that is easy to comprehend. However, since venture capital and unit trusts are concepts that are closely related to private equity drawing a clear distinction between these concepts is not an easy task. This is because these concepts are interrelated as both are alternative channels of investment thus there is bound to be some ambiguity.

³³ Retrieved on 15th March 2012 from <http://www.africa.com/south_africa/private_investment/finance_africa.com>

³⁴ R. K. Jain and Indrani Manna, Evolution of global private equity market: Lessons, implications and prospects for India”, Reserve Bank of India Occasional papers Vol. 30, No 1, Summer 2009 p115-116. Retrieved on March 2012 from < <http://rbidocs.rbi.org.in/rdocs/Content/PDFs/2RKSN010210.pdf> >

³⁵ Ibid

³⁶ Supra

The distinction between public and private equity is that:³⁷

- The investments held by private equity investors are not held for longer indefinite durations unlike those held by their public equity counterparts. Normally a private equity investor has an exit strategy at the time he makes the initial investment in the company. One such strategy would be to make a private company public and sell its shares in the securities/ stock market.³⁸
- Private equity investors combine the provision of capital and expertise hand in hand whereas public equity investors provide for this separately. Both private and public equity investors do not intervene in the day to day management of the business. Normally, they work with the management teams that are already in place. Private equity investors in addition to providing capital may offer specialised expertise in areas such as transaction structuring while public investors do not.
- Private equity investments are riskier as compared to public equity ones. For instance should the company the private equity investor invests in prosper, he stands to receive very high returns, whereas if it fails to prosper he risks losing most of his investment. This is a very risky gamble. In the case of public equity investors they normally receive a fixed return on their investments and normally make minimal losses if any.

Closely related but not similar to private equity is Venture Capital. Venture Capital³⁹ as defined by the Capital Markets Authority Kenya (CMA) is capital invested in a project where there is a substantial element of risk, especially money in a new venture or an expanding business in exchange for shares in the business.

The CMA does not regard venture capital as a loan; instead it is viewed as playing a critical role in addressing the funding needs of entrepreneurial companies that generally do not have

³⁷Ingrid Goodspeed, 'Private equity: Capitalism at its greedy worst or efficient best'. Retrieved on 1 March from <http://www.africa.com/south_africa/private_investment/finance_africa.com>

³⁸The Capital Markets Authority Act defines a stock market as place at which, or a facility which-
(a)Offers to sell, purchase or exchange securities are regularly made or accepted;
(b)Offers or invitations are regularly made, being offers or invitations that are intended or may reasonably be expected to result, whether directly or indirectly, in the making or acceptance of offers to sell, purchase or exchange securities; or
(c)Information is regularly provided concerning the prices at which, or the consideration for which, particular persons, or particular classes of persons, propose, or may reasonably be expected, to sell, purchase or exchange securities.

³⁹<http://www.cma.or.ke/index.php?option=com_content&task=view&id=32&Itemid=90>

the size, assets, and operating histories necessary to obtain capital from more traditional sources, such as public markets and banks.

Whereas the focus of private equity is on mature business, venture capital is normally injected into a business during its launch, early stages and expansion.⁴⁰

Unit trusts on the other hand are often confused as private equity firms. The CMA defines a unit trust⁴¹ as an investment scheme that pools money together from many investors who share the same financial objective. These funds are to be managed by a group of professional managers who invest the pooled money in a portfolio of securities such as shares, bonds and money market instruments or other authorized securities to achieve the objectives of the fund. In exchange of the money received from the investors, the fund issues units to investors who are known as unit holders. The fund earns income from the investment in the form of dividends, interest income and capital gains.

The Capital Markets Authority in its guideline⁴² has categorized unit trusts in Kenya as collective investment schemes and thus are an of investment product that private equity investors can invest in as opposed to the common belief that unit trust are private equity. Examples of unit trusts that are recognized by the CMA include Old Mutual Unit Trust Scheme and African Alliance Kenya Unit Trust Scheme.

⁴⁰ R. K. Jain and Indrani Manna, 'Evolution of global private equity market: Lessons, implications and prospects for India', Reserve Bank of India Occasional papers Vol. 30, No 1, Summer 2009 p 7 Retrieved on 1 March 2012 <<http://rbidocs.rbi.org.in/rdocs/Content/PDFs/2RKSN010210.pdf>>

⁴¹ The Capital Markets Authority Kenya, 'Collective Investment Schemes: What you should know' p.2

⁴² Ibid

2. The Historical Development of Private Equity from a Global Perspective

2.1 The Humble Beginnings of Private Equity and the Historical development of private equity in USA

In the Medieval ages, the financing of sea and exploration voyages such as those by Christopher Columbus and the British East India Company in the 18th Century was through private financing from Spanish monarchy and Italian investors and venture capital respectively.⁴³ Some other private equity investments include those carried out in Europe during the industrial revolution, for example when merchant bankers financed industrial enterprises in the 1850s in London and Paris.⁴⁴

In 1854, Credit Mobilier was founded by Jacob and Isaac Pereire, two Jewish journalists. Credit Mobilier was gained the reputation of being an aggressive, future-looking investment bank across Europe and North America.⁴⁵ Jacob and Isaac Pereire teamed up with Jay Cooke, a New York tycoon, at a later stage and together they jointly provided part of the financing for the American Transcontinental Railroad, which was built between 1863 and 1869.⁴⁶

In 1901, J. Pierpont Morgan, through his company J.P. Morgan & Co. acquired Carnegie Steel Company from Andrew Carnegie and Henry Phipps for USD480 million.⁴⁷ The monies used to acquire Carnegie Steel Company was obtained from private finance.

By the 1930s, individual venture capitalists from wealthy American families included the Rockefellers,⁴⁸ the Vanderbilts⁴⁹ and Jay H Whitney.⁵⁰ Very little information is recorded

⁴³ Spencer E Ante, *Creative Capital: Georges Doriot and the Birth of Venture Capital*, (Harvard Business School Press, 2008) Introduction, xiii. Retrieved on 5th July 2012 from Dr Tuimising NR 2012, 'Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.' (PhD Thesis, University of Warwick) p.67

⁴⁴ Valentine V Craig, 'Merchant Banking: Past and Present' (2000) FDIC Banking Review <<http://www.fdic.gov/bank/analytical/banking/2001sep/article2.html>> Retrieved on 5th July 2012 from Dr Tuimising NR 2012, 'Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.' (PhD Thesis, University of Warwick) p.67

⁴⁵ Charles P Kindleberger, *A Financial History of Western Europe* (1993) (2nd edn, Oxford University Press, 1993) 110 . Retrieved on 5th July 2012 from Dr Tuimising NR 2012, 'Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.' (PhD Thesis, University of Warwick) p.67

⁴⁶ Sven Beckert, *The Monied Metropolis: New York City and the Consolidation of the American Bourgeoisie, 1850-1896* (New Edition, Cambridge University Press, 2003). Retrieved on 5th July 2012 from Dr Tuimising NR 2012, 'Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.' (PhD Thesis, University of Warwick) p.67

⁴⁷ (...) 'Henry Phipps – The Founder' (*The Phipps Houses Group*) <http://www.phippsny.org/about_h_phipps.html> Retrieved on 5th July 2012 from Dr Tuimising NR 2012, 'Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.' (PhD Thesis, University of Warwick) p.68

about venture investing by wealthy individuals before the 1930s in the USA, just as is the case for Western Europe.

The governments of USA and UK commissioned studies on private equity that were conducted in 1935 and 1931 respectively after the Great Depression. These studies documented what is now known as ‘the funding gap’, which refers to the difficulty faced by small enterprises in accessing appropriate forms of enterprise capital. As a result of these studies public policy measures in support of private equity were formulated.⁵¹ The first formal private equity firm in USA was The American Research and Development Corporation (ARD). It was established after World War II in 1946.⁵² Its main function was to facilitate the formation of new business ventures and enhance their development.

During the 1950’s and 60’s, the United States Congress introduced legislation to promote the development of small business ventures, with moderate success. An increase in the market for initial public offerings in 1968-69 resulted in significant profitable realizations of venture capital investments made in the 1960’s.⁵³ In 1958, the USA government enacted the Small Business Investment Companies (SBICs) Act of 1958.⁵⁴ The Act facilitated the pooling of federally chartered funds that venture investors could leverage and it also enabled the formation of special companies that could gain access to such federally chartered fund

⁴⁸ Ron Chernow, *Titan: The Life of John D Rockefeller, Sr* (2nd edn, Vintage Books 2004) - helped found Eastern Airlines and Douglas Aircraft in 1938. Retrieved on 5th July 2012 from Dr Tuimising NR 2012, ‘Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.’ (PhD Thesis, University of Warwick) p.68

⁴⁹ T.J. Stiles, *The First Tycoon: The Epic Life of Cornelius Vanderbilt* (Reprint edn, Vintage Books 2010) - 1938: founded E.M. Warburg & Co., which later became Warburg Pincus LLP. Retrieved on 5th July 2012 from Dr Tuimising NR 2012, ‘Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.’ (PhD Thesis, University of Warwick) p.68.

⁵⁰ Spencer E. Ante, *Creative Capital: Georges Doriot and the Birth of Venture Capital* (Harvard Business School Press 2008). Retrieved on 5th July 2012 from Dr Tuimising NR 2012, ‘Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.’ (PhD Thesis, University of Warwick) p.68.

⁵¹ Charles M. Noone, ‘The 1968 Model SBIC’ (1967-1968) 23 *Bus.Law* 1214, 8 . Retrieved on 5th July 2012 from Dr Tuimising NR 2012, ‘Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.’ (PhD Thesis, University of Warwick) p.68

⁵² R. K. Jain and Indrani Manna, ‘Evolution of global private equity market: Lessons, implications and prospects for India’, Reserve Bank of India Occasional papers Vol. 30, No 1, Summer 2009 p.124-125 Retrieved on 1 March from <<http://rbidocs.rbi.org.in/rdocs/Content/PDFs/2RKSN010210.pdf>>

⁵³ *ibid*

⁵⁴ Charles M Noone and Stanley M Rubel, *SBICs: Pioneers in Organized Venture Capital* (Chicago Capital Publishing Company 1970); Charles M. Noone, ‘The Various Sources of Venture Capital available to Small Business Concerns,’ (1970-1971) 26 *Bus. Law* 721. Retrieved on 5th July 2012 from Dr Tuimising NR 2012, ‘Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.’ (PhD Thesis, University of Warwick) p.69

pools.⁵⁵ The companies that could access this facility were known as small business investment companies (SBICs). In addition to the SBICs, the USA government implemented the Small Business Investment Research (SBIR) program from 1958. This program was designed to support innovative research by start-up companies, as well as create and advance industry linkages between small and large technology-driven enterprises. It aided in stimulating rapid technological advancements, and was instrumental in heralding the takeoff of internet and telecommunications technologies in the 1990s.⁵⁶

It was not until the 1970s when the private equity industry in USA began to experience its first peak. During this time most of the venture capital partnerships began leveraging buy-outs⁵⁷ of divisions of large conglomerates.⁵⁸ Through regulatory and tax changes, US pension funds were able to invest in private equity for the first time. This, together with the success of new leveraged buy-out (LBO) firms, resulted in a boom in fund raising.

Between the 1970s and the 2000s, the USA government undertook a series of additional policy measures specifically aimed at unlocking fundraising for private equity investments. These policy measures included changes to the tax codes to create investment incentives targeted at institutional and individual investors, as well as regulatory changes that empowered institutional investments into private equity. It also introduced legislation that supported the emergence of professional services around private equity, starting with the role of investment advisors which was subjected to legal treatment from 1940.⁵⁹

The year 1978 saw the introduction of a very important regulatory change in the private equity market in USA. This was the post amendment to the so called ‘prudent man’ rule. The principle behind the ‘prudent man’ rule is that “*A fiduciary must discharge his or her duties*

⁵⁵ Retrieved on 5th July 2012 from Dr Tuimising NR 2012, ‘Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.’ (PhD Thesis, University of Warwick) p.69

⁵⁶ Joshua Gans and Stern Scott, ‘When does funding Research from Smaller Firms Bring Fruit? Evidence from the SBIR Programme’ (2003) 12 (4) *Economics of Innovation and New Technology* 361-384. Retrieved on 5th July 2012 from Dr Tuimising NR 2012, ‘Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.’ (PhD Thesis, University of Warwick) p.70

⁵⁷ While carrying out a Leveraged Buy-out (LBO) the acquiring company seeks to acquire a company from existing owners. This is done by obtaining a significant controlling share in the company it intends to acquire. The acquisition costs are met by a significant amount of debt obtained from a pool of private equity capital. The debt is secured by both the acquiring and acquired companies’ assets.

⁵⁸ A Conglomerate is a large corporation that is run as a single business, but made up of several firms (acquired through mergers or takeovers) supplying diverse goods and/or services. Retrieved on 5th March 2012 from <<http://www.businessdictionary.com/definition/conglomerate.html>>

⁵⁹ Retrieved on 5th July 2012 from Dr Tuimising NR 2012, ‘Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.’ (PhD Thesis, University of Warwick) p.70

*with the care, skill, prudence and diligence that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and aims.”*⁶⁰ This rule applied to all of the duties and obligations that a fiduciary or trustee may have with regard to a trust, pension plan or fund. Today, it has become substantive law and not only applies in USA but has extended in its application to many European countries.

The huge technology boom of 1998 saw the industry experience a second peak. During this time most venture capital firms took advantage this boom and were able to mobilise enough funds to provide a large amount of debt. In this respect they were able finance huge corporate takeovers and leveraged buy outs.⁶¹

A summary⁶² of the regulatory framework for private equity in USA from 1934 – 2010 is as follows:

Law/Development	Impact
Securities Exchange Act of 1934 ⁶³	Established the American financial services regulator – the Securities Exchange Commission, one of whose functions is the regulation of alternative investments (including hedge funds, private equity).
Investment Company Act of 1940	Made provision for stringent disclosure standards for investment companies and investment advisors. Exempted investment advisors from extensive registration requirements.
Small Business Investment Act of 1958 ⁶⁴	Established federal fund pools that could

⁶⁰Russell Galer, OECD, 2002, ‘Prudent Person Rule- Standard for Investment of Pension Funds Assets’ Retrieved on 5th March 2012 from <www.oecd.org/dataoecd/34/24/2488700.pdf>

⁶¹ R. K. Jain and Indrani Manna, Evolution of global private equity market: Lessons, implications and prospects for India”, Reserve Bank of India Occasional papers Vol. 30, No 1, Summer 2009 p.124-125 Retrieved on 1 March 2012 from <<http://rbidocs.rbi.org.in/rdocs/Content/PDFs/2RKSN010210.pdf>>

⁶² This summary table is courtesy of Dr Tuimising NR – PhD Thesis, Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues; University of Warwick, 2012, p.71-72

⁶³ L. 111-257, approved October 5, 2010 <<http://www.sec.gov/about/laws/sea34.pdf>> Retrieved on 5th July 2012 from Dr Tuimising NR 2012, ‘Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.’ (PhD Thesis, University of Warwick)

be leveraged by venture capitalists up to 4 times the amount of private funding. It expanded sources of private equity capital, supported the emergence of a pool of private equity professionals, and increased technological development in the USA.

Employee Retirement Income Security Act (ERISA) of 1974⁶⁵ Prohibited corporate pension funds from investing in risky investment vehicles, including in unquoted/privately held companies. It further demanded that investment risk was to be assessed at the individual investment level, upping the barriers to investment.

The US Department of Labour promulgated the “Prudent Man” rule (Section 404(a)(1)(B), ERISA 1974) Required fiduciaries to act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

Economic Recovery Tax Act of 1981⁶⁶ Lowered the capital gains tax rate to 20% from 28%, further sweetening risky investments.

⁶⁴ Small Business Investment Companies Act 1958, 15 U.S.C. § 661 et seq; Regulations - Part 107 Title 13 Code of Federal Regulations, 13 C.F.R. § 107.20 et seq. Retrieved on 5th July 2012 from Dr Tuimising NR 2012, ‘Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.’ (PhD Thesis, University of Warwick)

⁶⁵ P.L. 93-406, 88 Stat. 829, enacted September 2, 1974. Retrieved on 5th July 2012 from Dr Tuimising NR 2012, ‘Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.’ (PhD Thesis, University of Warwick)

⁶⁶ P.L. 97-34, ERTA (“Kemp-Roth Tax Cut): large increase in revenue from capital gains tax after ERTA; declined when taxes were subsequently raised to 28%. Retrieved on 5th July 2012 from Dr Tuimising NR 2012, ‘Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.’ (PhD Thesis, University of Warwick)

Tax law reforms – USA – 1986 through 1997⁶⁷ Tax Reform Act of 1986 – reversed the ERTA tax reductions, including the capital gains tax rate (raised to 28%).

1993, Clinton tax reforms–14% capital gains tax incentive for investments held for more than 5 years.

1997 – the Clinton administration lowered capital gains tax rate to 20%.³⁰

Dodd-Frank Act, 2010

Part IV (Title IV, s 403-417)

Extends exemptions applicable to investment advisors under the Investment Advisors Act of 1940 – by raising the minimum threshold from USD25 million to USD100 million.

Despite the challenges the US private equity market has been faced with over time, currently it is the biggest and most developed private equity market in the world and the industry's yearly earnings contribute significantly to the country's GDP.

2.1 b Comparative analysis between US and Kenyan Regulatory Frameworks

The US regulatory framework for private equity is somewhat similar to the Kenyan one in some aspects. For example Kenya has the Capital Markets Authority Act which establishes the CMA as the financial services regulator in Kenya. This Act is similar to the US Securities Exchange Act of 1934. Kenya does not have separate Acts for Investment Companies and Venture Capital Companies like the US Investment Company Act of 1940 and Small Business Investment Act of 1958. Investment and Venture Capital Companies are dealt with in the Capital Markets Authority Act. The Retirement Benefit Authority Act in Kenya is equivalent to the US Employee Retirement Income Security Act of 1974 which set private equity investment standards for pension funds. Kenya does not have an Economic Recovery Tax Act like the USA. The Dodd Frank Wall Street Reform and Consumer Protection Act was enacted to protect consumers from abusive financial practises and promote accountability and transparency among financial service providers. The closest Kenyan

⁶⁷ Paul Gompers and Josh Lerner, *The Venture Capital Cycle* (MIT Press, MA, 2nd edn, 2004) 36

equivalent to the US Act would be the Competition Act 2010 and The Capital Markets Authority Act. These Acts contain some provisions to promote accountability and transparency among financial service providers. In Kenya when it comes to tax matters the relevant laws that apply depend on the type of investment vehicle used to operate the private equity fund. Kenya does not have an exclusive Tax Act like the US.

2.2. Historical development of and legal framework for the private equity in UK

After World War II the Industrial and Commercial Finance Corporation (ICFC) and the FCI (Finance Corporation for Industry) were set up in 1945⁶⁸ in the UK and owned by the bank of England and clearing banks at the time. ICFC was set up to address the equity gap about €200,000 known as the 'Macmillan Gap' after the prime minister and the Macmillan Committee. The Macmillan committee recognised the existence of such a gap as far as back as 1930 when unquoted small medium sized firms could not secure bank financing.⁶⁹

From 1960s Technical Development Capital (TDC) a subsidiary of ICFC was set up to invest specifically in high technology projects. Private equity became an industry in Europe in the late 1970s and in early 1980s a number of private equity firms were founded. Professional associations for the private equity were set up for example the European venture capital association (EVCA) and the British Venture Capital Association (BVCA) which was established in 1963. In 1970 the FCI and ICFC merged forming "Finance for Industry" (FFI), which during the 1980s was rebranded to "Investors in Industry". In July 1994, at the time of its London Stock Exchange flotation and entry into the FTSE100, it became "3i" and still remains that to date.⁷⁰

Until the 1980's, the growth of the UK private equity industry was constrained by a multitude of factors, including political environment where mainly socialist governments had created harsh entrepreneurial climate and cultural impediments such as higher risk averseness.

