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FACULTY OF LAW

MASTER OF LAWS

ACCESSING VENTURE CAPITAL: ASSESSING THE LEGAL AND REGULATORY FRAMEWORK FOR THE GROWTH OF THE VENTURE CAPITAL INDUSTRY IN KENYA

THESIS SUBMITTED IN PARTIAL FULFILMENT OF THE REQIUREMENTS FOR THE AWARD OF THE DEGREE OF MASTER OF LAWS IN PUBLIC FINANCE AND FINANCIAL SERVICES LAW

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(Supervisor)

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DEDICATION

I dedicate this Thesis to my dear Dad, Father and Hero: Mr. Amota Nyasae Nyang'era. This was your long time dream, desire and cherished goal for me. I love you and may the Almighty God bless you abundantly.

To my Mum and Friend, the late Mrs. Maria Nyang'era, who passed on in the course of my studies, for your great vision, inspiration and instituting the virtues of hard work, discipline and humility in me. May the Lord rest your beautiful soul in eternal peace.

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My family - for their love and support has been invaluable - and my faith for making this whole journey and thesis possible.

To all my classmates in the LL.M programme and to everyone else who helped me along the way, may the Lord bless you.

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LIST OF ABBREVIATIONS

AIM	Alternative Investment Markets
BVCA	British Venture Capital Association
CDVT	Community Development Venture Fund
CMA	Capital Markets Authority
EAC	East African Community
EPZ	Export Processing Zones
ICPAK	Institute of Certified Public Accountants of Kenya
ICPSK	Institute of Certified Public Secretaries of Kenya
IPO	Initial Public Offer
ISO	Investment Stock Option
M&A	Mergers and Acquisitions
SBA	Small Business Administration
SBIC	Small Business Investment Companies
SMEs	Small and Medium Enterprises
SPSS	Statistical Package for the Social Sciences
SRO	Self Regulatory Organisation
OTC	Over The Counter
UK	United Kingdom
USA	United States of America
VC	Venture Capital
VCs	Venture Capitalists
VCTs	Venture Capital Trusts

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ABSTRACT

Small and Medium Enterprises in Kenya have been variously reported to suffer lack of financial resources for growth and sustainability, especially because debt financing is generally expensive. Venture capital has had a significant impact on Small and Medium Enterprises in the developed countries. It is an important alternative financing for small scale enterprises yearning to grow. Studies have shown that enterprises backed by venture capital are confirmed as key drivers of growth and sustainable development. This paper sought to assess whether the legal and regulatory framework for venture capital in Kenya was adequate to foster economic development by doing a comparative review of the legal and regulatory framework supporting venture capital in other jurisdictions with best practices; and to further make recommendations for the reform of the venture capital industry in Kenya.

The preliminary results of the study revealed the challenges to the growth of the venture capital sector. The findings however responded positively to the research question of whether policy directions and the legal and regulatory environment were hindering or stifling the growth and development of venture capital companies in Kenya. The principal conclusion was that the current legal and regulatory framework is neither sufficient nor adequate to foster its growth.

Finally, findings from this thesis would contribute to the venture capital industry academically.

"AN ECONOMY THAT DOES NOT HAVE A STRONG VENTURE CAPITAL SECTOR IS ONE THAT DISPLAYS SYMPTOMS OF DEEPER ECONOMIC PROBLEMS"

J.P. Cotis, Chief Economist OECD

CHAPTER ONE

INTRODUCTION

1.1 Background to the Problem

The lack of capital for investment has been a major impediment to the growth of the Kenyan economy.[1] The developing world and Africa in particular, faces a dearth of risk capital that has and will continue to constrain business growth. Businesses across the African continent have for many years sourced funds for growth from family members, friends and banks through the traditional lending vehicles. As much as it may be viable and indeed rewarding, and has seen many companies go from one level of growth to the next, a majority have fallen prey to traditional lending financial institutions debt obligations.[2] An alternative to the traditional form of raising capital exists in the form of venture capital (VC).

The European Venture Capital Association (EVCA) defines venture capital a subset of private equity investments made for the launch, early development or expansion of a business. It is capital typically provided by professional, outside investors to new growth businesses.[3] Venture capital finance is also viewed as early stage financing of new and young ventures seeking to grow rapidly. Venture capital is a process by which investors fund early stage, more risk-oriented ventures.[4]

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[1] United Nations Conference on Trade and Development, "Investment Policy Review of Kenya," United Nations: New York and Geneva, (2005), http://unctad.org/en/docs/iteipc20058_en.pdf> accessed 4 April 2010.
[2] Jonathan Adongo and Christoph Stork, "The Venture Capital Gap: Selected Issues for the Seed and Early Stages," *The Namibian Economic Policy Research Unit, Research Report Number 40* (2006).
[3] European Venture Capital Association, *The European Venture Capital Association*, (Brussels: European Venture Capital Association, 2007), 3-4.
[4] Fernan Ibanez, "Venture Capital and Entrepreneurial Development," Working Paper No. 53 (Washington: World Bank, 1989).

Venture capital investments are usually high risk, but have the potential for above average returns. The term VC is likely to be accepted as the generic term for business angels[5] or any similar investments made in early stages of business. A VC fund is generally managed by a VC company. The VC company invests the funds in investee companies to support them in four basic stages of development; Seed or start up, early growth, business expansion and later stage activities.[6] A venture capitalist is a person who makes such investments.