⁶⁸ Retrieved on 5th July 2012 from <<http://www.3i.com/about3i/history-of-3i.html>>

⁶⁹2007, Raising Venture Capital Finance in Europe, Arundale, Keith p.5

⁷⁰Retrieved on 5th July 2012 from <<http://www.3i.com/about3i/history-of-3i.html>>

Similarly, discouraging fiscal and legal rules of game added muscle to the stagnation of the industry.⁷¹

In the mid 80's that the State took progressive steps to promote the venture capital industry including development of missing markets, rationalization of marginal tax rates, etc. it established the Unlisted Securities Market (USM) which proved advantageous for the exit of small firms because of relatively easier listing requirements.

In 1983 the UK government conducted a review of progress since the 1931 study, and the findings confirmed the MacMillan Gap persisted. In response, it initiated the Business Expansion Scheme (BES), by which it made available tax relief for investments in unquoted securities. As a result of the BES program investors in unquoted equity avoided early stage and start-up companies, which were viewed as unpredictable commercial ventures hence the gap persisted.⁷²

As Europe emerged from the recession of the early 1990's, it too became a fertile environment for private equity. Private equity investment grew in the period from the late 1990s and currently after UK has a very well developed private equity market. The European private equity market has grown in the last decade. In 2005 the market had reached a peak of €47 billion according to surveys conducted by PwC and Thomson Financial for EVCA. The BVCA has 180 full member firms so far. There are some 1600 private equity firms all over Europe. The private equity industry's continual development has been aided by an improving entrepreneurial spirit in UK, a relatively strong economy, government incentives, consistent outperforming by the private equity industry of the stock market indices in the long term and short term.⁷³

Some of the UK public policy measures addressed at private equity include the provision of choice over organization form (hence private equity companies could register as limited liability partnerships, trusts, limited companies and even investment funds), the provision of

⁷¹R. K. Jain and Indrani Manna, Evolution of global private equity market: Lessons, implications and prospects for India", Reserve Bank of India Occasional papers Vol. 30, No 1, Summer 2009 p.125 Retrieved on 1 March 2012 from <<http://rbidocs.rbi.org.in/rdocs/Content/PDFs/2RKSN010210.pdf>>

⁷² Richard T Harrison, and Colin C Mason, 'Risk Finance, the Equity Gap and New Venture Formation in the United Kingdom: the Impact of the Business Expansion Scheme' in B.A. Kirchoff, W.A. Long, W.E. McMullen, K.H. Vesper, and W.W. Wetzel (eds), *Frontiers of Entrepreneurship Research* (Wellesley, MA: Babson College, 1988) 595-609. As cited by Dr Tuimising NR – PhD Thesis, Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues; University of Warwick, 2012 p.73

⁷³ Ibid fn 71

tax reliefs for investments into private equity and small enterprises and a strong culture of efficient business regulation.⁷⁴

A summary of the regulatory framework for private equity in UK

Law/ Development

Common Law

Learoyd v Whiteley⁷⁵

Pensions Act 1995⁷⁶

Impact

The House of Lords ruling in this case established the common law duty, imposed upon trustees regarding any proposed investments they might make, which is to 'Take such care as an ordinary prudent man would take if he were minded to make [an investment] for the benefit of other people for whom he felt morally bound to provide.'

S33-36 sets out the statutory duties of trustees. The Act:

- Imposes upon all trustees the duty to take care or exercise skill in the performance of any investment functions⁷⁷
- Gives trustees power to make an investment of any kind as if they were absolutely entitled to the assets of the scheme as well as delegate their functions⁷⁸
- Requires the trustees to secure that

⁷⁴ Dr Tuimising NR – PhD Thesis, Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues; University of Warwick, 2012 p.74

⁷⁵ [1887] LR 12 App Cas 727

⁷⁶ 1995 c. 26. Retrieved on 5th July 2012 from <<http://www.legislation.gov.uk/ukpga/1995/26/contents/enacted>>

⁷⁷ Section 33 Pensions Act 1995 c.26. Retrieved on 5th July 2012 from <<http://www.legislation.gov.uk/ukpga/1995/26/section/33/enacted>>

⁷⁸ Section 34 Pensions Act 1995 c.26 Retrieved on 5th July 2012 from <<http://www.legislation.gov.uk/ukpga/1995/26/section/34/enacted>>

there is prepared, maintained and from time to time revised a written statement of the principles governing decisions about investments for the purposes of the scheme.⁷⁹

- Requires that the trustees or fund manager, when choosing investments must have regard to the need for diversification of investments, in so far as appropriate to the circumstances of the scheme, and the suitability to the scheme of investments of the description of investment proposed and of the investment proposed as an investment of that description.⁸⁰

The Financial Services and Markets Act (FSMA) 2000 Is concerned with the regulation of financial services and markets in the UK. Under Section 19 of FSMA, any person who carries on a regulated activity in the UK must be authorized by the Financial Services Authority.

The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001⁸¹ Is secondary legislation under FSMA and specifies the activities and specified investments that are subject to regulation by the Financial Services Authority.

Money Laundering Regulations, 2007 The 2007 Money Laundering Regulations

⁷⁹ Section 35 Pensions Act 1995 c.26. Retrieved on 5th July 2012 from <<http://www.legislation.gov.uk/ukpga/1995/26/section/35/enacted>>

⁸⁰ Section 36 Pensions Act 1995 c.26. Retrieved on 5th July 2012 from <<http://www.legislation.gov.uk/ukpga/1995/26/section/36/enacted>>

⁸¹ SI 2001/544. Retrieved on 5th July 2012 from <<http://www.legislation.gov.uk/uksi/2001/544/contents/made>>

implement the requirements of the European Union's Third Money Laundering Directive.⁸²

Occupational Pension Schemes (Investment) Trustees are obligated under these Regulations 2005 (the "Investment Regulations") regulations to invest in members' best interests.

The Local Government Pension Scheme (Management and Investment of Funds) Retirement Benefit Authority to invest Fund Regulations 2009⁸³ monies. These regulations provide the statutory investment limits for different types of investments an Authority can invest in.⁸⁴

Alternative Investments Fund Managers (AIFM) Directive⁸⁵ Establishes a secure, harmonized EU framework for monitoring and supervising the risks that AIFMs pose to their investors, counterparties and other financial market participants and to financial stability; and permit, subject to compliance with strict requirements, AIFMs to provide services and market their funds across the internal market.⁸⁶

An in depth comparative analysis between the private equity in Kenya and the UK will be discussed in Chapter 3.

⁸² Financial Services Authority, 'The FSA's new role under the Money Laundering Regulations 2007, Our Approach', p.3 Retrieved on 1st July 2012 from <<http://www.fsa.gov.uk/pubs/other/approach.pdf>>

⁸³ 2009 No. 3093

⁸⁴ Schedule 1 to the Act contains a table of limits on investments

⁸⁵ The Directive was published in the *Official Journal of the European Union* on 1 July 2011. EU Member States, such as the UK, are required to transpose the Directive by 22 July 2013. Retrieved from <http://www.fsa.gov.uk/static/FsaWeb/Shared/Documents/pubs/discussion/dp12-01.pdf> Date Accessed 1/7/2012

⁸⁶ DP12/1, Financial Services Authority, "Implementation of the Alternative Investment Fund Managers Directive", p. 9 <<http://www.fsa.gov.uk/static/FsaWeb/Shared/Documents/pubs/discussion/dp12-01.pdf>> Date Accessed 1/7/2012

2.3 Historical development of and legal framework for private equity in India

Private equity in India began in the mid-1980s as venture capital firms which later graduated into the indigenous private equity firms by broadening their sphere of activities.⁸⁷ In 1984, the venture firms such as ICIC Bank Limited decided to launch venture capital schemes to encourage start-up ventures in the private and emerging technology sectors. This was followed by the establishment of 'Technology Development and Information Company Ltd' and IFCI sponsored 'Risk Capital and Technology Finance Corporation of India Ltd', which provided institutional support to first generation professionals and technocrats setting up their own ventures in the medium scale sector. Some commercial banks like Canara Bank also came up with their own venture capital funds. Subsequently, various regional venture capital funds came up in the country's major provinces such as Gujarat.

In late 80's and early 90's, various private sector funds were established. Between 1995 and 2000, several foreign Private Equity firms began their operations in India the biggest being US firm Warbug Pincus. Most of these firms were set up by Indian managers with foreign capital focussing on IT and internet related investments in tune with the technology boom in the USA.

The growth of the private equity industry slowed down between 2001 and 2003 after the technology boom in USA. Investment activity peaked again as from 2004 with an upward trend in domestic stock market. Since then up until now the investment focus shifted towards non- IT related investments like manufacturing, healthcare and those dependent on domestic consumption for growth.

The legal framework regulating private equity in India comprises of The Securities and Exchange Board of India⁸⁸ (Venture Capital Funds) Regulations, 1996 and the Securities and Exchange Board of India (Foreign Venture Capital Investors) Regulations, 2000 (SEBI FVCI Regulations) which are cumulatively referred to as the "SEBI Regulations".⁸⁹ These are the principal sources of legislation that contain the specific conditions that must be met by a private equity investor wanting to invest in an Indian company.

⁸⁷ R. K. Jain and Indrani Manna, 2009, "Evolution of global private equity market: Lessons, implications and prospects for India", p.1 Retrieved on 1 March 2012 from <<http://rbidocs.rbi.org.in/rdocs/Content/PDFs/2RKSN010210.pdf>>

⁸⁸ Also known as SEBI

⁸⁹ Akil Hirani, "Regulatory issues in venture capital/ private equity financing of Indian technology companies", Retrieved on 5th March 2012 from <<http://www.majmudarindia.com/pdf/Regulatory%20issues%20in%20private%20equity.pdf>>

The SEBI (Venture Capital Funds) Regulations, 1996 regulate the activities of venture capital/private equity funds that are formed and incorporated in India. They provide that the source of funding for venture capital funds is restricted to private placement of units. They are not allowed to carry out IPOs until the expiry of three years from the date of issuance of its units. Some other restrictions on investment conditions include that at the time of registration a venture capital fund must disclose its investment strategy, the fund cannot invest more than 25 percent of its capital in an Indian company/undertaking among other restrictions.⁹⁰

The SEBI FVCI Regulations regulate the activities of foreign venture capital funds which want to invest in Indian companies. The following are the prescribed guidelines⁹¹ that foreign venture capital/ private equity funds must adhere to:

- A foreign venture capital/private equity investor must disclose its investment strategy and life cycle to Securities Exchange Board of India (SEBI), and it must achieve the investment conditions by the end of its life cycle.
- At least 66.67% of the investible funds must be invested in unlisted equity shares or equity linked instruments.
- Not more than 33.33% of the investible funds may be invested by way of:
 - a) Subscription to initial public offer of a venture capital undertaking, whose shares are proposed to be listed.
 - b) Debt or debt instrument of a venture capital undertaking in which the foreign venture capital investor has already made an investment, by way of equity.
 - c) Preferential allotment of equity shares of a listed company, subject to a lock-in period of one year.
- The equity shares or equity linked instruments of a financially weak or a sick industrial company (as explained in the SEBI FVCI Regulations) whose shares are listed.

⁹⁰ R. K. Jain and Indrani Manna, 2009, "Evolution of global private equity market: Lessons, implications and prospects for India", p.151 Retrieved on 1 March 2012 from <<http://rbidocs.rbi.org.in/rdocs/Content/PDFs/2RKSN010210.pdf>>

⁹¹ Akil Hirani, "Regulatory issues in venture capital/ private equity financing of Indian technology companies", p 1-2 Retrieved on 5th March 2012 from <<http://www.majmudarindia.com/pdf/Regulatory%20issues%20in%20private%20equity.pdf>>

The SEBI FVCI Regulations permit a foreign venture capital investor to invest all of its capital into one venture capital fund. Unlike local venture capital/ private equity investors who are subject to a three year lock down period; foreign venture capital/ private equity investors duly registered by SEBI are not subject to the one year lock-in period in respect of pre-issue share capital held by it at the time of an IPO of the investee company.⁹²

Other regulations that govern venture capital/private equity funds in India are the Foreign Exchange Management (Transfer of Issue of Security by a Person Resident Outside India) Regulations, 2000 (The FEMA Regulations 2000) and Income-Tax Act, 1961.⁹³

The FEMA Regulations 2000 contain additional regulations which foreign venture capital/private equity investors must comply with before making any investment in India. These include:

- Depending on the quantum of investment, they must obtain the approval of the Foreign Investment Promotion Board or Secretariat of Industrial Assistance before they acquire shares in a company, which is engaged in the print media sector, atomic energy and related projects, broadcasting, postal services, defence and agricultural activities.
- Must apply to the Reserve Bank of India (“RBI”) for permission to invest in an Indian venture capital undertaking, a venture capital fund or in a scheme floated by a venture capital fund. This application is made through SEBI. The consideration amount for investment can be paid out of inward remittances from abroad through normal banking channels. They must also obtain RBI approval to maintain a foreign currency or rupee account with an authorized Indian bank. The funds held in such accounts can be used for investment purposes.⁹⁴

The Income Tax Act of 1961 contains the following provisions as regards venture capital/private equity funds/ companies:

⁹² Akil Hirani, “Regulatory issues in venture capital/ private equity financing of Indian technology companies” , p .2 Retrieved on 5th March from <<http://www.majmudarindia.com/pdf/Regulatory%20issues%20in%20private%20equity.pdf>>

⁹³ ibid

⁹⁴ Supra

- Their income is tax exempt provided they are registered with SEBI and in compliance with Indian government and SEBI Regulations. These funds/companies shall continue to enjoy this benefit should the undertaking in which its funds are invested get listed on a securities exchange.⁹⁵
- Tax is payable by the shareholders of or withdrawers from the company or fund. They are exempt from withholding tax in respect of income distributed to their investors. Furthermore, the provisions of the Act regarding taxation of dividends, distributed income and deduction of tax at source do not apply to them.⁹⁶

The above tax provisions serve as incentives so as to promote the growth of this industry.

2.3 b Comparative analysis between private equity in Kenya and India

The private equity market in India is fairly developed than the Kenyan market though not to a large extent. One of the common characteristics of these two markets is that they focus to a large extent on venture capital. Both the Kenyan and Indian private equity markets are not characterised by complex structures such as Hedge Funds and Real Estate Investment Trusts (REITs). The initial focus of private equity in India was on information technology. The Securities Exchange Board of India (SEBI) is the equivalent of the Capital Markets Authority and both serve the function of regulating financial services in their respective countries. The SEBI (Venture Capital Funds) Regulations 1996 are similar to the Capital Markets Authority (Registered Venture Capital Company) Regulations 2007. Both pieces of legislation regulate venture capital activities in India and Kenya respectively. Kenya does not have separate legislation that applies to foreign venture capital companies like India. Unlike India, Kenya is yet to have major international private equity funds set up shop. Kenya does not have specific tax provisions for venture capital companies like India. The applicable tax laws that apply to Kenyan venture capital are similar to those that apply to private companies.

⁹⁵ Akil Hirani, "Regulatory issues in venture capital/ private equity financing of Indian technology companies", p .2-3 Retrieved on 1 March 2012 from <<http://www.majmudarindia.com/pdf/Regulatory%20issues%20in%20private%20equity.pdf>>

⁹⁶ ibid

2.4 Historical development of and the legal framework for private equity in Australia

The private equity industry in Australia evolved from the venture capital industry that began as management investment companies (MICs) in 1984. The MIC program was the federal government's initiative and in order to promote their development, it offered full tax deductions to promote investments into them. The first management investment company was called First MIC Ltd later known as Hambro Grantham Capital Ltd (now Colonial First State Private Equity).⁹⁷

However, in 1991, the MIC program was discontinued because of the collapse of the stock market and the Second Board Stock Exchanges Australia in 1987, which saw many investors, lose out because they paid too much for investments in high risk, early stage companies. Due to bad market conditions private equity managers retreated into relatively safer, later stage investing, which became known as expansion stage capital and the government was extremely reluctant to have a second go at stimulating the growth of the industry. This led to the birth of non-MIC private equity companies were established.⁹⁸

The year 1992 was the beginning of a new growth phase for the private equity industry in Australia. Three key developments⁹⁹ in that industry which contributed to this growth phase, (which has continued unbroken since then) include:

- The launch of the Australian Venture Capital Journal which made information about the industry became more widely and systematically available.
- Formation of the Australian Venture Capital Association by private equity fund managers to promote private equity as a new asset class for institutional investors, and
- Launch of the Pooled Development Funds (PDF) program by the federal government. The PDF program was began so that new equity capital could be made available to small to medium sized businesses thus forming a new pool of private equity managers. The PDF program performed poorly at first on the retail market but with time they have become the largest group of listed private equity vehicles. In 1995, the

⁹⁷Victor Bivell, 2001, "The Rich History of Private Equity in Australia 1984 to Today", p.8 Retrieved on 5th March 2012 from <http://www.ifa.com.au/Brochures/Private_equity.pdf>

⁹⁸ Ibid

⁹⁹Victor Bivell, 2001, "The Rich History of Private Equity in Australia 1984 to Today", p.9-10 Retrieved on 5th March 2012 <http://www.ifa.com.au/Brochures/Private_equity.pdf>

first private equity fund-of-funds¹⁰⁰ was launched when the Development Australia Fund re-organized itself into an investable structure. The year 2000 saw the launch of the first Australian-based international fund-of-funds CHAMP Private Equity.¹⁰¹ To date all fund-of-funds have been unlisted vehicles.

During the late 1990s there was a big increase in the number of specialist management buyout funds (MBOs). They were a very attractive entry point for first time institutional investors in private equity, since they are later stage investments into established companies and so are deemed to have a lower risk profile and returns that are more consistent. Presently, MBO funds remain unlisted in the Australia.¹⁰²

Secondly, the federal government began an Innovation Investment Funds (IIF) Program in 1997. The IIF Program timed perfectly with the world technology boom and aimed to provide capital for small, early stage technology companies while also encouraging a new pool of venture capital fund managers. Early success led to a second IIF round in 2000 during which the federal government launched its Building on Information Technology Strengths (BITS) Program under which 10 technology incubators were financed to invest in seed and start-up stage information and communications technology companies.¹⁰³

From the late 1990s until now, the Australian private equity market has been experiencing the entry of many of the world's largest financial institutions – among them GE Equity, Deutsche Bank, ABN AMRO, UBS Capital and JP Morgan.¹⁰⁴

The private equity industry in Australia is regulated by two bodies. These are the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC). APRA has responsibility for ensuring capital adequacy, banking regulation and the superannuation industry. ASIC on the other hand deals with market

¹⁰⁰ Fund-of-funds are vehicles that invest in a portfolio of managed private equity funds, reducing investor risk through diversification by managers, business stage, industry sectors, and geography

¹⁰¹ <<http://www.champequity.com.au/pioneering-history/w1/i1001461/>>

¹⁰²Victor Bivell, 2001, “The Rich History of Private Equity in Australia 1984 to Today”, p.11 Retrieved on 5th March 2012 <http://www.ifa.com.au/Brochures/Private_equity.pdf>

¹⁰³ Ibid

¹⁰⁴Victor Bivell, 2001, “The Rich History of Private Equity in Australia 1984 to Today”, p.12 Retrieved on 5th March 2012 <http://www.ifa.com.au/Brochures/Private_equity.pdf>

integrity issues, including continuous disclosure, the regulation of directorial conduct and fiduciary obligations imposed on intermediating professions.¹⁰⁵

These regulatory bodies work hand in hand with the Treasury and specialist organizations, including the Reserve Bank of Australia (on macro-economic stability), the Australian Taxation Office (on the tax impact of financial engineering), the Australian Consumer and Competition Commission (on trade practices) and the Takeovers Panel (as the primary adjudicator of contractual disputes during merger and acquisition process).¹⁰⁶

2.4. b Comparative Analysis between Private Equity in Kenya and Australia

Private equity in Australia is very much like Kenya to the extent that the initial focus was on venture capital. In both the Australian and Kenyan cases, private equity was a government initiative aimed at promoting development. The Australian private equity market is far more developed than the Kenyan one. It provides for the listing of private equity vehicles and there are funds of funds such as CHAMP Private Equity. The Australian government unlike the Kenyan one has continuously invested in private equity through various development initiatives such as IIF and BITS. Private equity regulation in Australia is carried out by the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority. Australia adopts a twin peak regulatory model whereas Kenya adopts a single model regulatory approach i.e. the Capital Markets Authority is the regulator of private equity in Kenya.

2.5 Historical Development of Private Equity in Kenya

In Kenya private equity financing is seen as an engine for economic growth and private sector development.¹⁰⁷ The first private equity investment vehicle in Kenya was the Industrial and Commercial Development Corporation (ICDC) Investment, which was incorporated in 1967 as a government-affiliated investment entity. It had a seed capital of USD 26,000 and

¹⁰⁵ Jeremy Cooper, Corporate & Market Regulation: An Australian Securities and Investments Commission (ASIC) Update p.4 Retrieved on 1 March 2012 from <[http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/SDIA%20_speech_jun_%202007.pdf/\\$file/SDIA%20_speech_jun_%202007.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/SDIA%20_speech_jun_%202007.pdf/$file/SDIA%20_speech_jun_%202007.pdf)>

¹⁰⁶ Justin O'Brien, 2009, The Dynamics of Capital Market Governance, p.6-7 Retrieved on 5th April 2012 <<http://www.worldscibooks.com/economics/p520.html>>

¹⁰⁷ Deloitte, "East Africa Private Equity Confidence Survey, Taking Measures" p.12-13 Retrieved on 5th March 2012 <http://www.deloitte.com/assets/DcomKenya/Local%20Assets/Documents/Deloitte%20Report_EA%20Private%20Equity%20Confidence%20Survey%20Dec10.pdf>

was listed on the Nairobi Securities Exchange. In 2008 ICDC changed its name to Centum Investment Company Limited.¹⁰⁸

Private equity financing in Kenya began as investments in Small Medium Enterprises (SMEs).¹⁰⁹ At the time the SME sector was an underexploited capital niche between micro financing and corporate affairs. Many private equity fund investors looking to enter the Kenyan market saw it as a missing middle that presented risky yet lucrative opportunities for investors.¹¹⁰

Though the industry is under developed as compared to other global markets, it has experienced a continuous growth curve since 2002 owing to favourable market conditions thus, increased investor interest from abroad and investment by a group of high net worth individuals.¹¹¹ Were (2002) attributes this growth can be attributed to the fact that in Kenya, private equity is viewed as a product that widens the gap in the financial markets that has been left by commercial banks who have limited their lending to shield themselves from loan defaults in a turbulent business environment.¹¹² Following increased market activity one can expect that there will be competition in future thus access to debt will increase.

2.6. The structure of the Kenyan private equity market:

The Kenyan private equity market is made up of venture capital companies, quoted investment companies, privately owned funds and government owned funds. Apart from limited liability partnership private equity funds, there are very few captive funds which are owned by banks. To date Barclays bank of Kenya is the only bank which has a captive fund.¹¹³ There are two major quoted investment companies that deal in private equity in Kenya are Trans Century¹¹⁴ and Centum.¹¹⁵ These quoted investment companies have invested in sectors such as infrastructure, real estate and have acquired stakes in quoted and private companies.

¹⁰⁸ 'Centum company profile' <<http://www.centum.co.ke/>> Accessed on 22 June 2012

¹⁰⁹ Retrieved on 5th March 2012 <<http://www.ratio-magazine.com/20090514621/Kenya/-Kenya-SME-Private-Equity-Undeterred-by-Global-Crisis.html>>

¹¹⁰ ibid

¹¹¹ Supra fn 69

¹¹² Emmanuel Were, 2009, Business Daily, "Kenya's new capitalists go big on private equity". Retrieved on 5th March 2012 <<http://www.businessdailyafrica.com/-/539552/606824/-/552vni/-/index.html>>

¹¹³ ibid

¹¹⁴ Retrieved on 22nd June 2012 <<http://www.transcentury.co.ke/aboutus>>

¹¹⁵ Retrieved on 22nd June 2012 <<http://www.centum.co.ke/about-us>>

The investment focus of private equity in Kenya has shifted over time to new areas involving tangible activities such as agriculture, education, real estate and technology.¹¹⁶ Private equity investments are carried out following a clearly defined strategy mapped out by the fund management team. Most fund managers in Kenya have adopted a generalist investment strategy and are driven by the strong economic performance of the preferred sectors and opportunity for growth that Kenya offers.¹¹⁷

A fund management team comprises highly skilled individuals. These investments are made during the early years of the private equity fund. Over the next few years the management team implements value adding changes to the companies they have acquired and then realize the resulting capital gain by disposing of their investment through means such as trade sales or public offerings.¹¹⁸

A typical private equity fund has a life span of 10 years. In the Kenyan market majority of the fund managers hold their fund's investments for periods greater than two years and up to five years. The Kenyan market is therefore consistent with the inherent illiquid profile of private equity as a financial asset.¹¹⁹

Venture capital investment in Kenya is relatively young. Venture capital typically entails high risk for the investor, but it has the potential for above-average returns. It also includes managerial and technical expertise. Examples of venture capital companies in Kenya are Fanisi Venture Capital Fund and Industrial Promotion Services limited.¹²⁰ It is expected that the number of registered venture capital companies in Kenya will continue to grow since there is high demand for start-up capital although the market is yet to develop to allow for the listing of venture capital companies.

Venture capital has been injected to startup firms and small businesses that do not have access to capital markets, but have long-term growth potential. For example, Fanisi Venture

¹¹⁶Deloitte, 2010, "East Africa Private Equity Confidence Survey, Taking Measures' Retrieved on 5th March 2012<http://www.deloitte.com/assets/DcomKenya/Local%20Assets/Documents/Deloitte%20Report_EA%20Private%20Equity%20Confidence%20Survey%20Dec10.pdf>

¹¹⁷ Dr Tuimising NR – PhD Thesis, Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues; University of Warwick, 2012

¹¹⁸ R. K. Jain and Indrani Manna, 2009, "Evolution of global private equity market: Lessons, implications and prospects for India", p.119 Retrieved on 1 March 2012 from <<http://rbidocs.rbi.org.in/rdocs/Content/PDFs/2RKSN010210.pdf>>

¹¹⁹ Dr Tuimising NR – PhD Thesis, Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues; University of Warwick, 2012 p 174-175

¹²⁰Retrieved on 5th June from <http://www.investmentkenya.com/index.php?option=com_content&task=view&id=66&Itemid=52>

Capital Fund invested KES 124 million in to Elris, a telecommunications company in Kenya, a Kenya-based company that provides network implementation and management services to the telecommunications and broadcasting sectors in Kenya. It also invested KES80 million into card payment company Paystream Kenya to expand visa card technology in Kenya.¹²¹

Venture capital is divided into seed Finance,¹²² start-up finance,¹²³ first-stage finance¹²⁴, second-stage finance¹²⁵, third stage finance¹²⁶ and bridge finance¹²⁷ depending on what the portfolio company needs the additional capital.

2.7. The socio-economic role private equity plays in the Kenyan economy

Private equity investors have invested in various sectors including health, agricultural and energy. This is because they deem these sectors to be areas of high growth and social impact that can promote access to critical goods and services to low income populations.¹²⁸ They have also invested in small to medium size businesses that are in need of capital to finance a management or leveraged buyout (LBO)¹²⁹ or those businesses that need to effect a turn around.¹³⁰ For example SMEs that engages in activities for export, manufacture, supply goods and services to core industries driving the economy. More recently, institutions of higher learning such as universities are turning to private equity funds to finance their expansion and development projects.¹³¹

¹²¹ Retrieved on 5th July 2012 from <<http://www.fanisi.com/page.php?id=10>>

¹²² Seed finance is private equity finance is used to providing small sums of capital necessary to develop a business idea.

¹²³ Start -up finance is private equity finance is a source of capital for companies whose products are at the initial development and marketing stage

¹²⁴ At this stage, private equity finance enhances the commercialization and production of products.

¹²⁵ Private equity financing provides working capital funding and required financing for young firms during growth period.

¹²⁶ Private equity finance provides capital for the expansion of growing companies.

¹²⁷ Here private equity capital finances the last round prior to an initial public offering (IPO) of a company.

¹²⁸ Deloitte, 2010, 'Private equity news, new frontiers, more growth' <<http://www.deloitte.com/assets/Dcom-Kenya/Local%20Assets/Documents/Deloitte%20-%20Private%20Equity%20News.pdf>>

¹²⁹ In carrying out an LBO, the acquiring company seeks to acquire a company from existing owners. To do this the acquiring company must obtain a significant controlling share in the company it intends to acquire. The acquisition costs are met by a significant amount of debt obtained from a pool of private equity capital. Both the acquiring and acquired companies' assets secure the debt.

¹³⁰ A turnaround is a recovery strategy for a company that has been underrated or has been performing poorly for a long time. A private equity investor will normally provide capital to such a risky firm if he can accurately anticipate that the company will tremendously improve and that there are prospects of there being high, solid returns on the investment.

¹³¹ The Africa Integras Fund (AIF) is being launched by the Christie Company to pursue university community partnerships in Africa focused on investing in affordable student housing and educational facilities in mixed-use development projects. To do this, it is has partnered with Cassia Capital Partners, a local corporate finance advisory services firm with an interest in East Africa's emerging private equity market. Retrieved on 5th July 2012 from <<http://www.christiecompany.com/integras-fund.html>> and <<http://blog.7071group.com/?p=256>>

Following private equity capital investments, the Kenyan economy has benefited in the following ways:

- By providing start-up capital for small businesses, private equity functions to promote research and development in innovative technology and intellectual property.
- Job creation through the encouragement of local entrepreneurship projects
- Capital injected into small or medium enterprises has led to their growth and increased business productivity. This is in terms of sales, exports and expanded markets.
- Private equity has promoted corporate development through the provision of capital for expansions, consolidations, implementing change in a company's capital structure and spinouts of divisions or subsidiaries.

3. Conclusion

An in depth examination of the historical development of private equity has demonstrated the very important role it plays in facilitating growth and development of global economies. It can be observed that private equity has evolved over time from simple transactions to include complex transactions and market structures. In some countries such as USA and UK, private equity markets are highly developed while markets in countries such as the ones in India and Kenya are still emerging. It is also evident that some countries have adopted twin peak regulatory models while the majority has adopted single models.

Analysis of the Kenya private equity market shows that though in its infant stages, it is expected to experience a continuous growth curve. Competition among funds is bound to increase owing to expected increased market.

A shift in the investment focus of private equity investors from acquisition of stakes in small to medium size enterprises has been noted. This shift is not entire though. Private equity capital is being injected into various economic sectors such as education, infrastructure and real estate. It is also evident that private equity has gained wide acceptance and is preferred as a form of alternative investment by many Kenyan investors.

CHAPTER TWO: THE LEGAL FRAMEWORK FOR PRIVATE EQUITY REGULATION IN KENYA

2.1 Introduction

The regulatory framework for private equity¹³² in Kenya can be summarized as follows:

Law/ Development	Impact
1.The Capital Markets Authority Act (Cap 485 A)	Established the Capital Markets Authority which is the financial services regulator in Kenya.
2.The Retirement Benefits Act, 1997 and Schedule G to the Act	Regulates the kind of investments Retirement Benefit Schemes make as well as the activities of fund managers.
3.The Proceeds of Crime and Anti-money Laundering Act No. 9 of 2009	Is the regulatory framework that deals with financial crimes
4.The Competition Act No.12 of 2010	Regulates of competition among businesses in Kenya. Addresses the issue of multiple directorship
5.The Companies Act	Provides for the private limited company as a vehicle through which private equity funds can be operated. Also contains provisions relating to capital structuring.
6.The Limited Partnership Act	Provides for the limited liability partnership as a vehicle through which a private equity fund can be operated.

¹³² The term 'Private Equity' in this context will be used to refer to the entire industry i.e. venture capital, expansion and development stages of a business, equity capital for management buy-outs (MBOs) and management buy-ins.

- | | |
|--|--|
| 7. The Capital Markets (Registered Venture Capital Companies) Regulations, 2007, | Regulates the activities of registered venture capital companies. |
| 8. The Capital Markets (Collective Investment Schemes Regulations) 2001 | Regulates the activities of collective investment schemes in Kenya. |
| 9. The Capital Markets (Securities) (Public Offers, Listing and Disclosures) (Amendment) Regulations 2008. | Regulates activities such as IPOs and listing of companies in the Nairobi Securities Exchange. |

2.2. Private Equity Funds in Kenya

Private equity funds in Kenya are operated under various institutional forms. A detailed examination of the various types of institutional structures is given below.

2.2. a. Venture capital funds

Venture capital funds are operated by Venture Capital Companies. A venture capital company is one which has been duly incorporated under the Companies Act as a company limited by shares¹³³ with its principal object the provision of risk capital to small and medium size businesses in Kenya through equity, quasi-equity investments or other instruments whether convertible into equity or not as well as managerial or technical expertise to such business entities.¹³⁴ The Capital Markets Authority regulates all financial activities including those of venture capital companies. The applicable law that regulates venture capital companies in Kenya is the Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

A venture capital company must be registered with the Capital Markets Authority (CMA) before commencing its operations. The registration application form is set out in the First Schedule to the Act.¹³⁵ An application for registration as a venture capital company should be accompanied by among other things details of the investment policy¹³⁶ in respect of each

¹³³ Regulation 4 (a) The Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

¹³⁴ Regulation 4 (b) *ibid*

¹³⁵ Regulation 4 The Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

¹³⁶ The investment policy should set out the following particulars-

- (i) Investment objectives;
- (ii) Minimum and maximum investment amounts in any single enterprise;
- (iii) Investment rules, investment process (including minimum commitment and investment periods and procedures for draw down) and exposure limits to individual eligible venture capital enterprises;

fund to be operated by the applicant, the management agreement between the registered venture capital company and the fund manager containing their particulars and a bank reference from a commercial bank duly licensed under the Banking Act stating the length of its relationship with the applicant and containing a statement on the manner in which the applicant has managed its account(s).¹³⁷

A venture capital company is entitled upon making an application to the Authority in the prescribed form and on payment of the prescribed fee to be registered under the Capital Markets (Registered Venture Capital Companies) Regulations, 2007.¹³⁸

Venture capital companies are required to have a minimum paid up share capital of one hundred million shillings and a minimum fund of one hundred million shillings.¹³⁹ These funds are raised privately.¹⁴⁰ In order to engage in fundraising activities, a venture capital companies must publish a placement memorandum which shall contain details on the terms and conditions on which funds are to be raised from investors.¹⁴¹ The placement memorandum must be filed with the CMA thirty days before its publication.¹⁴² The company is also required to take all reasonable measures to verify the sources of its funds as well as its investments to ensure it is not used as a conduit for funds sourced from or to be applied to criminal or socially undesirable activities including but not limited to money laundering and corruption.¹⁴³

The law requires a venture capital company to appoint a licensed fund manager in charge of its operations, before it seeks registration.¹⁴⁴ Such a person must be approved by the CMA to manage the funds of the venture capital fund.¹⁴⁵ Fund management is a regulated activity. Section 23 (1) CMA Act provides that:

(iv)The preferred mode of divestiture from eligible venture capital enterprises; disclose a clear strategy for the diversification of investments in eligible venture capital enterprises.

(vi)Policies on fees and charges;

(vii)Profile of companies invested in (where applicable); and

(viii)Details of risks factors that are specific to the chosen investment sectors, or sectors intended to be invested in.

¹³⁷ Regulation 4 The Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

¹³⁸ Regulation 3 (1)

¹³⁹ Regulations 4 (c) and (d) the Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

¹⁴⁰ Regulation 15 the Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

¹⁴¹ Regulation 17 *ibid*

¹⁴² Regulation 16 the Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

¹⁴³ Regulation 29 *ibid*

¹⁴⁴ Regulation 3(1) (g)

¹⁴⁵ Regulation 9 the Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

(1) No person shall carry on business as a securities exchange, stockbroker, dealer, investment adviser, fund manager, investment bank, authorized securities dealer, authorized depository, or hold himself out as carrying on such a business unless he holds a valid license issued under the Act.”

(2) No person shall carry on or hold himself out as carrying on business as a registered venture capital company, collective investment scheme, central depository or credit rating agency unless he is approved as such by the Authority.

(3) A person approved by the Authority to carry out any business required by this Act to be approved shall comply with all requirements of the Authority and pay an annual fee to the Authority at such rate as the Authority may prescribe.

(4) Nothing in this section shall be construed as limiting the powers of the Authority to approve or license any other person operating in any other capacity which has a direct impact on the attainment of the objectives of this Act.

The duties of the fund manager include ensuring that a prudent investment policy is in place in respect of each fund, all fund investments are carried out in accordance with the disclosed investment policy and in compliance with the Capital Markets Act and Regulations and all other applicable laws and notify the Authority immediately and in any event in writing within twenty four hours of any event that results in less than seventy five percent of the investable funds of the registered venture capital company being invested in eligible venture capital enterprises.¹⁴⁶

A venture capital enterprise is a small or medium sized business entity incorporated under the Companies Act which is in need of venture capital investment for purposes of financing a new product or for expansion of the business entity. Their business does not involve trading in real property, banking and financial services and retail and wholesale trading services.¹⁴⁷

A close examination of the wording of Section 23(1) of the Capital Markets Act and Regulation 3(1) of the Registered Venture Capital Companies Regulations 2007 reveals that there is a dual framework for the regulation of private equity (venture capital) activity. The

¹⁴⁶ Regulation 10 *ibid*

¹⁴⁷ *ibid*

provisions of the Act requiring fund management and investment advisory services to be subject to regulation are not necessarily targeted at private equity per se. The provisions of the 2007 Regulations, on the other hand, are dedicated to private equity investment activity. The wording of Section 23 of the Act is not clear as to whether ‘approval’ and ‘licensing’ are equal or alternative terminologies and there is no case law that offers an interpretation of these terms. This ambiguity is one of the loopholes that necessitate law reform in the regulatory framework.

The law requires an applicant to meet the minimum capital requirements to register, having a capital base larger than the minimum required to qualify for registration does not give rise to a mandatory requirement to register. The overall effect is that only registered venture capital companies will be subject to the law while unregistered ones will operate outside it. It is not clear how to classify unregistered funds that fall under the minimum capital requirement threshold. This uncertainty leaves a gap in the regulatory regime thus making it unclear.

2.2. b. Collective investment schemes

The operation of collective investment schemes is a financial activity that is regulated by the Capital Markets Authority.¹⁴⁸ It is an offence for any person to carry on any business or engage in any activity as a collective investment scheme, in Kenya, unless they are registered under the CMA Act.¹⁴⁹ Persons seeking to establish a collective investment scheme (CIS) are known as promoters. An application for consent from the CMA to operate a collective investment scheme must be accompanied by the required documents.¹⁵⁰

Once the promoter has received CMA’s consent to register the collective investment scheme, they must make an application to the CMA in triplicate in Form 1 set out in the First Schedule, within three months after the grant of consent, accompanied by the required documents.¹⁵¹ The promoter will be given notice of the authority’s decision to register within thirty days of receipt of the application.¹⁵²

The key documents that contain management and administrative guidelines that aid in the effective management of a CIS include the rules, information memorandum, service agreement, trust deed and the incorporation documents. The incorporation documents provide

¹⁴⁸ Section 23 CMA Act, CMA (Collective Investment Scheme Regulations) 2000.

¹⁴⁹ Section 30(1) Capital Markets Authority Act

¹⁵⁰ Section 3&4 Cap 485 A, Laws of Kenya

¹⁵¹ Section 5 Cap 485 A, Laws of Kenya

¹⁵² Section 6 Capital Markets Authority Act

for the functions of the fund manager. The trust deed prescribes among other things the scheme's investment policy and the manner in which shares can be transferred as between holders.¹⁵³ Fund management is a regulated activity; therefore, a fund manager must be licensed by the Capital Markets Authority.¹⁵⁴

The fund manager is responsible for managing the day to day operations of the CIS. He is required by law at all times to maintain a paid-up share capital and unimpaired reserves of not less than ten million shillings for the operation of the CIS.¹⁵⁵ His other functions include but are not restricted to advising the trustees/ board of directors of the asset classes available for investment, arranging deals in and managing the portfolio investments, formulating a prudent investment policy¹⁵⁶, investing the scheme's assets in accordance with the scheme's investment policy, reinvesting any income of the CIS that has no immediate use¹⁵⁷ and maintenance of records such as proper books of accounts, resolutions and minutes of meetings.¹⁵⁸

In Kenya the law on collective investment schemes focuses on those that are open to public subscription i.e. mutual funds. There has been no development in the law to cater for schemes that are restricted circle of institutional investors and not to members of the public.