Unlike traditional financing methods, VC is more amenable to higher risk undertakings and higher returns. Thus VC can act as a substitute for domestic investment in countries where domestic investors are not well established or afraid to take risks.[7] On the supply side, banks tend to favour large enterprises and government assets to minimize risk. By the same token, because of the lack of information on creditors and the perceived default risk, there is a fragmentation of the financial system with a large part of the population lacking access to formal financial institutions.[8] Despite the size of the informal sector in most African economies, Kenya included, formal financial institutions tend to operate only on a fraction of the market and often do not take into account the informal sector. This is attributable to the fact that since those firms are not registered, it becomes more difficult for contracts to be enforced and thus

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[5]Business angels are defined in the European Venture Capital Association as wealthy, entrepreneurial individuals who provide capital for a business start up in return for a proportion of the company equity. They take a high personal risk in the expectation of owning part of a growing and successful business.

[6] Ibanez, "Venture Capital and Entrepreneurial Development."

[7] Jonathan Adongo, "Determinants of venture capital in Africa: Cross section Evidence," The African Economic Research Consortium (2011): p 1.

[8] *The Africa Competitiveness Report 2009*. Publication. World Economic Forum, World Bank, African Development Bank. <http://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/Africa%20Competitiveness%20Report%20 2009.pdf>.

more costly for banks in terms of monitoring and screening costs.[9] In most cases and certainly for small and medium scale investments, no guarantees are available. This means that a bank can only provide a maximum of thirty to forty percent of the required long term capital and the entrepreneur will therefore need to mobilize the seventy percent balance.[10]

A study on SMEs carried out in Kenya by the Kenya Institute of Public Policy and Research Analysis[11] shows that many SMEs barely survive past their third year of operation. Many of those that continue to operate stagnate at the 'small' level and do not progressively grow into medium or even large enterprises as envisaged in their conceptual plans. While capacity to run business among owners has been a factor, lack of funds and improper management has also been cited as a key reason for closure and stagnation of SMEs.[12]

In developing countries, the situation is even worse, with banks requiring equity of several times the value of the loan as security. And even then, banks prefer to provide only short term credits that are expensive and uncertain. The financial system in virtually all African countries is weak. Banks usually do not have the confidence of domestic savers and therefore cannot attract longer term funds. In addition, the loan does not provide the right type of capital. A highly leveraged entrepreneur will only have a very limited capacity left to obtain additional capital or short term loans that are often required in a start up phase; and usually interest

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[9] United Nations Industrial Development Organisation, "Venture Capital for Africa, "United Nations Industrial Development Organisation (2001). <http://ent.arp.harvard.edu/AfricaHigherEducation/Reports/UNIDO-VC.pdf> accessed 4 April 2012.
[10] Ibid.
[11] Eric Ronge and Lydia Ndungu "Review of Government Policies for the Promotion of Micro and Small Scale Enterprises," *Kenya Institute for Public Policy Research Analysis*, Discussion Paper Number 20 (November 2002): p 17.
[12] Florence Memba et al, "Venture Capital: Its Impact on Growth of Small and Medium Enterprises in Kenya," *International Journal of Business and Social Science* vol 3 No. 6 (March 2012):p 32-36.

payments start immediately, depriving the enterprise of funds in a stage where it needs all the funds it can get. Banks are also generally difficult to deal with due to the fact that they provide loans with high interest rates and short repayment periods which a newly established business cannot afford to keep up with.[13]

Furthermore, banks have from time immemorial dominated long term financial intermediation. The formal banking system has mainly concentrated in providing finance to already established enterprises because there is less risk involved. VC differs from the commonly known bank loans in that, whereas the venture capitalists go an extra mile to offer professional management services, banks rarely do that. In addition to being a source of funding, an advantage of VC is that a number of value-added services are provided to companies. For example, marketing the company's goods or services and mentoring the direction of the company.[14]

Furthermore, banks traditionally require collateral, which in most cases, companies and other individuals seeking finance cannot provide. For the typical venture capitalist, collateral often takes the form of intangible assets such as research results, innovative marketing ideas or technical skills.[15] The absence of collateral means that venture capitalists cannot simply leave the entrepreneurs to their own devices. They must ensure resources are not squandered so that they can earn a return on their investment. They provide finance in stages to ensure that option value is maximized. Venture capitalists take an active role in the management of the firm they

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[13] Ibid, 33.
[14] Allan Patricof and Julie Sunderland, "A Case for Venture Capital," *Journal of Financial Economics* 58(2005): p 10.
[15] Ibid., 11.

fund and work in close collaboration with the stock market to take the investee companies they fund public.[16] Therefore, they place emphasis on the support they offer start-ups and the controls they might be granted as well as the exit strategy available.[17]

VC also differs from pro-poor financing solutions such as micro finance. VC does not focus on the poor as individuals but on enterprises. More importantly, the enterprises it focuses on are not those whose owner's income is low and are pushed into self employment as a means of survival, as opposed to being attracted to its potential rewards, or whose aim is to grow to a point of supporting the livelihoods of its owner and a few additional employees.[18]

VC differs from equity where by a company issues its shares to the public in order for the public to subscribe for its shares. This mode of raising capital is very expensive for a small or medium enterprise as certain conditions have to be met including a prescribed minimum level of capital which is very high. In any case, the public is not willing to invest in a company that has no history at all. Thus a new entrepreneur is left with few or no option at all in financing a business.

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[16]Daibi Dagogo and Walter Ollor "The Effect Of Venture Capital Financing On The Economic Value Added Profile Of Nigerian Small and Medium Enterprises," *African Journal of Accounting, Economics, Finance and Banking* 5 (2009).
[17] Fernan Ibanez, "Venture Capital and Entrepreneurial Development," Working Paper Series 53, Washington: World Bank (1989).
[18] Jonathan Adongo and Christoph Stork, "The Venture Capital Gap: Selected Issues for the Seed and Early Stages," *The Namibian Economic Policy Research Unit, Research Report, No.* 40 (2006) p 10.

VC has become an important source of financing young entrepreneurial firms. VC backed firms are often perceived as more innovative and as creating more value than others.[19] Enterprises backed by VC are confirmed as key drivers of growth and sustainable development. The consequent impacts these companies have had on their local communities and the wider economy cannot be overstated. They provide employment, education, skills, healthcare, infrastructural development, housing, security and are an endowing source of opportunity.[20] VC is thus an important source of finance that can be able to support business formation and continuity in Kenya but the legal and regulatory framework is largely undeveloped to aid the growth of VC in Kenya. Perhaps for this reason, policy makers in Kenya should be keen to create a good legal and regulatory framework to facilitate the development of an active VC industry.

The legal framework regulating the activities and operations of VC companies are Capital Market Act which contain the statutory provisions and the Capital Markets (Venture Capital Companies) Regulations, 2007 as the subsidiary legislation. Regulation of various types of market intermediaries seeks the protection and benefit of the public at large and those regulations should be made by the government to protect and benefit the public. The Act sets out the requirements that all VC companies are to fulfil before being granted a license to operate as such. The regulations supplement the Act. The regulations should adequately address eligibility and registration requirements, restrictions in investments, fund managers and

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[19]Gil Avnimelech, "Venture Capital Policy in Israel: A Comparative Analysis and Lessons for Other Countries", *The Hebrew University, Mount Scopus Jerusalem.* (2002): p.12.

[20] Alan Patricof and Julie Sunderland, "Venture Capital for Development," Session III, Does Size Matter? Small and Medium Enterprises, Microfinance and Large Nationals Prepared for the Brookings Blum Round Table. (August 2005).

continuing reporting obligations and finally deregistration requirements. Unfortunately, as will be discussed in the preceding chapters this is not so.

1.2 Statement of the Problem.

Lack of a proper, legal and regulatory framework and investor friendly policies have hindered the development of the VC industry in Kenya. Kenya's laws meant to guide the operation of VC are very restrictive and thus stifle the growth and slow entry of VC companies in the country. The lack of a single and clearly defined policy for VC brings a cloud of confusion to the venture capitalists.

The regulations as enacted currently show a great deficiency and lack of appreciation of the core principles for attracting VC companies to set base in Kenya. For instance, high taxation rates do not offer any advantages that can attract foreign VC hence slowing down the growth of the VC industry.[21] In addition, no tax credit for losses or rebates is granted to VC investors. Further, investment regulations limit the investments in which a VC company cannot finance. The registration process is also touted to be long and expensive. Therefore, if the regulations do not contain elaborate provisions on the key determinants for the development of VC in Kenya, then it is doubtful that the regulations will attract VC.

Consequently, the legislative framework must be underpinned by a sound policy framework to ensure that it attracts and promotes the growth and development of VC companies in Kenya.

[21] Jonathan Adongo, "The Impact of the legal environment on venture capital and private equity in Africa: Empirical Evidence", Unpublished (May 2012): p 1.

This study seeks to analyse the legal and regulatory framework governing VC in Kenya and how it guarantees accessibility of VC to the Kenyan entrepreneurs. The regulatory reforms taking place in the world and the attendant changes in the financial sector require that Kenya should review the laws governing the financial services sector as a whole and in particular the VC industry

1.3 Justification for the Study

Rather than Kenya implementing a completely inward oriented program for development of a self contained VC industry, the government might want to implement policy reform measures aimed at attracting global VC flows. This implies evaluating a similar set of regulatory policies relevant for foreign direct investment attraction. Therefore, there is a need to review the legal and regulatory framework governing VC with a view to facilitate investment by VC companies as part of the investment program in SMEs.

This study is important because it is the first of its kind in Kenya. This study will help to show that a good and conducive legal and regulatory environment is essential for the growth and development of the VC industry in Kenya. The study will also assist the policy makers and legislators in formulating practical respective policies and laws that will generally promote the development of the less known VC form of financing in Kenya. The study will also help in analysing and assessing the current VC regulation in Kenya in the context of the legal and regulatory framework and the lessons that can be learnt from experiences of other countries which have a well developed VC industry.