2.2. c. Retirement Benefit Scheme Funds

The statutory definition of a Retirement Benefits Scheme (RBS) is, "any scheme or arrangement (other than a contract for life assurance) whether established by a written law for the time being in force or by any other instrument, under which persons are entitled to benefits in the form of payments, determined by age, length of service, amount of earnings or otherwise and payable primarily upon retirement, or upon death, termination of service, or

¹⁵³ Section 31, Capital Markets Authority (Collective Investment Scheme Regulations) 2001.

¹⁵⁴ Section 23 (1) CMA Act, Section 16 (1), Capital Markets Authority (Collective Investment Schemes Regulations) 2001

¹⁵⁵ Section 16(3) *ibid*

¹⁵⁶ The investment strategy determines:

- a) The funds focus on either early or late stage venture capital, growth capital, buy outs or all these.
- b) What sector the fund will invest in for example real estate, technology etc.
- c) Geographical location of the investments the fund will make.
- d) The size of the investment made.

¹⁵⁷ Section 17, Capital Markets Authority (Collective Investment Schemes Regulations) 2001.

¹⁵⁸ Section 18, *ibid*

upon the occurrence of such other event as may be specified in such written law or other instrument”.¹⁵⁹

An example of a RBS would be a pension scheme. All RBSs must be registered and issued with a certificate.¹⁶⁰The day to day operations of a RBS are run by a manager who is a limited liability company incorporated under the Companies Act whose liability is limited by shares and meets the requirements of Section 25 of the Act.

The manager’s functions include undertaking, pursuant to a contract or other arrangement, the management of the funds and other assets of a scheme fund for purposes of investment, providing consultancy services on the investment of scheme funds and reporting or disseminating information concerning the assets available for investment of scheme funds.¹⁶¹

Before any investments are made by the pension scheme, it is mandatory that it prepare and submit to the Authority (and after every three years revise and submit to the Retirement Benefits Authority) a written statement of the principles governing investments decisions for the purposes of the scheme or the pooled fund.¹⁶²The statement shall be signed by the trustees and the investment adviser and cover, among other things the policy of the scheme in compliance investment guidelines, the categories of investments to be held, risk, the realization of investments and asset liability matching.¹⁶³

Section 38 (1) of the Retirement Benefits Act, 1997 outlines the investment guidelines to be followed by RBSs. It provides that a retirement benefit scheme, or pooled fund, shall invest only in an asset class referred to in column 1 of Form 1G as prescribed to the extent to which the market value of the investment in the class expressed as a percentage of the total assets of the scheme or pooled fund, does not exceed the percentage listed in column 2 of Form 1G as prescribed in respect of such asset.

With regard to making investments in private equity Section 38 (1) (d) of the Act provides that the maximum investment a retirement benefit scheme can make in the unquoted equity, commercial paper, loan stock and debentures issued by the company controlled by or a related company of the sponsor is three per centum of the aggregate market value of the total

¹⁵⁹ Section 2 Retirement Benefits Act 1997

¹⁶⁰ Section 22 (1) and 23 The Retirement Benefits Act 1997

¹⁶¹ Section 2 Retirement Benefits Act, 1997

¹⁶² Section 37 (1) Retirement Benefits Act, 1997

¹⁶³ Section 37 (2) *ibid*

assets of the scheme; provided that Investments in the category "Any other asset" shall be subject to prior written approval of the Authority, which shall be formally considered by the Authority within thirty days of application by a scheme.

Pension scheme managers who want to invest in private equity first obtain the Board of Trustees Strategic Decision. Then the investment policy must be updated to allow for private equity investments and giving a strategic allocation range for private equity. The updated investment policy statement will then be submitted to the Retirement Benefits Authority (RBA). The RBA will work with the retirement benefit scheme's manager to identify General Partner (GP) or Fund of Funds to invest in. the RBS manager must exercise reasonable care and conduct an investigation or audit of the proposed investment. The trustees will then request the RBA in writing for consent to invest. Approval or denial of this written request to invest in the proposed investment must occur within 30 days.¹⁶⁴

Despite the consistent high returns on investment private equity investors enjoy, retirement benefit schemes are yet to enjoy the same seeing as the current legal regime is very prohibitive of them investing in private equity.

2.2. d. Limited liability partnership funds

A private equity firm can operate as a limited liability partnership¹⁶⁵ and establish a private equity fund in the form of a limited liability partnership fund. Such a fund is made up of not more than twenty investors. One or more investors act in the capacity of the general partner(s). The general partner is liable for all debts and obligations of the firm.¹⁶⁶ He functions as the fund manager¹⁶⁷ and is responsible for managing the fund as per the limited partnership agreement.

The other investors including (a body corporate) are referred to as limited partners. They are not involved in the day to day operations of the fund. Limited partners contribute capital

¹⁶⁴Kiptanui Tony, 2011, "Investing in Private Equity –A Regulatory Perspective" Retrieved on 5 April 2012 from <http://www.pencom.gov.ng/download/seminars/PE_Round_Table/Regulatory%20Perspective%20-%20Retirement%20Benefits%20Authority%20of%20Kenya.pdf>

¹⁶⁵Section 6 of the Limited Partnership Act 2011 provides that a limited liability partnership is an entity formed by being registered under this Act. On being registered under this Act, a limited liability partnership becomes a body corporate with perpetual succession with a legal personality separate from that of its partners.

¹⁶⁶ Kocis, James M.; Bachman, James C., IV; Long, Austin M... Inside Private Equity: The Professional Investor's Handbook. Hoboken, NJ, USA: Wiley, 2010. p16. Retrieved on 5 April 2012 <<http://site.ebrary.com/lib/uonbi/Doc?id=10371796&ppg=44>>

¹⁶⁷ Section 2 CMA Act defines a fund manager as one who manages the activities of a collective investment scheme, registered venture capital company or an investment adviser who manages a portfolio of securities in excess of an amount prescribed by the Capital Markets Authority (CMA) from time to time

valued at a stated amount, and are not liable for the debts or obligations of the firm beyond the amount so contributed.¹⁶⁸ The limited partnership agreement outlines the life span of the fund obliging the investors to remain committed (for the total amount committed less any cash returned to them following deal exits) for the total life time of the fund or until all of the investments have been successfully divested.¹⁶⁹

2.2. e. Funds owned by quoted investment companies

Quoted investment companies are investment companies whose shares are publicly traded. They previously operated as private investment companies. Such companies must be duly incorporated under the Companies Act. Examples of these are Centum, Trans Century and British American Investment Company Limited. Such companies have funds from which they make their investments. Their investment specialties vary from private equity, quoted equity, real estate and infrastructure. Their day to day operations are managed by fund managers whose duties are similar to those of a fund manager who manages a private equity fund operated by a limited liability partnership.¹⁷⁰

2.3. The Capital Structure of Private Equity Funds in Kenya

Capital structuring is the process through which a firm obtains funds to finance its overall operations and growth. One source of funds that is available to firms is private equity. The management of the portfolio company must alter its capital structure so as to enable private equity investors to provide funds to their companies. Private equity funding would involve the acquisition of the company's shares by the private equity fund. This in turn means that the company must raise new shares. The law allows a company to raise capital by issuing new shares, and in the process consolidate or divide all or any of its existing share capital into new share types and categories, including converting common equity into redeemable preference shares or vice versa, and can subdivide existing shares into lower-denominated securities

¹⁶⁸ Section 3(4) *ibid*

¹⁶⁹Section 12(1) Limited Partnership Act 2011, Financial Services Authority "Private equity: A discussion of risk and regulatory engagement" p.25 Retrieved on 15 March 2012 from <http://www.fsa.gov.uk/pubs/discussion/dp06_06.pdf>

¹⁷⁰'Trans Century' < <http://www.transcentury.co.ke/aboutus>>, 'Centum' <<http://www.centum.co.ke/about-us>> 'British American' < <http://www.britak.co.ke/index.php/about-us/company-profile.html>> Date Accessed 5th July 2012

provided the overall effect is not to reduce the company's share capital.¹⁷¹ It can also issue other securities such as share warrants¹⁷² and debentures.¹⁷³

It is mandatory for any private limited company limited by shares to seek special authority before it can alter its capital structure by issuing shares.¹⁷⁴ A special resolution by all shareholders, and court approval, is necessary prior to any share capital reduction.¹⁷⁵

Any capital structuring process following a private equity investment into a portfolio company therefore needs to ensure the company's share capital is either varied upwards or preserved after the conclusion of the share re-distribution following an investment. As a matter of practice usually, before a private equity firm makes an investment in a portfolio company, the company's memorandum and articles of association must be amended to entrench necessary powers and commitments in those constitutive instruments so that the investment can be supported under law.¹⁷⁶

Section 61 of the Companies Act enables companies to 'issue shares of difference' i.e. shares of the same class but carrying different amounts and subject to different times on payment calls. This is an important instrument in the hands of both the venture company and the private equity investor. It allows for the navigation of potentially difficult financing propositions, enabling the contracting parties to institutionalize their respective positioning in light of the intrinsic characteristics of the investment opportunity.

Although the holders of preference shares may not be entitled to voting rights, or to regular dividend payments, a company may under Section 74¹⁷⁷ of the Companies Act introduce new class rights for this special share category to allow them a form of voting rights,

¹⁷¹ *ibid*

¹⁷² Section 85 Companies Act

¹⁷³ Section 88 Companies Act

¹⁷⁴ Section 63 Companies Act

¹⁷⁵ Section 69 Companies Act

¹⁷⁶ Dr Tuimising NR, PhD Thesis: Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues, University of Warwick, 2012 p. 179

¹⁷⁷ Section 74 (1) - " If in the case of a company, the share capital of which is divided into different classes of shares, provision is made by the memorandum or articles for authorizing the variation of the rights attached to any class of shares in the company, subject to the consent of any specified proportion of the holders of the issued shares of that class or the sanction of a resolution passed at a separate meeting of the holders of those shares, and in pursuance of the said provision the rights attached to any such class of shares are at any time varied, the holders of not less in the aggregate than fifteen per cent of the issued shares of that class, being persons who did not consent to or vote in favour of the resolution for the variation, may apply to the court to have the variation cancelled, and, where any such application is made, the variation shall not have effect unless and until it is confirmed by the court."

including veto rights, as well as entitle them to periodic dividend payments. Conditions could also be attached to the vesting of shares, whatever class the shares may fall into. These conditions could include performance indicators, and triggers to conversion based on exigencies defined under the financing agreement.

2.4. Private equity transactions

A simple private equity transaction involves a purchase and a sale agreement. For example the process of purchasing shares in a private company involves an acquisition or subscription transaction. In order for the investor/shareholder to realize the value in the shares they acquired in a company they sell their stake.

The total private equity transaction opportunity set in Kenya is a function of operational factors which include among others the liquidity of the Nairobi Securities Exchange, increased investment by pension funds in private equity, the assessment of the level market penetration and competition among current players and new entrants and the legal environment.¹⁷⁸

Types of private equity transactions:

Syndication

Private equity investors would syndicate a deal when the amount of funding required is particularly large, or when the investment is considered to be relatively high risk, the private equity firm may consider syndicating the deal. The process of syndication involves several private equity firms which participate in the deal, each putting in part of the total equity package for proportionate amounts of equity, usually with one private equity firm acting as lead investor.¹⁷⁹

Management Buy Outs

A Management Buy-Out (MBO) transaction is one where a company's management team buys the company they work for from its current owners with private equity backing. It is an acquisition transaction during which a private equity fund can acquire the target company.¹⁸⁰

This transaction is much like any other corporate merger and acquisition (M&A) deal. The

¹⁷⁸Ernst & Young, 2012, Private Equity Round up Africa p.5 Retrieved on 5th April 2012 from <[http://www.ey.com/Publication/vwLUAssets/Private_Equity_in_Africa/\\$FILE/PE%20in%20Africa_A4_lowres_FR0051.pdf](http://www.ey.com/Publication/vwLUAssets/Private_Equity_in_Africa/$FILE/PE%20in%20Africa_A4_lowres_FR0051.pdf)>

¹⁷⁹ BVCA, 'A Guide to Private Equity'

¹⁸⁰ A company which is the subject of a merger or acquisition attempt.

key document is the share purchase agreement, which sets out the terms on which the private equity fund will acquire the company from its current owners.

Often, the acquisition will be leveraged i.e. will be financed partly through debt (that is, by taking a loan from a bank or other debt provider in this case a private equity investor). Where the acquisition is financed by private equity investors, the private equity fund will need to negotiate the terms on which it will borrow from the lenders. The key document for this element of the transaction is the facility agreement.

The Kenyan law on the provision of debt to finance the purchase or subscription for any shares in a company is contained in Section 56 (1) of the Companies Act. Section 56 of the Companies Act expressly prohibits any form of financial assistance relevant to the conduct of private equity transactions. This provision makes it illegal for a company to give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares in the company, or where the company is a subsidiary company, in its holding company.

Where private equity investors provide debt to finance the acquisition, the portfolio company or its subsidiaries might be required to give security as collateral for the acquisition loan. The board of directors in the target company must pass a resolution authorizing the issuance of such guarantees or security. The issue of conflict of interest arises on the part of the directors if by giving a security or guarantee they contravene Section 56 of the Companies Act. In **Standard Bank Ltd V Mehotoro Farm Ltd & 2 Others**,¹⁸¹ the appellant provided a loan to the company to enable the respondents to purchase the company's shares. This was completed by the making of a direct payment to two directors through the company and releasing the directors from their joint and several guarantees in respect of outstanding bank overdraft. The share acquisition transaction was secured by fresh guarantees by the acquiring directors in respect of the cost of the shares to be purchased, which guarantees were up-stamped by instruments of variation, and charged on the immovable assets of the company. Justice Lutta, BCW, JA, held the transaction amounted to financial assistance under Section 56 of the Companies Act, and was void for illegality. *Judge Lutta*, BCW, observed, orbiter, in

¹⁸¹CC 54 [1972] CA Pp.12-14. <<http://kenyalaw.org/CaseSearch/>> As cited by Dr Tuimising NR, PhD Thesis, Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues, Warwick University 2012 p. 227

this case, that, “financial assistance” covers any transaction where not only money but also a security, is provided by a company in order to enable a person to purchase or acquire its shares”.

Under Section 56 of the Companies Act there are no exceptions to the general rule that make it possible for financial assistance of the kind desired by Kenyan private equity intermediaries to be granted. The Kenyan market is therefore a conservative one.

Sometimes a private equity takeover may not necessarily be in the interest of a target company. Minority shareholder protection remains an important issue fund managers ought to consider when designing private equity investments. The law protects minority shareholders in various ways. For example, they cannot be coerced into selling out to the acquisition shareholder unless the buyout involves the transaction of over 90% of the shares in the company acquired.¹⁸² The law requires that where minority shareholders’ holding is at least 10% of the company’s issued share capital, an extraordinary meeting of the company, must be convened by the directors; before. In addition, 15% or more of the minority shareholders aggrieved by a decision or action of the directors can petition the court for protection.¹⁸³

Section 47¹⁸⁴ of the Competition Act No.12 of 2010 requires that in effecting a merger or acquisition, the protection of the legitimate interests of all stakeholders affected by the transaction must be considered.

Kenyan law does not expressly prohibit corporate raids and such negative practices as greenmails¹⁸⁵ and poison pills.¹⁸⁶ Being strategies that private equity has employed before, it is important that the current private equity legal regime be reformed to address these issues.

¹⁸² Section 210 Companies Act

¹⁸³ *ibid*

¹⁸⁴ Section 47

¹⁸⁵ A situation in which a large block of stock is held by an unfriendly company. This forces the target company to repurchase the stock at a substantial premium to prevent a takeover. Retrieved on 5th June 2012 from <<http://www.investopedia.com/terms/g/greenmail.asp#ixzz1zjP2oG8t>>

¹⁸⁶ A strategy used by corporations to discourage hostile takeovers. With a poison pill, the target company attempts to make its stock less attractive to the acquirer. There are two types of poison pills: A "flip-in" allows existing shareholders (except the acquirer) to buy more shares at a discount. A "flip-over" allows stockholders to buy the acquirer's shares at a discounted price after the merger. Retrieved on 5th June 2012 from <<http://www.investopedia.com/terms/p/poisonpill.asp#ixzz1zjOYC9zG>>

2.5. Corporate Governance

Corporate Governance refers to the manner in which the power of a company is exercised in the stewardship of the corporation's total portfolio of assets and resources with the objective of maintaining and increasing shareholder value and satisfaction of other stakeholders in the context of its corporate mission.¹⁸⁷ Corporate governance affects matters related to financial information and conflicts of interest. The focus is on the conduct of fund managers in executing their duties, since they owe a fiduciary duty to investors. In particular, the corporate governance requirements for venture capital companies shall be the subject of discussion.

Venture Capital Funds

i. Conduct of business requirements

Part V of The Registered Venture Capital Companies Regulations 2007 (herein referred to as 'The Regulations') seeks to regulate the conduct of business by venture capital fund managers as well as prudential requirements they must meet. The provisions contained therein affect matters such as the approval of fund managers,¹⁸⁸ their resignation,¹⁸⁹ their removal,¹⁹⁰ them handing over to new fund managers¹⁹¹ and the appointment of a new fund manager following the removal of the previous one.¹⁹²

ii. Prudential business requirements

The Regulations also contain provisions pertaining to the obligations of fund managers.¹⁹³ These obligations which are prudential in nature, include to ensure that: a prudent investment policy is in place in respect of each fund,¹⁹⁴ all fund investments are carried out in accordance with the disclosed investment policy and in compliance with the Capital Markets Act and Regulations and all other applicable laws,¹⁹⁵ and to notify the Authority immediately and in any event in writing within twenty four hours of any event that

¹⁸⁷Principles for Corporate Governance in Kenya and a Sample Code of Best Practice for Corporate Governance Retrieved on 5th June 2012 from <http://www.ecgi.org/codes/documents/principles_2.pdf>

¹⁸⁸ Regulation 9 The Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

¹⁸⁹ Regulation 11 The Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

¹⁹⁰ Regulation 12 The Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

¹⁹¹ Regulation 13 The Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

¹⁹² Regulation 14 The Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

¹⁹³ Regulation 10 *ibid*

¹⁹⁴ Regulation 10 (a) The Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

¹⁹⁵ Regulation 10 (b) The Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

results in less than seventy five percent of the investable funds of the registered venture capital company being invested in eligible venture capital enterprises.¹⁹⁶

iii. Financial Reporting Requirements

Financial reporting is a very important aspect of information disclosure. Disclosure in private equity is quite hard to pin down. Unlike listed entities whose activities are subject to public scrutiny, the disclosure requirements of private equity companies are dependent on the partners' discretion and such disclosures are kept away from the public eye. It is up to the funds to volunteer information about themselves. Most private-equity limited partnership agreements call for some sort of regular disclosure to investors, such as aggregate annual and quarterly financial statements prepared as per International Financial Reporting Standards.¹⁹⁷

The information contained in annual and quarterly reports may not require line item information about particular investments. However, in practice, some disclosure beyond this usually occurs. The most typical information that is disclosed would relate to where the money has been invested, expectations or forecasts of future profitability, and a valuation of the individual portfolio firms.¹⁹⁸

In Kenya, venture capital fund managers are required to keep books of account and maintain records that accurately reflect the affairs of the funds under its management. These records are to be preserved for at least seven years after the completion of the transaction to which it relates.¹⁹⁹ They are also required to make quarterly returns within one month after the end of each quarter detailing of any investments made by each fund under its management during the quarter, the consideration paid for those investments, details of any disposals of investments during the quarter, and any profit derived or loss incurred from those disposals (including details of how that profit or loss was calculated).²⁰⁰ The directors of the registered venture capital company are required to within three months of the end of the registered venture capital company's financial year, file with the Authority statements of the company's annual returns.²⁰¹

¹⁹⁶ Regulation 10 (c) *ibid*

¹⁹⁷ James C. Spindler, 2009, 'How Private Is Private Equity, and at What Cost?' ,The University of Chicago Law Review, Vol. 76, No. 1, pp. 311 Retrieved on 5th April 2012 from< <http://www.jstor.org/stable/27654704>> p 325

¹⁹⁸ *ibid*

¹⁹⁹ Regulation 19 The Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

²⁰⁰ Regulation 20 *ibid*

²⁰¹ Regulation 21 The Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

Continuing Obligations

The Capital Markets Authority Act requires venture capital fund managers and companies to ensure that they renew their licenses subject to the procedure contained in the Act and conditions of the Capital Markets Authority.²⁰² Furthermore the Act requires holders of venture company capital licenses to report any changes to the business for example should they cease to conduct that business and changes to particulars of the business²⁰³ that are entered in the Register of businesses.²⁰⁴ It is a statutory requirement that Capital Markets Authority maintains an updated register of license holders for publication in the Kenya Gazette before 30th April every year.²⁰⁵

Conflicts of interest

Multiple Directorships

As was mentioned earlier, the disclosure requirements of listed companies are more as compared to that of private ones. This ensures that upon acquisition of a portfolio company, information such as the business restructuring plans used by the private equity firm remain secret. In the case of a buy-out transaction one of the after effects include changes in management and ownership of a company.