1.4 Objectives of the Study

As a country's legal system plays a significant role in attracting foreign direct investment, the objectives of this study will be to find out how lack of a proper legal and regulatory framework has hindered the development of venture capital in Kenya and what role the government could play including the measures it would put in place to attract and foster the development of venture capital. The specific objectives will be:

(a) To critique the current legal and regulatory framework for venture capital in Kenya

(b) To make a comparative analysis on the legal framework governing venture capital in Kenya and a few selected jurisdictions with best practices; and

(c) To make recommendations for the reform of the legal and regulatory measures that can be put in place to attract or foster the development of the venture capital industry in Kenya.

1.5 Hypothesis

The study is based on the assumption that the current legal and regulatory framework governing the venture capital industry in Kenya is inadequate and does not promote nor attract investment in the country by venture capital companies, hence making Kenya unable to achieve its economic development goals.

1.6 Research Questions

This study will set out to answer the following questions;

(a) Is the current legal and regulatory framework suitable for the growth of venture capital in Kenya?

(b) What best practices exist in other jurisdictions for the promotion of venture capital internationally?

(c) What reforms are necessary to enable the growth and development of the venture capital industry in Kenya?

1.7 Scope of Limitations

Accessing literature on venture capital specifically relating to Kenya is hard as it is a new financing concept on which much has not been written. The VC industry is a closed one bound by confidentiality contracts between the entrepreneur or investee companies and the VC companies therefore making it hard to obtain information. The study will therefore rely on literature from other jurisdictions to gauge Kenya's performance.

1.8 Research Methodology

Research methodology refers to the sum total of the techniques and procedures of collecting data, analysing and presenting the findings. The study adopted an exploratory design. This is precisely because the focus is on in-depth investigation of the respondent's perceptions, views and opinions of a particular issue without the motivation to generalise. The choice was further guided and informed by the fact that there are no earlier studies to refer to with regard to the law governing VC in Kenya.

The researcher relied heavily on primary data key being, data collected from selected respondents using target respondent interviews by use of open ended questionnaires to fund managers and venture capitalists of VC companies. Interviews were preferred because they gave an opportunity to probe and obtain detailed information on this issue. Other sources include Statutes, for example the Capital Markets Act, the Regulations and statutes from other jurisdictions with well established VC regulations.

Secondary data shall be gathered from existing literature from materials such as, working papers, journals and published articles on VC. This approach of data collection is justified on the grounds of accessibility of data.

1.9 Key Concepts of the Study

The following concepts are key to this study.

1.9.1 Venture Capital

It is capital typically provided by professional, outside investors to new growth businesses. It is considered as a form of long term investment for start-up companies and growing business that have the potential to develop into significant economic contributors. Venture capital investments are usually high risk, but have the potential for above average returns.

The venture capital company invests the funds in firms to support them in four basic stages of development; Seed or start up, early growth, business expansion and later stage activities.

1.9.2 Small and Medium Enterprises

SMEs are defined as those enterprises that have between 1 and 50 employees, whether formal or informal.[22] A vibrant small and medium scale enterprises sector, should result in a broad and diversified domestic production base, stimulate indigenous entrepreneurship, mitigate rural-urban migration, promote the development of local technology and contribute to the achievement of macro-objectives such as full employment and equal income distribution. Due to these potential benefits, various efforts have been undertaken to solve deficiencies in the sector and alleviate constraints that affect it. From the experience of policy makers and practitioners it has been realised that the micro and small-scale portion of small and medium scale enterprises spectrum is plagued by various unique deficiencies. These factors contribute to relatively higher rates of business failure in this category and have discouraged many development idealists.

1.10 Theoretical Framework

Regulation is widely considered as the key issue in reforms of service sectors. Many writers have written on the role of government regulation in the development of the national economy. There are number of theories that explain the pattern of government regulation in any given economy. These theories include the public interest theory and interest group or capture theory.[23] Posner classifies both of these theories as theories of economic regulation and states that the properly defined economic regulation refers to taxes and subsidies of all sorts. It also includes the legislative and administrative control over rates, entry and other facets of economic

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[22] Kenya Economic Report, "Building a Globally Competitive Economy," *Kenya Institute for Public Policy Research and Analysis* (2009).
[23] Richard Posner, "Theories of Economic Regulation,"*The Bell Journal of Economics and Management Science*, vol 2 no. 5(1974):p 335.

activities. Professor Croley[24] has also expounded on the public interest and capture theories, as theories of regulation and not strictly as theories of economic regulation as Posner has done.

1.10.1 Public Interest Theory of Regulation

Public interest theory is an economic theory that was first developed by Arthur Cecil Pigou[25] that holds that regulation is supplied in response to the demand of the public for the correction of inefficient or inequitable market responses practices. The public interest theory states that regulation seeks the protection and benefit of the public at large at large and those regulations should be made by the government to protect and benefit the public. The usual definition of economic regulation stresses the active intervention of the government in an industry in order to augment social welfare. Such an intervention in the tradition of Pigou is usually based upon an identification of market failures requiring the government to intervene through an economic policy aiming at correcting these failures. In these public interest theories of regulation, the government intervenes in the market in order to maximise social welfare; he behaves like a benevolent and omniscient dictator acting on behalf of society as a whole.

Richard Posner also argues that that public interest theory holds that regulation is supplied in response to the demand of the public for the correction of inefficient or inequitable market practices.[26] In addition, public interest theory is rooted in the perception that government must step in to regulate markets in instances when markets are unable to regulate themselves. It also

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[24]Steven P. Croley, "Theories of Regulation: Incorporating the Administrative Process," *Columbia Law Review*, vol 98, No. 1(1988):p 65-70.

[25] Arthur Pigou, "*The Economic of Welfare*,"(London: Macmillan & Co., 1932), p 70.

[26] Richard Posner, "Theories of Economic Regulation,"*The Bell Journal of Economics and Management Science*, vol 2 no. 5(1974):p 335.

assumes that economic markets are extremely fragile and apt to operate very inefficiently or inequitably if left alone and that government regulation is virtually costless.

The public interest theory at the basic level states that the regulatory world is populated by three types of actors - the regulator, the citizenry at large, and special interest groups. Special interest groups are described as that part of economy which is sensitive to certain regulatory policies and have strong preferences about what constitutes desirable regulatory outcomes in particular areas.[27] Examples of special interest groups would be manufactures, lawyers or stockbrokers who would all have a special interest in the regulatory policies regarding their particular area of specialization.[28]

The goals of the citizenry and of special interest groups are straightforward. Members of the citizenry want regulatory outcomes that satisfy their preferences and the opportunity to pursue all of their other goals. In other words, members of the citizenry seek what they consider to be desirable regulatory policies but their pursuit of desirable regulatory policies competes with their pursuit of other goals, such as employment and other aspects of daily existence. Their stake in regulatory policy making is thus limited. Special interest groups' stake in regulatory policy is also limited but less so. In fact, what distinguishes a special interest group from the rest of the citizenry is exactly its heightened stake in the regulatory outcome. Special interest groups, like the citizenry at large, seek what they consider to be desirable regulatory policies in whatever regulatory areas that affects them particularly. The special interest groups pursue the

[27] Ibid., 336.
[28] Ibid., 337.

desirable regulatory interests more actively than the rest of the citizenry.[29] First, regulators will want to show their superiority and hold their positions tight. Regulators seek to preserve their positions both for the current personal benefits associated with those positions and for the expected personal benefits they will receive upon leaving those positions as a consequence of having held them.[30] The above theory encourages governments and policy makers to look at market facts and re-enforce the support given to VC, specifically by easing the regulatory environment both for establishing new companies and for their VC partners as the study seeks to analyse the legal and regulatory framework for VC in the country.

Contemporary public interest theorists argue that regulatory outcomes encourage market failures and vindicate the citizenry's interest though not routinely. The originators of the contemporary public interest theory, Michael Levine and Jennifer Forrence states as follows:

"We can see regulation as the necessary exercise of collective power through government in order to cure market failures to protect the public from such evils as monopoly behaviour, destructive competition, the abuse of private economic power, or the effects of externalities. Something like this account, explicitly or implicitly, underpins virtually all public interest accounts of regulation."[31] Regulation is justified because the regulatory regime can do what the market cannot.

[29]Supra note 24 at 66.
[30]Supra note 25 at 69.
[31] Michael E. Levine and Jennifer L. Forrence, Regulatory Capture, Public Interest and the Public Agenda: Toward a Synthesis, 6J.L. Econ 7 Org. 167, 185 as quoted in Steven P. Croley, Theories of Regulation: Incorporating the Administrative Process," *Columbia Law Review*, Vol 98, No. 1(1988):p65-70.

The capture theory of regulation as asserted by George Stigler[32] provides insight into the close connection that tends to arise between a government regulatory agency and the industry it is charged with regulating. The government sector is the economy's rule maker. Governments create and enforce the rules. That is, the public sector regulates the private sector. The stated objective of such regulations is to protect the public interest. Regulation is then undertaken to prevent the industry from creating problems.

The capture or interest group theory takes the view that the regulatory framework is the result of a market regulation. This theory indicates that it is difficult, in many cases, to pinpoint a public interest that can be protected by the regulatory framework. It draws attention to the fact that the state is apparently quite capable of failure. Capture theory imputes a direct interest on the part of particularly affected market players for regulation that is to their advantage. The real architects of regulatory structures are therefore identified as being individual players, especially financial market players, who call for regulatory intervention, often as a means of preventing entry into the market by new players and additional competition.[33] This suggests that a regulatory agency should be protected from outside influence as much as possible. A captured regulatory agency is often worse that no regulation because it yields the authority of government, increased transparency of the agency may mitigate the effects of capture.

[32] George Stigler, "The Theory of Economic Regulation," The Bell Journal of Economics, vol 2 (1971): p 3-21.
[33] Deutsche Bundesbank Monthly Report, “Securities Market Regulation: International Approaches,” *Columbia Law Review*, 67, No. 7 (2012):1-40.

The public interest theory is the guiding theory to be used in this research paper. The justification being that because activities in the financial sector have effects on participants such as investors and the general public at large, there is a public interest in regulating the financial market participants. In light of this, the review of the legal and regulatory framework is important firstly, for investor protection and promotion of economic development; secondly, for the safeguarding and maintenance of a functioning competitive framework; and lastly, for the prevention of potential systemic risks. The study is primarily concerned with the rules and regulations that relate to VC within Kenya with a view to establish whether the provisions of the Capital Markets Act are adequate or sufficient to allow for reasonable entry of VC companies into the country. To this end, the study proceeds on the basis that there is need to examine the law in order to establish whether it allows for the easy entry of VC companies into the country.