Conflicts of interest can arise in two instances between fund managers and the portfolio (target) company to be acquired. The first instance is in the case of a management buy-out transactions the share purchase agreement sets out the terms on which the private equity fund will acquire the company from its current owners. One of these terms maybe that the directors of the target buy out company will need to enter into deals with the external private equity investors, while at the same time still remaining as its directors.

Kenyan law requires a director of a company who is in any way, whether directly or indirectly, interested in a contract or proposed contract with the company has a duty to declare the nature of his interest at a meeting of the directors of the company.²⁰⁶ *Justice OK Mutungi* in the case of **Azim Virjee & Two Others v Glory Properties Limited**²⁰⁷ said that

²⁰² Section 25 Capital Markets Authority Act

²⁰³ Section 27 (2)of the CMA Act: The particulars of the business in this respect include: (a) the name of the license holder (b) the address of the principal place at which he carries on the licensed business; and (c) the name or style under which the business is carried on if different from the name of the holder of the licence.

²⁰⁴ Section 28 CMA Act

²⁰⁵ Section 27 (1) CMA Act

²⁰⁶ Section 200 (1) Companies Act

²⁰⁷ [2007] eKLR, CC559/1999 (HC)

a director who holds 50% beneficial ownership in a property owned by the company suffers a direct conflict of interest and contravenes the law.

The second instance where conflict of interest may arise between fund managers and the target or portfolio company is in the case where a fund manager acquires shares in two companies operating in the same sector; thus entitling them to sit in the boards of the invested or acquired companies. Thus giving rise to the problem of multiple directorships. Such a director might act as a conduit, conscious or unconscious, of commercially sensitive information between the portfolio companies.

The Competition Act 2010 is the only statute that deals with the issue of multiple directorships by seeking to limit instances that this would occur. This Act envisages that this situation would arise within horizontal relationships which are illegal²⁰⁸ therefore there is a presumption by default that a concerted practice potentially restrictive of trade exists where two or more undertakings share a director – or where one entity owns a substantial interest in more than one entity.²⁰⁹ The presumption under subsection (5) of Section 21 of the Competition Act 2010 is rebuttable. An undertaking or a director or shareholder concerned can establish that a reasonable basis exists to conclude that any practice in which any of the undertakings engaged was a normal commercial response to conditions prevailing in the market.²¹⁰

The Common law position on multiple directorships has evolved such that for example in earlier cases such as **London and Mashonaland Exploration Co. Ltd V New Mashonaland Exploration Co. Ltd**²¹¹ the court held that there did not exist any rule of law that prevented a director from becoming a director in a competitor company. Similarly, in **Balston V Headline Filters**²¹² it was held that a director who formed a company and took orders for future delivery and agreed a leasing arrangement with the new company did not breach the duty on conflict interest. In more recent cases such as **Bristol and West Building**

²⁰⁸ Section 21 (1) Competition Act 2010: Agreements between undertakings, decisions by associations of undertakings, decisions by undertakings or concerted practices by undertakings which have as their object or effect the prevention, distortion or lessening of competition in trade in any goods or services in Kenya, or a part of Kenya, are prohibited, unless they are exempt in accordance with the provisions of Section C of this Part. (2) Agreements, decisions and concerted practices contemplated in subsection (1), include agreements concluded between: a) parties in a horizontal relationship, being undertakings trading in competition(...)

²⁰⁹ Section 21 (5) (a) Competition Act 2010

²¹⁰ Section 21 (6) Competition Act 2010

²¹¹ [1891] WN 165

²¹² [1990] FSR 385

Society V Mothew²¹³ *Millett J* held that a director that works for two competitor companies “without obtaining the informed consent of both” breaches the duty of undivided loyalty, giving rise to a conflict of interest. However, from recent judgments the court is seen to be of view that each case must turn on its own facts, but overt actions that clearly show a conflict of interest are prohibited (for example the staff and customer poaching schemes sometimes observed in private equity transactions).²¹⁴ This judgment has left it open for courts to apply the law on the unique facts of each individual case for example in the case of **Helmet Integrated Systems v Tunnard**²¹⁵ the court did not find that the development of a competing product and formation of a company amounted to ‘overt’ actions giving rise to a conflict of interest.

The Companies Act of Kenya does not articulate a clear position on whether a director can have multiple directorships in portfolio companies. There is a need for law reform especially since this tends to affect the decision of fund managers with respect to their portfolios.

Conflict of interest can also arise as between the fund managers and their investors especially as regards information asymmetry.²¹⁶ When fund managers source for capital from investors there is a possibility that they may misrepresent their past performance by misreporting critical financial information. Since investors have little say over the management of the fund, its investment and disbursement policies, the fund managers can either mismanage the investor’s money or neglect a particular fund and direct their efforts to other funds knowing perfectly well that they will derive their income from asset management fees.²¹⁷

Conflicts of interest between the investors and entrepreneurs can also arise where entrepreneurs mislead the investors as to the quality of their start -up firms or product potential and end up reducing the effort they initially put into the business thus negatively impacting on the startup company’s performance (i.e. the investor gets low returns on their investment). Sometimes entrepreneurs of venture backed companies engage in asset

²¹³ [1998] Ch 1 18 CA

²¹⁴ *Shepherds Investments Ltd v Walters* [2007] 2 BCLC 202

²¹⁵ [2007] CA

²¹⁶ Information asymmetry is a condition in which at least some relevant information is known to some but not all parties involved. Information asymmetry causes markets to become inefficient, since all the market participants do not have access to the information they need for their decision making processes.<
http://www.investorwords.com/2461/information_asymmetry.html>

²¹⁷ *ibid*

tunneling²¹⁸ which has detrimental consequences to the portfolio company or when the PE investors and entrepreneurs do not agree on the timing and terms of the exit.²¹⁹ In **Kalashian v. Advent VI Limited Partnership**²²⁰, the board of directors of Alentec Corporation was sued for breach of fiduciary duty and fraud after approving a down round and several subsequent rounds of financing that greatly reduced the ownership percentage of the company's founders in favor of a venture capital fund which owned the company's preferred stock. The court's finding in this case suggests that any stockholder that is subjected to additional dilution mandated by a down- round might have a claim that directors of the company failed to exercise their fiduciary duties and protect the stockholders' interests when the directors voted to approve the transaction. The Registered Venture Capital Company Regulations 2007 do not contain provisions on asset tunneling.

2.5 Exit Options

Exit, or the sale of the portfolio company, is perhaps the most important step in the investment cycle for a private equity investor. The purpose of a private equity fund is to produce returns for investors. The main way for private equity funds to earn money from their investments is to sell/ divest of them. For example a sale may involve the shares they hold in their portfolio companies.²²¹

The exit is the very last stage of involvement by the private equity fund in the company. Acknowledging that the investments made by private equity funds are not long-term, exit conditions determine the potential gains that the fund can make. Fund managers are largely rewarded on the basis of the exit value they also have incentives to divest of the investment at the most profitable opportunity without unnecessary delay. The outcome and profitability of the exit strategy is a method used by the investors to examine the fund manager's competency. For a good number of venture capital investors an exit is the only way to make a return on the investment since they do not receive any dividends from the portfolio company.²²²

²¹⁸ Asset tunneling is the transfer of future opportunities for the startup company to other companies in order to increase their value or the probability of a successful exit.

²¹⁹ Supra p.367

²²⁰ Sup. Ct. Calif., No. CV-739278

²²¹ Cumming, Douglas (Editor). Robert W. Kolb Series: Venture Capital: Investment Strategies, Structures, and Policies. Hoboken, NJ, USA: Wiley, 2010. p.389. Retrieved on 5th April 2012 from <<http://site.ebrary.com/lib/uonbi/Doc?id=10388357&ppg=399>>

²²² ibid

Exit strategies are normally developed by fund managers to include any necessary measures to liquidate the investment at the highest possible return.²²³ In Kenya exit control clauses are added by fund managers into their contracts with portfolio companies, the most prevalent clauses being drag along rights, warrants and put options – in fairly equal proportions, and warrants as a less common exit control mechanism. These clauses confer upon the private equity fund rights that enable it to engineer a desired exit strategy, at a time most conducive to the investor.²²⁴

There are many types of exit options available to private equity firms.²²⁵ The three main methods are:

Trade sales

This is a process whereby the private equity fund sells its share of the shares in the portfolio company to another company in the same industry. A trade sale brings in high value as opposed to an IPO because the purchaser will need the company to supplement its own business area. This is the most preferred method used by Kenyan fund managers to exit investments since it has less regulatory constraints.²²⁶

Re purchase

The portfolio company in this case will buy back the shares held by the private equity fund. In this case the applicable law will be company law. This is also a very popular method Kenyan fund managers use to exit their investments.²²⁷

IPOs

This means that the portfolio company (usually a private one) is going public. When the firm is going public, the private equity fund or venture capitalist will also list their own private shares and thus convert them into public shares. IPOs are attractive as exit option to PE investors because they may need to signal their success to attract limited partner investments

²²³ Cumming, Douglas (Editor). Robert W. Kolb Series: Venture Capital: Investment Strategies, Structures, and Policies. Hoboken, NJ, USA: Wiley, 2010. p.389. Retrieved on 5th April 2012 from <<http://site.ebrary.com/lib/uonbi/Doc?id=10388357&ppg=399>>

²²⁴ Dr Tuimising NR, PhD Thesis: Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues, University of Warwick, 2012, p.189

²²⁵ 2007 Raising Venture Capital Finance in Europe Arundale, Keith p.280-281

²²⁶ Dr Tuimising NR, PhD Thesis: Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues, University of Warwick, 2012, p.189

²²⁷ *ibid*

to their new fund. Secondly, their private investment in the firm will not be lost as opposed to if disposal was done through a trade sale.²²⁸

Public listing enables them to sell these shares at the market price. The IPO stage is not the exit per se but only a pre stage. In majority of the cases private equity firms may not be able to sell their shares for some time. This period is referred to as the lock up period. The main reason why the lock up period is important is because it allows for an orderly market to develop in the shares.²²⁹ The lock up period in Kenya is one year by virtue of Section 8 Capital Markets Securities Public Offer Listing and Disclosure Regulations 2002.

In Kenya, IPOs are the least attractive to fund managers as means of exiting investments owing to the regulatory constraints that have been put in place that make the public equities market inaccessible.²³⁰

2.6. The Regulator

The Capital Markets Authority (CMA) is the regulator of all financial activities in Kenya. CMA derives its mandate from the Capital Markets Authority Act. Its objectives include the development of all aspects of the capital markets with particular emphasis on the removal of impediments to, and the creation of incentives for longer term investments in, productive enterprises and the protection of investor interests.²³¹ It has a duty of enforcing the law so as to ensure market discipline.

Owing to numerous fraud cases in the Securities Exchange, the Authority has focused a lot on the public equities market at the expense of the private one. There is very little content in the law on private equity. The piece of legislation that stands out is the one that regulates venture capital. However commendable this gesture may be, the Authority's failure to facilitate dialogue between the market players in order to develop a proper, relevant framework has led to the blind importation of laws from other jurisdictions. Whereas it is good to borrow some practices from models that work, the Authority should be clear on the objectives they would like to fulfill through the borrowed practice.

²²⁸2010, Robert W. Kolb Series : Venture Capital : Investment Strategies, Structures, and Policies p.358. Retrieved on 5th April 2012 from <<http://site.ebrary.com/lib/uonbi/Doc?id=10388357&ppg=367>>

²²⁹ Arundale, Keith. Raising Venture Capital Finance in Europe. London, GBR: Kogan Page Ltd., 2007. p 281. Retrieved on 2 April 2012 from <<http://site.ebrary.com/lib/uonbi/Doc?id=10180629&ppg=32>>

²³⁰ supra

²³¹ Section 11(a) (d) CMA Act

As the market continues to show a lot of promise in terms of increased investment, such may be hampered because the Authority has not taken steps to develop new laws or revise the existing ones to facilitate this. From earlier discussions one can conclude that the law on private equity in Kenya is wanting in the area of clarity. This has in turn undermined the Authority's role as a disciplinarian and as a result Kenya is yet to have a strong culture of efficient business regulation.²³²

2.7 Conclusion

This chapter sought to test the research hypotheses, the first one being whether the existing private equity legal regime in Kenya is adequate. The answer is in the negative. The regulatory framework for private equity in Kenya is inadequate and lacks clarity and purpose. For example, Section 23 (1) of the Act and Regulation 3(1) of the Registered Venture Capital Companies Regulations 2007 the law creates a dual regulatory framework. The wording of the law is also ambiguous such that it has the potential of exempting some private equity entities from its purview.

The law's purpose ought to be to promote market efficiency. Instead it has created some barriers to investing in private equity thus amounting in inefficiencies. For example, retirement benefit schemes are restricted when it comes to investing its funds in private equity. Currently, the law categorizes private equity as "unquoted equity" and has placed a maximum investment threshold for retirement benefit scheme. The whole approval procedure to be followed before an investment in this area has made investing in private equity a daunting task for retirement benefit schemes. There is need to reform the law so that retirement benefit schemes can benefit from the returns made from private equity investments. Section 56 (1) of the Companies' Act needs to be reviewed. The express prohibition of any form of financial assistance relevant to the conduct of private equity transactions presents the Kenyan market as a conservative one thus discouraging investment. This has in turn inhibited the market's growth.

The law has failed to fulfill its purpose which is that of ensuring market discipline. The law is yet to make provision for practices such as multiple directorships which can not only give rise to conflicts of interest but also market indiscipline. Although the Competition Act 2010 contains some provisions on multiple directorships, the Companies Act of Kenya is yet to

²³² Dr Tuimising NR – PhD Thesis, Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues; University of Warwick, 2012 p.74

articulate a clear position on the same. There is a need for law reform in this area especially since this tends to affect the decision of fund managers with respect to their portfolios.

The law is also yet to make provision when it comes to fund management for vices such as asset tunneling and hostile take-over strategies such as green mails and poison pills. Adequate penalties ought to be formulated and provided for in the law to discourage these practices. Regarding disclosure, there is a need to review the existing financial requirements and not only align them with International Financial Reporting Standards (for private equity firms), but also develop guidelines for private equity firms so as to enhance credibility, transparency and safeguard investors' assets.

The ambiguity and lack of clarity of the law has undermined the Capital Markets Authority's powers as a regulator. It is rather absurd for the regulator to enforce unclear laws. This has greatly hindered the Authority's ability to effectively regulate financial services in Kenya.

It therefore follows that hypothesis two is answered in the affirmative. Kenya does need a new legal regime to regulate private equity. This can be achieved through the process of reviewing existing laws as well as developing new ones.

It is evident that the Kenyan private equity legal regime needs to be reviewed in order to promote efficient market operations, sustain the growth of the industry and safeguard the interests of the country and investors.

CHAPTER 3: PRIVATE EQUITY REGULATION: THE UK EXPERIENCE

3.1 Private Equity in the UK

a. The structure of the market

The private equity market provides companies that are not quoted on a public equity market with medium- to long-term capital. This capital takes the form of both equity and debt. The equity elements are typically provided by private equity funds, which in turn raise their capital from investors such as funds of funds, pension funds, investment funds, endowments and high net worth individuals. The debt is typically provided by banks. The private equity business model extends to the application of expertise and strategic vision to the privately owned companies.²³³

The UK private equity industry is somewhat stratified with a relatively small number of major firms typically undertaking fairly large domestic and international transactions, a larger group of firms who tend to focus on mid-size (predominantly) domestic transactions and a third, large group of firms focusing on smaller domestic transactions.²³⁴ The market is highly diverse and encompasses everything from funding new company start-ups, helping existing companies grow and develop through to increasing the operating potential of mature companies and turning failing companies around. Private equity firms characterize their funds as venture capital, expansion and buyout or distressed according to the life stage of the companies in which they invest.

There are a number of private equity funds listed on the London Stock Exchange (LSE) including buyout funds, development capital funds, general funds, turnaround/restructuring

²³³ DP 06/06 Financial Services Authority, 'Private equity: a discussion of risk and regulatory engagement Retrieved on 5th May 2012 from <http://www.fsa.gov.uk/pubs/discussion/dp06_06.pdf> p.12

²³⁴ DP06/06 Financial Services Authority, 'Private equity: a discussion of risk and regulatory engagement Retrieved on 5th May 2012 from <http://www.fsa.gov.uk/pubs/discussion/dp06_06.pdf> p.6

funds, venture capital funds, and funds of funds. This represents quite a broad range of funds but is not necessarily representative of the private equity market as a whole as, to achieve a listing, entities must comply with a number of specific requirements. Some hedge funds are also investing in the equity element of private equity transactions.²³⁵

Apart from the typical fund structures there are other methods which are available to investors to make equity investments in the UK private equity market. They include:

- A bank may join forces with a third party to establish an independent fund structure or have a captive fund. A captive fund is a private equity fund which receives its funds for investment in portfolio companies from the parent company i.e. the bank.²³⁶
- A financial group may acquire companies with growth potential, applying management and financial expertise to that company before divesting of the company at a profit. The purchase of such companies is usually undertaken on a leveraged basis. The companies are bought with the specific intention of transforming them and so increasing their value.
- Wealthy individuals can also make direct private equity investments, either in isolation or as part of a joint/club approach. Frequently these individuals have extensive industry experience and may have acquired their wealth in the corporate sector.²³⁷

b. Fundraising for private equity funds

Funds for the private equity industry in UK are obtained from institutions such as banks, pension funds, university endowment funds and insurance companies that are looking to diversify their assets. The structure of many private equity firms is the limited liability partnerships (LLPs). Pension funds and other institutions invest their money into a private equity fund as limited partners. These institutions are limited partners because their exposure is limited to the amount that they are investing in the fund. This would normally follow a fundraising process by the managers of the private equity firm who are the general partners.