1.10.2 Utilitarianism

The utilitarian approach to business dates to philosophers such as David Hume, Jeremy Bentham and John Stuart Mill.[34] The utilitarian's hold that an action is judged good or wrong depending on its consequences. They believe that an act must produce the greatest good to the greatest number of people.[35] Utilitarian's are therefore committed to the maximization of good and the minimization of harm. As a philosophy of business, it focuses attention on the need to weigh carefully all the benefits and costs of an action and to pursue only those actions where

[34] Charles Hill, *Global Business Today* (New York: McGraw-Hill 6th edn, 2009), p 144.
[35] Charles, *Global Business Today*.

the benefits outweigh the costs.[36]Utilitarian decision making relies on systemic comparison of the cost and benefit to all affected parties. Using such a cost benefit analysis, a utilitarian decision maker calculates the utility of the consequences of all possible alternatives and then selects the one that results in the greatest utility.[37] Utilitarian concepts are widely practices by government policy makers, economists and business professionals.

Utilitarianism is a useful principle in conducting a stakeholder analysis since it forces decision makers to firstly consider collective as well as particular interests. Secondly, to formulate different alternatives based on the greatest good for all parties involved in a decision and finally to estimate costs and benefits of alternatives for different groups affected. Therefore, regulators should aim at promoting the good and welfare for the greatest number of investors. This is because at the very heart of the regulations is investor protection. As noted above, government policy makers are one of the groups of people who apply utilitarianism in their decision making. Evidently, the regulations are aimed at benefiting the majority of the venture capitalists as intermediaries in the capital markets by promoting investor confidence and protection.

1.11 Literature Review

It is worth noting that there is extreme paucity of any specific research in VC. This is basically because VC is a relatively new phenomenon in Kenya. It is therefore submitted that this study then provides a ground breaking opportunity to delve into researching VC. Although there is

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[36] Supra note 34 at145.

[37] John Fraedrich, *Business Ethics: Ethical Decision Making and Cases* (Boston: Houghton M. A. Mifflin Company, 1995), p 56.

no specific literature about VC in Kenya, the following literature is generally relevant to the study that touches on the research objectives.

Eno Inanga and David Ekpenyong in their book[38], give a general background to the importance of economic growth with regard to sound legal and regulatory framework. Their general argument is that there is increasing evidence that a country's legal system plays a significant role in attracting foreign direct investment. The authors assert that there is increasing evidence that a country's legal, regulatory and institutional environment play a great role in facilitating the growth of VC through increased investor confidence. The legal framework includes company law, taxation laws, intellectual property laws and dispute resolution laws. The authors continue to state that for both developing and developed countries alike, economic growth is a priority brought about by innovations through start ups. A vibrant small and medium scale enterprises sector, should result in a broad and diversified domestic production base, stimulate indigenous entrepreneurship, mitigate rural-urban migration, promote the development of local technology and contribute to the achievement of macro-objectives such as full employment and equal income distribution. The financial sector forms an important link between a country's macroeconomic policy and the rest of the economy.[39] Its basic role in development is resource mobilization and allocation among productive sectors through financial intermediation.[40]

Venture capital, cannot be effective without sound legal and institutional framework.

38 Inanga Eno, and Ekpenyong, David, *Financial Liberalisation In Africa: Legal And Institutional Framework and Lessons Learnt From Other Less Developed Countries* (Lagos: International Development Research Centre, 2002), p 491.
39 Ibid., 57.
40 Means attracting funds from savers in the surplus sector and channelling them to borrowers for purposes of profitable investment.

The book further discusses how a proactive approach is the best possible approach to financial system development. The proactive approach strategy provides legal and regulatory framework which accelerates financial market development. As a matter of fact, regulatory deficiencies in developing countries seriously limit the growth and development of venture capital. Venture capital is too important to be left solely to venture capitalists. Specialist venture capital policy instruments without compatible tax and proper legislation will always be ineffective.[41]

In addition, developing countries have much to gain from improved legal and regulatory framework for the reason that such reforms can be instrumental in promoting economic development and reducing the level of poverty in developing countries. The authors further argue that the main obstacle in developing a significant high quality venture capital industry is systems failure. This means that there are no proper policies and laws.

From the foregoing, this then means that the legal framework in Kenya is largely unclear and very restrictive, thus determining a significant delay in the diffusion of venture capital in the country. Kenya's laws do not adequately address these issues that would aim at fostering the growth of the industry. The current research will therefore advance further by reviewing and interrogating the aspects of the law relating to venture capital to determine the extent to which the laws enhance the easy diffusion of venture capital in Kenya and on measures to attract or foster the venture capital industry in the country.

[41] Supra note 38 at 148.