²³⁵ DP06/06 Financial Services Authority, 'Private equity: a discussion of risk and regulatory engagement Retrieved on 5th May 2012 from <http://www.fsa.gov.uk/pubs/discussion/dp06_06.pdf> p.18

²³⁶ Arundale, Keith. Raising Venture Capital Finance in Europe. London, GBR: Kogan Page Ltd., 2007. p 16. Retrieved on 2 April 2012 from <<http://site.ebrary.com/lib/uonbi/Doc?id=10180629&ppg=32>>

²³⁷ DP06/06 Financial Services Authority, 'Private equity: a discussion of risk and regulatory engagement Retrieved on 5th June 2012 from <http://www.fsa.gov.uk/pubs/discussion/dp06_06.pdf> p.18

c. The investment cycle

Limited liability private equity funds in the UK have a life of 10 years. The first four years of the fund's life are spent by the management team sourcing for and making suitable investments. Cash flows out of the fund and into the portfolio companies. During the other four years of the fund's life, the general partners of the fund serve on the various boards of the portfolio companies, monitoring investments and adding value through strategic or hands on advice so that the companies achieve maximum profits and growth. Towards the fifth year of the fund's life, the fund's managers will start looking to raise a new fund in the same or different industry. During the last two years of the fund's life, the managers look for suitable exit routes i.e. they are looking to sell their investment. This is usually done through trade sales or a stock market flotation. When the investment is sold, cash is received back into the fund which is returned to the limited partners thus generating the internal rate of return (IRR).²³⁸

d. Types of Private Equity Funds

Private equity fund in the UK are operated by onshore limited partnerships, offshore limited partnerships (e.g. Jersey/Guernsey), UK quoted Private Equity Investment Trusts (PEITs), and UK quoted Venture Capital Trusts (VCTs) and offshore tax exempt corporate vehicles.²³⁹The most common structure the private equity fund takes is the form of an English Limited Liability Partnership (LLP).

i. Limited Liability Partnerships

Limited Liability Partnerships (LLPs) are established under the Limited Partnership Act 1907. LLPs were first operational in the USA beginning with the well-known Silicon Valley Venture Capital firms for example Accel. This model was adopted in Europe by many private equity firms such as Advent Venture Partners UK.²⁴⁰

The private equity firm usually establishes a subsidiary, as an English Limited Company, that becomes the general partner. Investors in the private equity fund become limited partners and generally have a passive role. An additional limited partner (often called the founder limited

²³⁸ Arundale, Keith. *Raising Venture Capital Finance in Europe*. London, GBR: Kogan Page Ltd., 2007. p 14. Retrieved on 2 April 2012 from <<http://site.ebrary.com/lib/uonbi/Doc?id=10180629&ppg=32>>

²³⁹ DP06/06 Financial Services Authority, 'Private equity: a discussion of risk and regulatory engagement' Retrieved on 5th June 2012 from <http://www.fsa.gov.uk/pubs/discussion/dp06_06.pdf> p.17

²⁴⁰ Arundale, Keith. *Raising Venture Capital Finance in Europe*. London, GBR: Kogan Page Ltd., 2007. p12. Retrieved on 2 April 2012 from <<http://site.ebrary.com/lib/uonbi/Doc?id=10180629&ppg=32>>

partner and structured as a Limited Partnership) is typically created as a carry vehicle for the executives in the private equity firm.²⁴¹

The Limited Partnership fund will usually be an unregulated Collective Investment Scheme (CIS) under Section 235 of the Financial Services and Markets Act (2000). Establishing and operating a CIS is a regulated activity. General partners are usually not regulated. They will appoint a regulated entity to act as the manager/operator of the fund. The private equity fund manager, can be structured as an English Limited Liability Partnership (LLP) or Private Limited Company (plc.).²⁴²

General partners determine the investment strategy of the fund which has to be followed once the limited partners have invested in the fund. They prepare the business plan or fund placement memorandum. They have total control over all the investments made by the fund. The limited partners sit on the advisory board but do not have similar powers to those of the general partners.²⁴³

The LLP model is quite popular in UK because it is tax transparent for the limited partners (recall investors) who the taxman treats as if they are directly investing in the company thus effectively bypassing the fund itself. This is advantageous because if this were not the case, it would result in double taxation of the fund i.e. when it remits the sale proceeds to the limited partners and when the underlying investments are sold in excess of costs.

ii. Venture capital trusts

Venture capital Trusts (VCTs) are also present in the UK and they invest in private equity. In theory they have an unlimited lifespan though in practice this is not often the case. VCTs are quoted vehicles that aim to encourage investment in smaller unlisted (unquoted and AIM quoted) UK companies by offering private investors tax incentives in return for a five-year investment commitment. If funds are obtained from a VCT, there may be some restrictions regarding the company's future development within the first few years.²⁴⁴

A small number of firms are quoted on the London Stock Exchange (LSE). The most famous venture capital firm which has been listed on the LSE since 1994 is 3i; which has been

²⁴¹ *supra*

²⁴² Financial Services Authority, 'Private equity: a discussion of risk and regulatory engagement Retrieved on 5th June 2012 from <http://www.fsa.gov.uk/pubs/discussion/dp06_06.pdf> p.17

²⁴³ *Ibid* p.13

²⁴⁴ BVCA, A Guide to Private Equity

registered as an investment trust. In the UK venture capital trusts (VCTs) are quoted on the stock exchange and function similarly as unit trusts. These are preferred by public sector funds which want to invest in private equity as opposed to direct investment in portfolio companies.²⁴⁵

e. Private Equity Transactions

The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 lists some of the regulated activities which private equity firms in the UK are likely to engage in. They include dealing in investments as a principal²⁴⁶ or agent,²⁴⁷ arranging deals in investments,²⁴⁸ safeguarding and administering investments, or arranging for the safeguarding and administration of investments,²⁴⁹ establishing or operating a collective investment scheme²⁵⁰ and advising on investments.²⁵¹

²⁴⁵ *ibid*

²⁴⁶ Article 14: Dealing in investments as principal- Buying, selling, subscribing for or underwriting securities or contractually based investments (other than investments of the kind specified by article 87, or article 89 so far as relevant to that article) as principal is a specified kind of activity. Retrieved on 10 July 2012 from <<http://www.legislation.gov.uk/uksi/2001/544/article/14/made>>

²⁴⁷ Article 21: Dealing in investments as agent- Buying, selling, subscribing for or underwriting securities or contractually based investments (other than investments of the kind specified by article 87, or article 89 so far as relevant to that article) as agent is a specified kind of activity. Retrieved on 10 July 2012 from <<http://www.legislation.gov.uk/uksi/2001/544/article/21/made>>

²⁴⁸ Article 25: Arranging deals in investments includes:

(1) Making arrangements for another person (whether as principal or agent) to buy, sell, subscribe for or underwrite a particular investment which is (a) a security, (b) a contractually based investment, or (c) an investment of the kind specified by article 86, or article 89 so far as relevant to that article, is a specified kind of activity. (2) Making arrangements with a view to a person who participates in the arrangements buying, selling, subscribing for or underwriting investments falling within paragraph (1)(a), (b) or (c) (whether as principal or agent) is also a specified kind of activity. Retrieved on 10 July 2012 from <<http://www.legislation.gov.uk/uksi/2001/544/article/25/made>>

²⁴⁹ Article 40: Safeguarding and administering investments is:

(1) The activity consisting of both (a) the safeguarding of assets belonging to another, and (b) the administration of those assets, or arranging for one or more other persons to carry on that activity, is a specified kind of activity if the condition in sub-paragraph (a) or (b) of paragraph (2) is met.

(2) The condition is that: (a) the assets consist of or include any investment which is a security or a contractually based investment; or (b) the arrangements for their safeguarding and administration are such that the assets may consist of or include such investments, and either the assets have at any time since 1st June 1997 done so, or the arrangements have at any time (whether before or after that date) been held out as ones under which such investments would be safeguarded and administered.

Retrieved on 10 July 2012 from <<http://www.legislation.gov.uk/uksi/2001/544/article/40/made>>

²⁵⁰ Article 51(1): The following are specified kinds of activity:

(a) establishing, operating or winding up a collective investment scheme;
(b) acting as trustee of an authorized unit trust scheme;
(c) Acting as the depositary or sole director of an open-ended investment company.

(2) In this article, “trustee”, “authorized unit trust scheme” and “depositary” have the meaning given by section 237 of the Act.

Retrieved on 10 July 2012 from <<http://www.legislation.gov.uk/uksi/2001/544/article/51/made>>

²⁵¹ Article 53: Advising a person is a specified kind of activity if the advice is—

(a) given to the person in his capacity as an investor or potential investor, or in his capacity as agent for an investor or a potential investor; and

f. Exit options

The most common exit options used by fund managers of private equity firms in the UK are:

IPOs

Normally UK investment banks insist on general lockups of at least 3 months for large shareholders with 1% ownership or more to allow for an orderly market to develop in the shares. Such shareholders include management and the directors, strategic partners, entrepreneurs or founders of venture capital firms.²⁵²

In Europe IPO levels peaked in 2000 with over 600 companies floating its shares in the exchange markets according to a survey by PwC and IPO Watch Europe Review.²⁵³

Trade sales which involve sales to corporate bodies whose existing business model would be expanded/complemented/suitably diversified by the acquisition of the company; and **Secondary sales** which are sales to other private equity funds are also common in the UK.²⁵⁴

The Alternative Investment Market (AIM)

This is the LSE international market for smaller growing companies. It was established in 1995 and is the leading secondary exchange in Europe. AIM companies include young venture capital backed up or start-ups to mature organizations looking to expand. Many venture capital companies in the UK transit to the LSE main market later on since it provides better liquidity than the AIM. However it should be noted that the regulatory process (which shall be discussed in the next chapter) on AIM is lighter.²⁵⁵

(b)advice on the merits of his doing any of the following (whether as principal or agent)—

(i)buying, selling, subscribing for or underwriting a particular investment which is a security or a contractually based investment, or

(ii)exercising any right conferred by such an investment to buy, sell, subscribe for or underwrite such an investment.

Retrieved on 10 July 2012 from <<http://www.legislation.gov.uk/ukxi/2001/544/article/53/made>>

²⁵² Arundale, Keith. *Raising Venture Capital Finance in Europe*. London, GBR: Kogan Page Ltd., 2007. p 281. Retrieved on 2 April 2012 from <<http://site.ebrary.com/lib/uonbi/Doc?id=10180629&ppg=32>>

²⁵³ Arundale, Keith. *Raising Venture Capital Finance in Europe*. London, GBR: Kogan Page Ltd., 2007. p 284. Retrieved on 2 April 2012 from <<http://site.ebrary.com/lib/uonbi/Doc?id=10180629&ppg=32>>

²⁵⁴ Dp06/6 Financial Services Authority, 'Private equity: a discussion of risk and regulatory engagement'. p.50 Retrieved on 5th June 2012 from <http://www.fsa.gov.uk/pubs/discussion/dp06_06.pdf>

²⁵⁵ *ibid*

In the UK, a valuation of investments on exit is usually carried out by private equity firms. This valuation must be one that is mutually acceptable. The Capital Valuation Guidelines in the UK are contained in the International Private Equity and Venture Capital Valuation Guidelines.

g. Conflicts of interest

Conflicts of interest may arise between fund managers and the fund investors where co-investment is involved.²⁵⁶ Co-investment creates two risks. First, by leaving the selection of the co investment vehicle to the fund manager, the risk is that the fund manager could unfairly steer potentially more lucrative deals into these structures to enhance the weighting of these companies in their personal portfolios. The second risk is that staff investment may not be fully aligned with that of the investors for example if staff members are able to under or over commit to specific transactions – effectively cherry picking.

Conflicts of interest would arise between the fund manager and the investors when the fund manager causes the company to make significant payments to its directors. This would reduce the value of the company and consequentially the fund's value while benefitting the fund manager.

Conflicts of interest can also arise between the fund manager and different investors in separate funds, at different stages in their investment cycle, which may be run concurrently by the same manager. For example a conflict of interest may arise if both funds have an investment in the same underlying portfolio company and the fund manager has to act in the best interests of both. Similarly conflicts of interest can also arise where an employee/partner of the fund manager is also acting as a director/has a seat on the board of a company owned by the fund i.e. multiple directorships In this case the fund manager has to choose between their personal responsibility to the company and their responsibility to the fund investors/the fund manager.

²⁵⁶ Co-investment vehicles are common to the UK private equity sector. The fund manager selects investments that may be the subject of a co-investment and make allowances for certain investors to make an additional investment over and above that made by the fund. These certain investors who can co- invest in a private equity investment are the fund's own staff members who commit their own capital to the pool of funds under management.

The English statutory position on the duties of directors as contained in the UK Companies Act 2006 requires directors to act strictly within their powers²⁵⁷, imposes on them the general duty to act in the company's best interest²⁵⁸ and the duty to exercise judgment independently,²⁵⁹ requires them to act with reasonable care, skill and diligence²⁶⁰ and avoid conflicts of interest²⁶¹, bestows upon directors the duty not to accept external inducements in the discharge of corporate affairs²⁶² and makes it mandatory for directors to declare interest in proposed transactions²⁶³ while imposing on them the duty to give notice of any interest in existing transactions.²⁶⁴ The Courts interpretation of the statutory provisions relating to directors duties as demonstrated in the case of **Thermascan Ltd v Norman**²⁶⁵ is interpreted using common law rules and principles.

Conflict of interest between the interests of the fund manager, the fund and the company can also arise where loans are provided to the management teams of companies backed by the fund, to enable them buy an equity stake in the leveraged buy-out. This is because the fund manager has the power to call a loan made to the director of a company. This might cause that director to act in the interests of the fund manager or the fund rather than the company they direct.

3.2 The UK Regulatory Framework for Private Equity

The regulatory framework for private equity in the UK administered by the Financial Services Authority (FSA) is risk based. The FSA's risk-based approach to regulation is premised on a clear statement of the realistic aims and limits of regulation.²⁶⁶ According to the FSA this approach is important since it helps them determine the overall intensity of their regulatory approach by judging the risk that a private equity firm would pose to its statutory objectives. Risk based regulation also helps determine the amount of capital private equity

²⁵⁷ S171 UK Companies Act 2006

²⁵⁸ S172 UK Companies Act 2006

²⁵⁹ S173 UK Companies Act 2006

²⁶⁰ S174 UK Companies Act 2006

²⁶¹ S175 UK Companies Act 2006

²⁶² S176 UK Companies Act 2006

²⁶³ S177 UK Companies Act 2006

²⁶⁴ S182 UK Companies Act 2006

²⁶⁵ [2009] EWHC 3694 (Ch)

²⁶⁶ Financial Services Authority, 'The FSA's Risk Assessment Framework', p.7
<<http://www.rdec.gov.tw/public/Data/851414194871.pdf>> Date Accessed 19th June 2012

firms must hold, issues that the senior management must address and what actions within the Risk Mitigation Programme (RMP) will be directly driven by the risk assessment.²⁶⁷

In 2006, The FSA revised its risk management process formerly known as the Advanced, Risk-Responsive Operating Framework (ARROW) to ARROW II; through a process known as the ARROW Project which begun in 2004.²⁶⁸ ARROW II allows the FSA to calibrate the degree of intensity of their supervision according to the impact and probability of the risks that are apparent within a particular firm, based on defined criteria.²⁶⁹ ARROW II is designed to identify the main risks to the FSA's statutory objectives as they arise measure the importance of those risk, mitigate those risks where their size justifies this and monitor and report on progress of the FSA's risk management.²⁷⁰

Within the ARROW framework, the two basic approaches used to manage risks arising from sources external to the FSA are the ARROW Firms and ARROW Themes. The ARROW Firms approach involves assessing and dealing with risks as they apply to an individual firm or group of connected firms. Whereas, under the ARROW Themes approach, the FSA considers specific issues as they affect a number of firms, an entire sector, or the market as a whole.²⁷¹

The Financial Services Authority (FSA) has identified the following as some of the risks that form the basis for risk based regulatory approach in the UK private equity market: excessive leverage, unclear ownership of economic risk, reduction in overall capital market efficiency, market abuse, conflicts of interest, market access constraints and market opacity.²⁷²

Using the ARROW II Risk Model, a risk is considered to be the combination of two factors namely impact (the potential harm that could be caused) and probability (the likelihood of the particular event occurring). A combination of these two factors gives the FSA a measure of

²⁶⁷Financial Services Authority, 'The FSA's Risk Assessment Framework', p.3
<<http://www.rdec.gov.tw/public/Data/851414194871.pdf>> Date Accessed 19th June 2012

²⁶⁸ Ibid p 5

²⁶⁹ supra

²⁷⁰Financial Services Authority, 'The FSA's Risk Assessment Framework', p.5-6
<<http://www.rdec.gov.tw/public/Data/851414194871.pdf>> Date Accessed 19th June 2012

²⁷¹Financial Services Authority, 'The FSA's Risk Assessment Framework', p.8
<<http://www.rdec.gov.tw/public/Data/851414194871.pdf>> Date Accessed 19th June 2012

²⁷²Dp06/6 Financial Services Authority, 'Private equity: a discussion of risk and regulatory engagement'.p.8-11
Retrieved on 5th June 2012 from <http://www.fsa.gov.uk/pubs/discussion/dp06_06.pdf>

the overall risk posed to its statutory objectives. The FSA then uses this measure to prioritize risks and make decisions on what, if anything, their regulatory response should be. They also use it to set their strategic aims and outcomes and to allocate resources based on our regulatory priorities.

Scoring within the ARROW framework is on a simple four-point scale where impact, probability and risk (the combination of the two) are each rated as either low, medium low, medium high or high. In the UK, a vast majority of private equity firms have been assessed as Low Impact. This score is derived from an assessment of two main constituents; a calculation of the firm's size/impact within the market and the application of a private equity sub-sector weighting which is based on an over-arching assessment of the risks inherent within the private equity industry as a whole.²⁷³

It should be noted that should the Financial Services Bill 2012-2013 be implemented, the ARROW risk mitigation programme will soon be replaced by two separate risk mitigations programmes, one for prudential and one for conduct. Firms will now have two separate sets of mitigating actions, of equal importance, to address.

3.3. The Institutions that Regulate Private Equity

There are two institutions in the UK that deal with matters related to private equity and venture capital in the UK. These are the Financial Services Authority (FSA) and the British Private Equity & Venture Capital Association (BVCA).

3.3. a The Financial Services Authority (FSA)

The Financial Services Authority (FSA) was created by the Financial Services and Markets Act 2000 (FSMA). The FSMA 2000 is the primary piece of legislation from the FSA derives its powers and functions. The FSA make Rules and guidance which are contained in the FSA Handbook. The Treasury has the power to enact make secondary legislation under FSMA, which affects the way the FSA operates. The most important piece of secondary legislation is the Financial Services and Markets Act (Regulated Activities) Order 2001 (RAO).The RAO sets out the specific activities which firms must receive FSA permission (known as a Part IV permission) to carry on.

²⁷³ *ibid*

The FSA is a body corporate limited by guarantee and is subject to generally applicable company and accounting law. It has powers over unregulated firms and persons regarding market abuse, breaches of money laundering regulations and short selling. The FSA also has the power to prosecute unauthorized firms or persons carrying on regulated activities.

The FSA is the designated competent authority under the European single market directives for banking, insurance, investment business, payment services, collective investment schemes and other financial services, including insurance intermediation. It is also the competent authority under a host of other EU directives, including the Market Abuse and Prospectus Directives. European legislation affecting the FSA in regulated financial services is implemented through FSMA FSA rules and/or Treasury regulations.

The Financial Services and Markets Act 2000 (FSMA) gives the FSA four statutory objectives:²⁷⁴

1. Maintaining market confidence in the UK financial system.
2. Contributing to the protection and enhancement of the stability of the UK financial system, while having regard to: the economic and fiscal consequences for the UK of instability of the UK financial system; the effects (if any) on the growth of the UK economy of anything done for the purpose of meeting that objective; and the impact (if any) on the stability of the UK financial system of events or circumstances outside the UK.
3. Securing the appropriate degree of protection for consumers, while having regard to: the differing degrees of risk involved in different kinds of investment or transaction; the differing degrees of expertise and experience of consumers; information provided to the FSA by the Consumer Financial Education Body; the needs that consumers may have for advice and accurate information; and the general principle that consumers should take responsibility for their decisions.
4. Reducing the extent to which it is possible for a regulated business to be used for a purpose connected with financial crime, such as money laundering, fraud and insider dealing.

²⁷⁴ Retrieved on 15th June 2012 from <<http://www.fsa.gov.uk/about/aims/statutory>>

The FSA's objectives are supported by a set of '**principles of good regulation**' which they must have regard to when discharging their functions. These are:

1. The need to use our resources in the most efficient and economical way;
2. Recognizing the responsibilities of regulated firms' own management;
3. The principle that the burdens and restrictions imposed by regulation should be proportionate to the benefits;
4. The international character of financial services and the desirability of maintaining the UK's competitive position;
5. The desirability of facilitating innovation;
6. The desirability of facilitating competition between those subject to regulation;
7. The need to minimize the adverse effects of regulation on competition; and
8. The desirability of enhancing the understanding and knowledge of members of the public of financial matters (including the UK financial system).

The FSA remains as the regulator of financial services in UK until the Financial Services Bill²⁷⁵ is implemented. It recently introduced a shadow internal structure during 2011, allocating staff and responsibilities in anticipation of the creation of the twin peaks operating model. Under this model two new organizations namely the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) to deal with financial services regulation.

The PRA, a subsidiary of the Bank of England (BoE), will be responsible for micro-prudential regulation of systemically important firms. These firms are referred to as dual-regulated firms, as the FCA will be their conduct. The PRA's general objective is to promote the safety and soundness of regulated firms. It will seek to meet this objective primarily by seeking to minimize any adverse effects of firm failure on the UK financial system and by ensuring that firms carry on their business in a way that avoids adverse effects on the system.²⁷⁶

²⁷⁵ The Bill seeks to amend the Bank of England Act 1998, the Financial Services and Markets Act 2000 and the Banking Act 2009; to make other provision about financial services and markets; to make provision about the exercise of certain statutory functions relating to building societies, friendly societies and other mutual societies; to amend section 785 of the Companies Act 2006; to make provision enabling the Director of Savings to provide services to other public bodies; and for connected purposes. Retrieved on 10 July 2012 from <<http://services.parliament.uk/bills/2012-13/financialservices.html>>

²⁷⁶ Retrieved on 10 July 2012 from <<http://finance.practicallaw.com/7-503-5430#a679987>>

The FCA will inherit the majority of the FSA's existing roles and functions. In particular, it will:

- Be responsible for the conduct of business regulation of all firms, including those regulated for prudential matters by the PRA.
- Be responsible for the prudential regulation of firms not regulated by the PRA.
- Inherit the FSA's market conduct regulatory functions, with the exception of responsibility for systemically important infrastructure which will be transferred to the BoE.²⁷⁷

Although the supervision models will be different for the PRA and FCA in that prudential supervision will continue to have dedicated resources supervising firms; and conduct supervision will focus more on thematic work, and less on firm-specific work.²⁷⁸

3.3. b The British Venture Capital Association (BVCA)

The British Private Equity & Venture Capital Association (BVCA) is the industry body and public policy advocate for the private equity and venture capital industry in the UK. BVCA was founded in 1983. Its voice is one of authority when speaking for, or negotiating on behalf of, the UK industry. Its aim is to aid understanding, clarity and transparency around the activities of our members, promoting our industry to entrepreneurs and investors as well as to Government, the EU, trade unions, international media and the general public.²⁷⁹

Currently, The BVCA membership comprises over 230 private equity and venture capital firms ("Full" members) with an accumulated total of approximately £200 billion funds under management as well as nearly 300 "Associate" members who provide a variety of legal, tax, regulatory and consultative services to the fund management houses.²⁸⁰

In 2007, the private equity industry responded to widespread concern about its lack of accountability by commissioning Sir David Walker to carry out a review of the adequacy of disclosure and transparency in private equity. This review resulted in the publication of the

²⁷⁷ *ibid*

²⁷⁸ Retrieved on 10 July 2012 from <http://www.fsa.gov.uk/about/what/reg_reform>

²⁷⁹ Retrieved on 10 July 2012 from <<http://www.bvca.co.uk/About-BVCA/Our-Mission>>

²⁸⁰ Retrieved on 10 July 2012 from <<http://www.bvca.co.uk/About-BVCA/Our-Industry>>

“Guidelines for Disclosure and Transparency in Private Equity” in November 2007 often referred to as the “Walker Guidelines”.²⁸¹

These voluntary guidelines are directed at both portfolio companies, fund managers and the BVCA. These guidelines are applicable to funds approved by the British Financial Standards Authority and concerned only large portfolio firms with a value of more than £300 million (£500 million for private acquisitions), more than 50% of revenue generated in the UK and more than 1,000 employees in the UK.²⁸²

Some of the guidelines include:²⁸³

1. Private equity firms should publish an annual review accessible on its website, or ensure regular updating of its website, to communicate:

(a) A description of the way in which the firm fits into the group of which it is a part, the firm’s history and investment approach, including investment holding periods, where possible illustrated with case studies.

(b) A commitment to conform to the Guidelines on a “comply or explain” basis and to promote similar conformity on the part of the portfolio companies owned by the firm’s fund or funds.

(c) An indication of who the senior members of the management in the UK are, together with a confirmation that arrangements are in place to deal appropriately with conflicts of interest.

(d) A description of UK portfolio companies in the firm’s portfolio.

(e) A categorization of the limited partners in the funds that invest in UK portfolio companies, by geographical location and type of customer (such as pension funds, corporate investors, banks, academic endowments, and private individuals).

²⁸¹Kaye Scholer LLP, ‘The UK Regulatory Environment for Funds and Private Equity Firms.’ Retrieved on 10 July 2012 from <http://www.kayescholer.com/news/publications/20110711/_res/id=sa_File1/PERB2011.pdf>

²⁸²Steen Thomsen, 2009, ‘Should Private Equity Be Regulated?’ *European Business Organization Law Review*

²⁸³Kaye Scholer LLP, ‘The UK Regulatory Environment for Funds and Private Equity Firms.’ Retrieved on 10 July 2012 from <http://www.kayescholer.com/news/publications/20110711/_res/id=sa_File1/PERB2011.pdf>

2. When making reports to the limited partners, private equity firms should follow the European Private Equity and Venture Capital Association (“EVCA”) guidelines in relation to reporting, monitoring and valuation.

3. Private equity firms should also provide the BVCA with various types of data to support the move to establish the BVCA as the recognized authoritative source of intelligence and analysis of private equity matters in the UK.

4. Private equity firms should ensure timely and effective communication with employees of portfolio companies at a time of significant strategic change.

3.4 The Legal Regime for Private Equity in UK

The main regulatory standards for UK private equity firms are set out in the FSA Handbook Rules and Guidance. The FSA Handbook rules include the High Level Standards, Prudential Standards and Business Standards. The requirements on individual private equity firms are dependent on the nature of the firm’s business model and the specific activities the firm has permission to undertake.

3.4. a. High level standards

The High-Level Standards include the Principles for Businesses Sourcebook (PRIN) and the Senior Management Arrangements, Systems and Controls Sourcebook (SYSC) together with other material. PRIN sets out the fundamental obligations of all firms under the regulatory system. There are eleven principles which set the foundation for other rules and guidance in the Handbook; as well as setting standards in their own right. These are summarized below:

Principle	Impact
1. Integrity	A firm must conduct its business with integrity.
2. Skill, care and diligence	A firm must conduct its business with due skill, care and diligence.
3. Management and control	A firm must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems.

4. Financial prudence A firm must maintain adequate financial resources.
5. Market conduct A firm must observe proper standards of market conduct.□
6. Customers' interests A firm must pay due regard to the interests of its customers and treat them fairly.
7. Communications with clients A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8. Conflicts of interest A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. Customers: relationships of trust A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
10. Clients' assets A firm must arrange adequate protection for clients' assets when it is responsible for them.
11. Relations with regulators A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice

Source: FSA Handbook ²⁸⁴

The Senior Management Arrangements, Systems and Controls Sourcebook (SYSC) sets out the FSA's rules and guidance on high-level systems and controls and the firm's apportionment of responsibility. For example authorized firms are required to take reasonable care to maintain a clear and appropriate apportionment of significant responsibilities between

²⁸⁴Retrieved on 10 July 2012 from <<http://fsahandbook.info/FSA/html/handbook/PRIN/2/1> <Date accessed 10 July 2012>

directors and senior managers, and to establish and maintain such systems and controls as are appropriate to their business. SYSC also serves to emphasize the importance the FSA places on senior management taking responsibility for ensuring that firms comply with their regulatory responsibilities.²⁸⁵

There are no specific exemptions or concessions from SYSC for private equity firms, but the nature of the systems and controls a firm will need to maintain depends on a number of factors. This includes the nature, scale and complexity of its business; the diversity of its operations; the volume and size of its transactions; and the degree of risk associated with each area of its operation.

3.4. b. Prudential standards

The prudential requirements for private equity firms i.e. the amount of regulatory capital firms need to have previously depended on whether the firm's activities brought it within the scope of the Investment Services Directive (ISD). Activities that fell under ISD regulation included firms that carried out corporate finance business and venture capital activity.

The ISD was replaced by the Markets in Financial Instruments Directive (MiFID)²⁸⁶ and the Capital Requirements directive (CRD) in 2007. The prudential requirements for private equity firms now depend on whether the firm falls within the scope of MiFID or not.

Non- MiFID firms are subject to the requirements of the interim prudential sourcebook for investment firms (IPRU (INV)). An example of a Non –MiFID firm is a collective investment scheme which has funds of £5,000 and does not deal with retail customers.

MiFID firms now include two new investment services which were not included in the ISD. These are private equity firms who act as advisers to funds without operating them, or advise third party funds or persons as well as operating their own funds.²⁸⁷ Such MiFID firms will

²⁸⁵ Kaye Scholer LLP, 'The UK Regulatory Environment for Funds and Private Equity Firms.' Retrieved on 10 July 2012 from < http://www.kayescholer.com/news/publications/20110711/_res/id=sa_File1/PERB2011.pdf>

²⁸⁶ The Markets in Financial Instruments Directive (MiFID) came into effect on 1 November 2007. Retrieved on 13 July 2012 from < <http://www.fsa.gov.uk/about/what/international/mifid>>

²⁸⁷ FSA, 'A summary guide to MiFID and the CRD for Non-ISD firms carrying on both corporate finance and venture capital activity,' p.2 Retrieved on 13 July 2012 from <http://www.fsa.gov.uk/pubs/international/summary_mifid.pdf>

be subject to a capital requirement which allows it to hold own funds of €50,000 or a prescribed level of professional indemnity insurance (at least €1,000,000 applying to each claim and €1,500,000 per year in aggregate applying to all claims), or a mixture of the two that provides equivalent coverage.²⁸⁸

Private equity firms which do not fall within the MiFID and Non- MiFID categories will be subject to the prudential sourcebook for banks, building societies and investment firms (BIPRU), which incorporates the Capital Requirements Directive (“CRD”). The amount of regulatory capital required will depend on the type of business that the firm carries on and, if the firm is a member of a group, whether that group is subject to consolidated supervision or not.²⁸⁹

3.4. c. Business standards

Business standards deal with financial crimes and conduct of business. The anti-money laundering requirements which private equity firms in the UK must comply with are contained in the Terrorism Act 2000, the Proceeds of Crime Act 2002 and Money Laundering Regulations 2007.

The FSA rules²⁹⁰ requires firms to ensure that they have systems²⁹¹ and controls that enable it to identify, assess, monitor and manage money laundering risk²⁹² and are comprehensive

²⁸⁸ IPRU (INV) 9.2.4R.

²⁸⁹ Kaye Scholer LLP, ‘The UK Regulatory Environment for Funds and Private Equity Firms’ Retrieved on 10 July 2012 from <http://www.kayescholer.com/news/publications/20110711/_res/id=sa_File1/PERB2011.pdf>

²⁹⁰ FSA Handbook, SYSC 6.3 Retrieved on 10 July 2012 from <<http://fsahandbook.info/FSA/html/handbook/SYSC/6/3>>

²⁹¹ SYSC 6.3.8: The systems and controls include:

- (1) appropriate training for its employees in relation to money laundering;
- (2) appropriate provision of information to its governing body and senior management, including a report at least annually by that firm's money laundering reporting officer (MLRO) on the operation and effectiveness of those systems and controls;
- (3) appropriate documentation of its risk management policies and risk profile in relation to money laundering, including documentation of its application of those policies
- (4) appropriate measures to ensure that money laundering risk is taken into account in its day-to-day operation, including in relation to:
 - (a) the development of new products;
 - (b) the taking-on of new customers; and
 - (c) changes in its business profile; and
- (5) appropriate measures to ensure that procedures for identification of new customers do not unreasonably deny access to its services to potential customers who cannot reasonably be expected to produce detailed evidence of identity.

²⁹² SYSC 6.3.2 - "Money laundering risk" is the risk that a firm may be used to further money laundering. Failure by a firm to manage this risk effectively will increase the risk to society of crime and terrorism.

and proportionate to the nature, scale and complexity of its activities.²⁹³ Firms are also required to have a director or senior manager whose responsibility for the establishment and maintenance of effective anti-money laundering systems and controls; i.e. the firm's money laundering reporting officer (MLRO).²⁹⁴

The Money Laundering Regulations 2007, which among other things require private equity firms to carry out customer due diligence measures²⁹⁵ as a means of identifying and verifying the identity of the customer and the purpose and intended nature of the business relationship. In carrying out customer due diligence, firms are required to obtain information on the purpose and intended nature of the business relationship.

The FSA requires firms to demonstrate that the measures they have adopted are appropriate, so a documentary record of customer due diligence measures will need to be kept. The usual proofs of identity that firms require for individuals are a passport and recent utility bill, to confirm both name and address; but other proofs can be used, including assurances from reputable third parties

The FSA also requires firms to adopt appropriate procedures to avoid infringing, the provisions of the Bribery Act 2010, in order to satisfy their obligations under Principle 3 (Management and Control) of the Principles for Businesses.²⁹⁶

3.2. d. Conduct of business

The FSA's Conduct of Business Source Book (COBS) supplements the new requirements of the conduct of business introduced by the MiFID. It has been enforced since 1 November

SYSC 6.3.6 - In identifying its money laundering risk and in establishing the nature of these systems and controls, a firm should consider a range of factors, including:

- (1) its customer, product and activity profiles;
- (2) its distribution channels;
- (3) the complexity and volume of its transactions;
- (4) its processes and systems; and
- (5) its operating environment.

²⁹³ SYSC 6.3.1

²⁹⁴ FSA Handbook, SYSC 6 Financial crime Retrieved on 10 July 2012 from <<http://fsahandbook.info/FSA/html/handbook/SYSC/6/3>>

²⁹⁵ "Customer due diligence measures" is defined as identifying the customer and verifying the customer's identity on the basis of documents, data or information obtained from a reliable and independent source. This process includes identifying all beneficial owners who are not the customer, such as (where the customer is an unlisted body corporate) a person with more than 25% of the shares or voting rights or (where the customer is a partnership other than an LLP) a person who is entitled to or controls more than a 25% share of the capital or profits of the partnership.

²⁹⁶ Kaye Scholer LLP, 'The UK Regulatory Environment for Funds and Private Equity Firms' Retrieved on 10 July 2012 from <http://www.kayescholer.com/news/publications/20110711/_res/id=sa_File1/PERB2011.pdf>

2007. Some of the new requirements in the COBS affect the manner in which professional clients are treated. Firms are required to pay attention to best execution practices²⁹⁷ when dealing with listed retail and professional clients. They are also required to also apply the suitability test to their professional clients where they are providing investment advice or portfolio management services. This means that private equity firms have to establish whether the proposed transaction to be entered into meets the professional client's investment objectives.²⁹⁸ Before a private equity firm can opt up a client test to elective professional client status in respect of business covered by MiFID under COBS,²⁹⁹ they must carry out a quantitative test (satisfaction of two out of three stated criteria) as well as a qualitative one (sufficient knowledge and experience).

3.2. e. Conflicts of interest

The FSA's new rules on conflicts of interest which were enacted in July 2011 are set out in SYSC 10³⁰⁰. Under these rules common platform firms are required to take all reasonable steps to prevent conflicts of interest from giving rise to a material risk of damage to the interests of clients,³⁰¹ implement and operate an effective written policy for identifying and managing conflicts of interest,³⁰² specify in the conflicts policy certain procedures and measures to ensure appropriate independence and further steps if these prove inadequate,³⁰³ disclose the conflict to the client, if the arrangements under the firm's policy are not adequate to prevent material risks of damage to a client³⁰⁴ and in considering its own policy in respect of its duties to its clients, take account of any circumstances, of which the firm is or should be aware, which may give rise to a conflict arising as a result of the structure and business activities of other members of the group.

²⁹⁷ MiFID requires that firms executing orders, or who place orders with other entities for execution when providing the service of portfolio management, or who transmit orders to other entities for execution when providing the service of reception and transmission of orders, must have arrangements in place to take all reasonable steps to obtain the 'best possible result' for their clients. Retrieved on 13th July 2012 from <http://www.fsa.gov.uk/pages/about/what/international/mifid/key_topics/best_execution/index.shtml>

²⁹⁸ COBS 9.2.2R and 9.2.8R

²⁹⁹ COBS 3.5.3R

³⁰⁰ Retrieved on 13th July 2012 from <<http://fsahandbook.info/FSA/html/handbook/SYSC/10>>

³⁰¹ SYSC 10.1.3 R 01/07/2011

³⁰² SYSC 10.1.10 R 01/07/2011

³⁰³ SYSC 10.1.11 R 01/07/2011

³⁰⁴ *ibid*

Article 13(3)³⁰⁵ MiFID Level 1 Directive³⁰⁶ requires a firm to maintain and operate effective organizational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest from adversely affecting the interests of its clients. Article 18³⁰⁷ of the Level 1 Directive also requires firms to identify conflicts of interest and to clearly disclose such conflicts where organizational or administrative arrangements made to manage conflicts are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented.

Articles 21-23 of the Level 2 Commission Directive³⁰⁸ require firms to identify conflicts potentially detrimental to a client, have a conflicts policy and keep and regularly update a record of the kinds of services or activities giving rise to conflicts.

3.4. f. Fund Management: The Alternative Investment Fund Managers Directive (AIFMD)

Background

Hedge funds and private equity funds began receiving the attention of the Commission in 2006 and the European Parliament in 2008. The global financial crisis, and in particular the contraction of the market for debt prompted by the collapse of Lehman Brothers in September 2008, had a significant impact on the private equity sector. Since 2008, the

³⁰⁵ Article 13 (3): An investment firm shall maintain and operate effective organizational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in Article 18 from adversely affecting the interests of its clients.

³⁰⁶ Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004. Retrieved on 13 July 2012 from <<http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2004L0039:20070921:EN:PDF>>

³⁰⁷ Article 18: Conflicts of interest:

1. Member States shall require investment firms to take all reasonable steps to identify conflicts of interest between themselves, including their managers, employees and tied agents, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and ancillary services, or combinations thereof.

2. Where organizational or administrative arrangements made by the investment firm in accordance with Article 13(3) to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm shall clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business on its behalf.

3. In order to take account of technical developments on financial markets and to ensure uniform application of paragraphs 1 and 2, the Commission shall adopt, in accordance with the procedure referred to in Article 64(2), implementing measures to:

(a) define the steps that investment firms might reasonably be expected to take to identify, prevent, manage and/or disclose conflicts of interest when providing various investment and ancillary services and combinations thereof;

(b) Establish appropriate criteria for determining the types of conflict of interest whose existence may damage the interests of the clients or potential clients of the investment firm.

³⁰⁸ COMMISSION DIRECTIVE 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organizational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive. Retrieved on 13 July 2012 from <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:241:0026:0058:EN:PDF>>

number and value of private equity deals reduced substantially. The impact of the financial crisis on private equity funds heightened calls for private equity to be regulated. It is in this atmosphere that the Alternative Investment Fund Managers Directive (AIFMD) was introduced, to impose new regulations on both hedge funds and the private equity industry in the EU.³⁰⁹

According to some regulators, including those at the G20 London Summit in April 2009 some activities in the Alternative Investment Fund (AIF) industry embedded significant risk and that the abrupt unwinding of large leveraged positions in response to tightening credit conditions had, with increased investor redemptions, to some extent impaired market liquidity and affected the financial system.³¹⁰

i. Alternative Investment Funds (AIFs)

The Directive defines an AIF as a collective investment undertaking, including an investment compartment thereof, which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors.³¹¹ So far the FSA considers the following as being likely to be categorized as AIFs³¹²:

- Hedge funds, hedge funds of funds
- Private equity and venture capital funds
- Property funds
- Investment trusts
- Real Estate Investment Trusts (REITs)
- FSA-authorized non-UCITS funds including Non-UCITS Retail Schemes (NURS) Funds of Alternative Investment Funds (FAIFs) and Qualified Investor Schemes (QIS)
- Charity funds

³⁰⁹ Jennifer Payne, 2011, Private Equity and Its Regulation in Europe, *European Business Organization Law Review*

³¹⁰ DP12/1, Financial Services Authority, 2012, 'Implementation of the Alternative Investment Fund Managers Directive', p.14 < <http://www.fsa.gov.uk/static/FsaWeb/Shared/Documents/pubs/discussion/dp12-01.pdf>>

³¹¹ Article 4 1 (a) of DIRECTIVE 2011/61/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 <<http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF>>

³¹² Ibid p.10

- Commodity funds and infrastructure funds.