Zhang Mako and Zhihua Zeng's book on Promoting Enterprise Led Innovation in China,[42] found the government to be a necessary ingredient in the development of venture capital in a country. From its inception, China's domestic venture capital industry has had heavy government backing. The early history shows that government was the dominant player at the outset of the Chinese venture capital industry. In 1984, the importance of venture capital was officially recognized and in 1985 the first venture capital firm was established with government funds. Since the establishment of the first venture capital company, governments at all levels in China have invested directly in venture capital funds as majority shareholders or directly in start ups.[43]

Although the government still has a strong presence in the domestic venture capital industry in China, foreign venture capital firms have come to control the majority venture capital activities in China today. Governments intervene through improvements or changes in laws and regulations that govern venture capital.[44] The government also intervened in the process by signalling what quality of the start up and early-growth firms was sufficient to warrant other sources of external funding. This book deductively provides for a pro-active strategy, that is, legal, regulatory and prudential framework which accelerate financial markets development through mechanisms, institutions and financial instruments that produce positive externalities that ripple through the economy.[45]

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[42] Chunlin Zhang and Douglas Zeng, *Promoting Enterprise –Led Innovation in China (*Washington D.C: The International Bank for Reconstruction/ World Bank, 2009), p 91, 93.
[43] Ibid., 92.
[44] Supra note 42 at 92.
[45] Chunlin Zhang and Douglas Zeng, *Promoting Enterprise –Led Innovation in China, 92.*

The discussion in the book is a useful foundational framework for the study as it shows how government intervention is needed and how it is appropriate in getting nascent business off the ground. This study will help to show how the government of Kenya can help in assimilating venture capital. The point of departure between the book and the current study is that the authors focus on the legal and regulatory arrangements for venture capital. The institutional framework is not dealt with. The current study will focus on both the legal and institutional framework with regard to the provision of venture capital.

Fernan Ibanez in his working paper [46] argues that if solutions that alleviate constraints on both the demand and supply sides are implemented many potential entrepreneurs who take the leap and try to prove their ideas and capabilities in the marketplace will find appropriate financing and support to assist them in their efforts.[47] Evidence has shown that the supply of venture capital can be largely influenced by the fiscal climate.[48] Investments tend to reflect the fiscal advantages afforded to the investors. Many countries have used fiscal reforms to encourage the creation of new enterprises and the investment of new and existing monies in risky ventures.[49] The legal framework under which venture capital investors have to operate will certainly influence their attitudes towards investments and investment procedures. The main justification of this argument is that in both developed and developing countries the venture capital industry is characterized by great uncertainty, difficult-to-value assets, and substantial

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[46] Fernan Ibanez, "Venture Capital and Entrepreneurial Development", Working Paper Series 53. Washington, D.C.: World Bank, (1989) p 20.
[47] Ibid., 15.
[48] Ibid., 19.
[49] See Avnimelech, supra note 19 at 13.

information asymmetries, therefore there is no reason why similar benefits cannot occur in Africa as in the United States or Asia or where venture capital has truly flourished. [50]

Unfortunately, the investment climate is a major contributing factor to the success or failure of a venture capital solution to supporting enterprise growth. An onerous climate could hinder the success of venture capital even if demand and supply issues are addressed. Fernan agrees with Mako and Zeng on the fact that government activities in the fiscal and regulatory area can help create the enabling environment for both the venture capital industry and the potential venture capital investee companies. Government measures either directly through subsidies or indirectly through participation in private sector projects are crucial at this stage. Government policy should thus be enabling than disabling.

The current study differs from Fernan's paper as it goes deeper in evaluating other factors that also hinder the development of the venture capital industry. Further, the study will compare the legal framework in Kenya to other jurisdictions. However, Fernan's paper is relevant to the study as it analyses the importance of the fiscal environment in supporting the growth and development of the venture capital industry in Kenya.

Raffiq Dossani in his article 'Developing Venture Capital in India' [51] concurs with Zhang Mako and Zhihua Zhen in that the source of risk capital everywhere was either the government, government sponsored institutions meant to invest in such ventures, or informed investors that usually had some prior linkage to the entrepreneur. In general, private banks have been

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[50] Ibid., 14.

[51]Raffiq Dossani,"Developing Venture Capital in India," *Asia/Pacific Research Centre, Stanford University*, (1999):p 12.

unwilling to lend money to a newly established firm because of the high risk and lack of collateral. Venture capital started out in the United States half a century ago and has vigorously grown since then. A set of intermediaries, the venture capitalists, emerged whose sole activity was investing in fledging firms.

From its earliest beginnings, venture capital gradually expanded and became increasingly formalized.[52] Almost half of new firms in the United States which are sold off at Initial Public Offerings (IPOs) have been backed by venture capital. Venture capital related policies in the US seem to have played an extremely important proactive role in creating favourable background (pre-emergence) conditions for the venture capital industry emergence during the late sixties. First and foremost is the Small Business Investment Companies (SBIC) program which contributed enormously to expand VC activity through learning processes by both market agents and policy makers.[53] The role of the government was that of an enabler.

The relevance of this report is that it reviews the key elements for the development of venture capital with regard to government participation. The current research will review the aspects of the Kenyan government participation to determine the extent to which it has participated and whether its function has been enabling rather than disabling.

Countries have mixed experiences with direct government involvement in the venture capital industry as Dossani and Kenney found out in their article 'Creating an Environment for

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[52] Ibid., 15.
[53] Ibid., 19.