In UK the regulation focus of AIFs has been collective investment schemes. The Directive (AIFMD) on the other hand is more detailed. Among its requirements are those relating to risk and liquidity management, transparency and prescribed levels of regulatory capital. There are new rules on investment in securitizations and more detailed rules on the valuation of AIF assets, irrespective of whether this is performed in-house by AIFMs or by external valuers.³¹³

ii. Scope of the AIFMD

The AIFMD seeks to regulate the structuring, management, operation and marketing of AIFs in the EU. This therefore means that these regulations will also affect AIFs in the UK. The AIFMD will apply to all private equity firms with assets under management in excess of €100 million. This threshold is raised to €500 million if there is no leverage and there is a lock-in period of five years or more. The higher threshold excludes many start-up and venture capital funds. However, this threshold will be of less value to buyout funds.

Firms that manage assets below these thresholds are required under the AIFMD to be registered with their home Member State regulator and to provide the regulator with details of their investment strategies, the main investments in which they are trading, and their principal exposures. This is unlikely to make any material difference to the position in the UK, where private equity firms carrying on regulated activities are required to be FSA authorized in any event.

iii. Capital requirements under the AIFMD

The AIFMD requires firms within its scope to have minimum regulatory capital of €25,000. This could be a big (and costly) change for those UK private equity firms who are currently obliged to hold only £5,000 by way of regulatory capital. In addition, there is an extra capital requirement, capped at €10 million, of 0.02% of the value of assets under management in excess of €250 million.

iv. Marketing passports

³¹³ DP12/1, Financial Services Authority, 2012, 'Implementation of the Alternative Investment Fund Managers Directive', p.17 < <http://www.fsa.gov.uk/static/FsaWeb/Shared/Documents/pubs/discussion/dp12-01.pdf> >

The AIFMD allows a firm within its scope to market its funds to professional investors in other Member States free of local legislation. This aspect removes the legal barriers that were faced by private equity firms who wanted to invest in other countries, thus creating favourable investing conditions.

v. Notification of the acquisition of major holdings and control of non-listed companies

When the fund acquires, disposes of or holds shares of a non-listed company, the fund manager must notify its home state regulator of the proportion of voting rights held by the fund whenever the proportion reaches, exceeds or falls below 10%, 20%, 30%, 50% and 75%. Where a PE fund acquires more than 50% control over a non-listed company the fund manager must, within ten working days of acquiring control, notify the non-listed company, its shareholders and the fund manager's regulator of the acquisition of control, and when control was reached, the level of control in terms of voting rights and how control has been reached. In addition, the fund manager must request the board of directors of the non-listed company to inform the employees or their representatives of the change of control and the information outlined above, and use its best efforts to ensure that this occurs.³¹⁴

The fund manager must also disclose to its regulator and the investors in the fund "information on the financing of the acquisition", which would appear to include all types of finance employed by the fund. Such disclosure will not be required from the fund's potential competitors, such as sovereign wealth funds and wealthy individuals.³¹⁵

When the fund acquires control of a non-listed company, the fund manager must:

- Request and use its best efforts to ensure that the company's annual report includes certain additional information and is made available to all employee representatives or employees.
- Include that information relating to that company in the annual report which the fund manager is required to produce under Article 22 of the AIFMD.
- The additional information must include at least a fair review of the development of the company's business representing the situation at the end of the period covered by the annual report, along with an indication of any important events that have occurred

³¹⁴ Article 27 (1) AIFMD Retrieved on 13 July 2012 from <<http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF>>

³¹⁵ Article 28 AIFMD

in the financial year and the company's likely future development; and information concerning acquisitions of own shares required by the Second Company Law Directive (Directive 77/91/EEC), including the number and nominal value of the shares and any consideration paid.³¹⁶

v. Implementation of AIFMD in the UK

Articles 25 (3) to 25 (8) of the Directive require EU Member States to ensure that their competent authorities possess the necessary powers to supervise the use of leverage and impose supervisory restrictions on AIFMs where necessary to limit the extent to which use of leverage by AIFMs contributes to the build-up of systemic risk in the financial system. This process is coordinated with ESMA, the ESRB and other EU regulators where relevant.³¹⁷

3.5 Comparative analysis between Kenyan and UK approaches to regulating private equity

The private equity market in the UK is far more developed than the Kenyan one. The Kenyan market primarily is very simple and focuses on venture capital while the UK one is far more complex and advanced with products such as hedge funds, captive funds, real estate investment trusts among others. Private equity investors in the UK also invest the secondary market products such as futures, swaps and derivatives. Whereas the UK secondary market is very advanced, Kenya plans to introduce a secondary market and it is yet to be determined whether private equity investments will include the secondary market products.

Limited liability partnerships are the most common vehicles used to operate private equity funds in the UK. On the other hand venture capital funds are operated by venture capital trusts which are listed on the LSE. In Kenya limited liability partnerships are also used to operate PE funds. When it comes to the operation of venture capital funds however, private companies are the statutory vehicles. The law does not yet provide for listed companies to operate venture capital funds.

In terms of transactions LBOs constitute the bulk of transactions for a majority of private equity funds in the UK.³¹⁸ In Kenya on the other hand they are very few LBOs. The bulk of

³¹⁶ Article 28 (3) AIFMD

³¹⁷ Retrieved on 15 July 2012 from <http://www.fsa.gov.uk/static/FsaWeb/Shared/Documents/pubs/discussion/dp12-01.pdf>

³¹⁸ DP 06/6 Financial Services Authority 'Private equity: a discussion of risk and regulatory engagement' p.27-28 Retrieved on 15 July 2012 from http://www.fsa.gov.uk/pubs/discussion/dp06_06.pdf

the private equity transactions are centered on venture capital financing. When it comes to exit options Kenyan private equity investors prefer to divest off their assets through trade sales and repurchases. IPOs are the least preferred of the exit methods. UK investors have similar preferences to Kenyan investors when it comes to exit options. It should be noted that as compared to Kenya IPOs are preferred as exit options by PE investors.³¹⁹

The main regulators of financial services are the Capital Markets Authority (CMA) and the Financial Services Authority (FSA) in the Kenya and UK respectively. The FSA has adopted the twin peak regulatory model while Kenya has adopted the single regulatory model. The FSA is divided into two organizations namely the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) deal with financial services regulation. The British private equity industry has its own supervisory bod BVCA which works hand in hand with the FSA. Kenya does not have an industry body. Both the CMA and FSA have adopted a risk based approach to regulation.

Kenya and UK are both member states of various regional blocs, notably the EU and EAC. The European Union is in the process of synchronizing the activities of the private equity markets in member states. The European Securities Market Authority (ESMA) which is an independent EU Authority that contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection.³²⁰

The EU has also developed directives governing the operations of the financial markets of member states and requiring them to achieve certain results. Private equity funds in EU member states do not have to comply with local legislation in other member states should they want to establish their funds there. The AIFMD applies in this case. The EAC is yet to take similar measures.

In terms of the regulatory framework for private equity, since both countries are commonwealth jurisdictions common law applies. The Capital Markets Authority Act in Kenya is equivalent to the Financial Services Market Act 2000 in the UK since both form the basis for the regulation of financial services and markets. Additional regulation for private

³¹⁹ Ibid p 50

³²⁰ Retrieved from on 28 July 2012 from <<http://www.esma.europa.eu/>>

equity firms in the UK is contained in the FSA handbook and Markets in Financial Instruments Directive (MiFID).

The UK Pensions Act of 1995, Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 and Occupational Pension Schemes (Investment Regulations 2005 are similar to the Retirement Benefits Act 1997 of Kenya in that they all regulate the activities of pension schemes and set out the statutory duties of trustees and fund managers. The UK Proceeds of Crime Act 2002 and Money Laundering Regulations 2007 are similar to the Kenyan Proceeds of Crime and Anti Money Laundering Act No 9 of 2009.

In Kenya, fund management is one of the regulated activities under the Capital Markets Authority Act. In the UK fund management is regulated by the Financial Services Management Act 2000(Regulated Activities Order) 2001 and the Alternative Investments Fund Managers Directive (AIFMD). The AIFMD deals solely with fund management and applies to the whole of the EU.

3.6 Conclusion

There are some similarities between the Kenyan and UK approaches to regulation, although the UK regulatory approach is far more advanced. One of the major factors contributing to this disparity is that the private equity market in the UK is way more advanced than the Kenyan one. Another contributing factor is that the EU is really keen on fostering economic cooperation between member states and it has been quiet proactive. By introducing various financial directives the EU is almost realizing its objectives of harmonizing the regulation for investment services across its member states, increasing competition and consumer protection in investment services and enabling member states improve the macro-prudential oversight of the sector and to take coordinated action as necessary to ensure the proper functioning of financial markets. The face of UK law regulating private equity is now changing to accommodate/implement the changes brought about by EU Directives.

The Kenyan regulatory framework is yet to develop to such advanced stages. As member states of the EAC enhance their efforts to foster economic cooperation between themselves legislators and policy makers will have to look at ways in which they can harmonize their laws.

CHAPTER 4: THE WAY FORWARD: RECOMMENDATIONS

4.1 A summary of the preceding chapters

Private equity is not a new phenomenon. It has significantly enhanced capital market efficiency by widening the availability of capital, increasing the effectiveness of company valuations, identifying companies with growth potential and facilitating their transformation. One cannot simply say that private equity is just an alternative asset class. The private equity market is one that is continuously evolving. New products are emerging and transactions are becoming even more complex as private equity takes a global turn. One of the new trends is that regional blocs such as the EU are coming together to integrate their laws so as to promote and enhance private equity in their local markets. Thus, regulation of private equity is no longer restricted to localities.

4.2 A 'More' versus 'less' approach to the regulation of private equity

The 'more' school of thought believes that if private equity increases value in society, then there should be some form of more stringent regulation to the industry. It is argued that private equity is not well understood since the contracts have become too complex and it is short term in its outlook and provides unjustifiably high returns to its participants with the costs being largely borne by other stakeholders in the corporate sector.³²¹ Those who support the regulation of private equity argue that it is necessary since the industry is characterized by inadequate information disclosure to the public and has numerous corporate governance issues.³²² Proponents for additional regulation suggest that the best way for private equity to

³²¹Ian Mac Neill, Private equity: The UK Regulatory Response Retrieved on 15 July 2012 from <<http://cmlj.oxfordjournals.org/content/3/1/18.full>>

³²² Morris and Phalippou, 2010, Duisenberg School of Finance Policy Paper Series, "Regulating Private Equity" Retrieved on 15 July 2012 from

deal with this issue is by improving its transparency. They propose that regulators should introduce standards that will promote information disclosure and market efficiency.³²³

The ‘less’ school of thought that is against additional regulation of private equity industry deem it as that which is unnecessary to the industry since it is already regulated. Some argue that since private equity is relatively new, it has yet to find its proper niche in society. In the long run, this will happen more or less automatically if markets are left to their own devices.³²⁴ Others argue that private equity is not systemically relevant and therefore should not be lumped together with other categories of leveraged financial institutions. They believe that additional regulation will merely shackle the private equity industry and reduce its productivity.³²⁵

4.3 A new set of laws?

Acknowledging that venture capital markets continue to grow internationally and in a bid to encourage the same in Kenya, the Capital Markets Authority (CMA) spearheaded an initiative to unlock the potential of Small and Medium Enterprises (SMEs). The initiative dubbed ‘The CMA East Africa Impact Investing Task Force Report’ was funded by the Rockefeller foundation.

The formation of this taskforce is one of the proactive steps the authority has taken to identify methods to facilitate venture capital investments in Kenya in line with their mandate of developing capital markets and the Vision 2030 Economic Blueprint.³²⁶ The taskforce’s mandate was to provide insights on the challenges faced by impact investors with a keen interest in early stage ventures in East Africa, an overview of the impact investing opportunities, and propose creative solutions to help overcome the challenges over the

<<http://www.dsf.nl/assets/cms/File/Research/DSF%20Policy%20Paper%20No%209%20Regulating%20Private%20Equity%20November%202010.pdf>>

³²³ Regulating private equity, 2009, p.8

³²⁴ Steen Thomsen, 2009, ‘Should private equity be regulated’. p.8 *European Business Organization Law Review* 10: 97-114

³²⁵ Oliver Smidy and Toby Lewis, 2009, Crunch time for private equity regulation, Retrieved on 5th April 2012 from <<http://www.efinancialnews.com/story/2009-02-23/crunch-time-for-private-equity-regulation>>

³²⁶ *ibid*

medium to long term.³²⁷ This move by the CMA is indicative of the fact that it is high time to implement reforms to the private equity regulatory regime.

4.4 Structural reforms

4.4. a The Capital Markets Authority

The CMA has a key role to play in ensuring market discipline and efficiency. The Authority has put in some effort in trying to come up with legislation though it seems to be doing so at a very slow pace. The Capital Markets Authority ought to consider increasing its technical capacity through training and continuous education. It should also be more proactive and engage industry stakeholders through forums and discussions so that they can carry out their tasks as regulator more effectively.

4.4. b The Kenya Venture Capital and Private Equity Association

One success story of an industry association is the Kenya Bankers Association. It has been in existence for close to 50 years now and has managed to work closely with the Regulator -the Central Bank of Kenya to ensure that Government initiatives and policies are implemented smoothly. A similar association for the private equity and venture capital industry in Kenya would be successful and prove useful in the long run. The main objectives of the Kenya Venture Capital and Private Equity Association would be:

- Serve as the public policy advocate for the private equity and venture capital industry in Kenya.
- To aid understanding, clarity and transparency around the activities of its members.
- Promoting the Kenyan private equity and venture capital industry to entrepreneurs and investors as well as to Government, the East African Community, international media and the general public.
- Provide services and best practice standards for its members across a spectrum of activities covering a network of interconnected committees, which focus on segment-led, legal, technical, regulatory, investor-led and service-led needs.

³²⁷CMA,2011, ‘CMA supports strengthening of SMEs by facilitating access to capital’ Retrieved on 20th July 2012from<http://www.cma.or.ke/index.php?option=com_content&view=article&id=136:cma-supports-strengthening-of-smes-by-facilitating-access-to-capital&catid=14&Itemid=232>

- Provide networking opportunities, training and professional development courses, research, publications, public affairs and communications on behalf of the industry.

The proposed structure for the Kenya Venture Capital Association would be as follows:

a. The Council

The council would be made up of the Chairperson of the Association, the Chairpersons of all the Committees, a small number of other Committee members and the Chief Executive officer of the Association.

Its principal objectives include:

- Promoting to both local and international investors the case for investing in the Kenyan private equity and venture capital industry. This would be so as to not only increase the number of investors but also to increase the type of investors to include pension funds and insurers.
- Influencing public policy by serving as a voice for the Kenyan private equity and venture capital industry when decisions which impact the industry are taken.
- Raising the awareness of the economic benefits of private equity and venture capital. This will be achieved through conducting regular research into the economic impact of private equity and venture capital on the Kenyan economy and disseminating that research to key opinion formers.
- To influence and work with regulatory and professional bodies and lawmakers to create an appropriate framework for the private equity and venture capital industry.
- To provide services relevant to its members and to communicate effectively with them.

b. Committees:

i. The Venture Capital Committee

The Venture Committee would be responsible for improving the sector's access to capital and supporting the interests of the Kenyan venture industry and the high growth companies that it backs. Its objectives would include

- Providing support to venture firms fundraising efforts by supplying appropriate industry data, insights and making the case for the asset class
- Telling the story of entrepreneurship to a wider audience, and show how venture capital supports entrepreneurs, changes lives and builds jobs in Kenya.
- Achieving high levels of venture membership and ensure there is a high level of satisfaction with the service the association provides.
- Promoting an entrepreneurial economy through appropriate fiscal and regulatory policies

ii. The Legal and Advisory Committee

The legal committee would be made up of representatives from the industry together with representatives from legal and accountancy firms whose role would be to provide invaluable assistance to the members in seeking to address and clarify legal, technical and accounting issues relating to the industry. The Committee would also seek to ensure that the role of the private equity and venture capital industry in the context of financial services regulation is understood and accommodated by Government, the regulators and EAC.

Its objectives would include:

- To shape policy and the implementation of policy to ensure that it accommodates the needs of the Kenyan venture capital and private equity industry.
- To communicate with Kenya Venture Capital Association members on legal and technical matters which affect them, their investors and portfolios.
- To raise the profile of the industry and its concerns with regulators and other key industry bodies.
- Keep the Kenya Venture Capital Association members abreast of developments within the regulatory environment.
- Deal with regulators at both a national and supranational level, to ensure the Kenya Venture Capital Association's interests are effectively represented, and that the regulatory environment continues to allow the industry to flourish.
- Provide an interface between the CMA and the industry

iii. Research committee

The research committee would function as an advisory board providing guidance and advice as well as thought leadership to the private equity industry. The Board would comprise of leading practitioners, academics and consultants who are recognized for their research excellence, experience and insight into the venture capital and private equity industry. Its key objective would be to provide guidance and critical oversight to the research work undertaken by the Association, ensuring that research themes cover a pan - African and global perspective.

iv. Members committee

The committee's main objective would be to ensure that the Association continuously provides high quality and professional services to its members. Apart from maintaining a membership directory, the committee would fulfill other functions such as:

- Facilitating various training courses so as to support the development of individual competence and continues to develop according to the regulatory requirements within member firms.
- Hosting of membership events through which would seek to promote optimum networking opportunities for its members.

4.5 Legal reforms

The following legal reforms would go a long way in promoting increased investment in private equity and venture capital in Kenya.

Amendments

- Section 38 (1) (d) of the Retirement Benefits Act, 1997 which provides that the maximum investment a retirement benefit scheme can make in the unquoted equity is 3 per centum of the aggregate market value of the total assets of the scheme subject to written approval of the written approval of the authority. This section created a barrier to pension scheme fund managers who may want to invest in private equity. The law ought to be amended so that retirement benefit schemes can benefit from the returns made from private equity investments.

- Section 56 (1) of the Companies' Act which expressly prohibits any form of financial assistance relevant to the conduct of private equity transactions is in itself a barrier to investment and presents the Kenyan market as a conservative one.
- The wording of Section 23 (1) of the CMA Act and Regulation 3(1) of the Registered Venture Capital Companies Regulations 2007 create a dual regulatory framework for private equity. The wording of section 3(1) of the regulations is very ambiguous and has the potential of exempting some firms that engage in private from its purview. The law ought to be clearly defined so as to determine its scope of application. The current state of ambiguity and lack of clarity of the law has undermined the Capital Markets Authority's powers as an enforcer of the law.
- The law regulating collective investments schemes and fund management ought to be reviewed. The scope of collective investment schemes should be restricted to those open to public subscription.

New laws

- Both the Capital Markets Authority Act and Companies Act ought to be reviewed to include provision for practices that are likely to give rise to conflicts of interest such as multiple directorships, asset tunneling and hostile take-over strategies such as green mails and poison pills. Similarly stringent penalties ought to be formulated and provided for in the law to discourage these practices.
- The laws on disclosure by private equity firms ought to be added to. It is important to appreciate the fact that although some funds are operated by limited liability partnerships or private companies financial reporting for these firms is largely dependent on their activities. Since the market is developing there is a need for formulation of financial reporting guidelines for private equity firms so as to enhance credibility, transparency and safeguard investors' assets.
- Since the CMA, Kenya's financial services regulator is looking to partner with other financial regulators in East Africa, new laws will have to be developed to facilitate this cooperation. Examples of such laws would be those that create marketing 'passports' therefore allowing private equity firms to market their funds to

professional investors in other Member States free of barriers posed by local legislation.

4.5 Conclusion

All is not lost concerning private equity regulation in Kenya. Although it may be a costly and time consuming exercise, the entire private equity legal regime needs an overhaul. Nothing should be left to chance. Setting up a task force once to investigate the happenings in the private equity market is not enough. The Capital Markets Authority should be proactive and engage industry practitioners, stakeholders and intellectual persons on a continuous basis so that they can come up with relevant industry tailored laws rather than just stagnating/borrowing some irrelevant portions of laws from other jurisdictions and trying to enforce them here. Developing a proper, relevant regulatory framework will not only help the Authority avoid the failures and scandals it has experienced in the past with the public equities market but also it will promote the market's growth and efficiency. It is better to prevent than to cure.

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