Venture Capital'.[54] The efficacy of direct government engagement in the sector is subject to debate; the transparency of the government interventions and the academic studies of their effects have both been very limited. A few government programs have been successful in promoting the venture capital industry, while others have resulted in a substantial waste of public resources and have put the venture capital industry on a worse footing than before. On the other hand government intervention can generate problems in terms of creating market distortion, crowding out the private sector, failing to meet public policy goals and deploying public resources inefficiently.

The World Bank Report titled World Development Report[55] sees the legal and institutional framework of most developing countries as inadequate to support modern financial processes. Examples of such inadequacy include outdated legal systems leading to poor enforcement of laws and lack of investor protection. As regards legislation, Company law is needed because it not only governs the operations of business enterprises but also protects the interests of various company stakeholders. Because of the role of financial institutions in the development of a sound financial system, additional legislation is normally needed for their operations to complement company law. These are prudential regulations that hold an important part between savings and investment. The legal, regulatory and institutional framework discussed is essential for fostering the growth and development of the venture capital industry. Specialist venture capital policy instruments without compatible tax and company legislation will always

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[54] Raffiq Dossani, and Martin Kenney, "Creating an Environment for Venture Capital," *Asia/Pacific Research Centre, Stanford University*, (2001): p 14.
[55] World Bank, "World Development Report," Washington, D.C. (1999).

be ineffective. This still shows that a favourable legal and regulatory framework is essential for the development of venture capital.[56]

The issue of domestic regulation comes into play. Here, the report argues that domestic regulations remain the dominant barriers to assimilation of venture capital. Domestic regulations are used to limit the entry of venture capital firms. As a matter of fact, regulatory deficiencies in developing countries and the resultant concerns regarding the potential of venture capital seriously limit the appetite for investors by governments in developing countries.

From the foregoing, a number of challenges arise in the regulatory structure in Kenya that need to be addressed. The present regulatory regime has resulted in the duplication and overlapping roles in various sub-sectors in the financial services industry. This means that issues of compliance are necessarily complicated because each of the individual regulators has specific regulatory goals. In addition, compliance with such a diverse set of regulatory provisions may lead to increased costs of compliance because of the possibility that the requirements may be in conflict with one another. [57]

However the report argues that developing countries have much to gain from an improved legal, regulatory and institutional structure.[58] This study will go on to examine the various

[56] Ibid.
[57] Ibid.
[58] Ibid.

issues regarding venture capital and domestic regulation and the implications for effective market access with the aim of striking a balance between the potential gains from venture capital and the concerns of entrepreneurs in Kenya.[59]

Jonathan Adongo and Christoph Stork in their article 'The Venture Capital Gap', [60] found out that like the rest of Sub-Saharan Africa, the private sector in Kenya is dominated by micro, small and medium scale enterprises whose major financing is the owner's savings. This is due to the fact that in Kenya, the major providers of finance are banks who are generally difficult to deal with due to the fact that they usually finance established and ongoing business that have sound financial statements and show a great potential to attract investment. All these requirements make it hard for even a small scale trader to find finance. Therefore in Sub-Saharan countries with a less developed financial sector, venture capitalists play a key role in facilitating access to finance for business formation, newly established SMEs who often do not have collateral to get a bank loan to support them in their effort of financing a business.[61]

Since a key barrier to entrepreneurship is a lack of capital, public sector involvement to bridge the financing gap can be useful. In particular public policy involvement in fostering a venture capital industry has proven to be enabling. The venture capital industry considers public policy to be relevant and keeps an eye on whether the policy environment is suitable to promote the development of venture capital markets and to encourage entrepreneurship. The study will go

[59] Ibid.
[60] Jonathan Adongo and Christoph, "The Venture Capital Gap: Selected Issues for the Seed and Early Stages," The Namibian Economic Policy Research Unit, (2006).
[61] Ibid., 54.

further to establish what specific public policies are adequate to enable the flourishing of venture capital in Kenya.

Allan Patricof and Julie Sunderland in their article 'Venture Capital for Development'[62] discuss that a three pronged approach, in terms of principles be formulated to promote and encourage the flowering of venture capital in any economy. The three principles include;[63] Firstly, governments must reform their business environments with the focus on easing regulation and stemming the corruption that feeds on it. Secondly, access to capital for these enterprises must be expanded with government or donor-supported capital augmenting private sources. And finally, entrepreneurs and managers of businesses and SME's need access to skills gleaned from practical experience and international best practices. All three must be pursued simultaneously; with any component missing, competitive business will not take root.

Jonathan Adongo in his article, 'Determinants of Venture Capital In Africa', [64] identifies the determinants of venture capital activity using a cross-sectional data set covering thirty six African countries in a semi-logarithmic model. The main hypothesis in his paper is that macroeconomic, financial and regulatory factors explain differences in venture capital activity in Africa. He finds that rule of law, research and development expenditure as a percentage of Gross Domestic Product and better information between investors and potential investees are positively and significantly related to venture capital activity in Africa. Overall, the paper finds

[62] Allan Patricof and Julie Sunderland, "A Case for Venture Capital," *Journal of Financial Economics* 58" (June 2005): p 20.
[63] Ibid., 21.
[64] Jonathan Adongo, " Determinants of Venture Capital in Africa: Cross Section Evidence," *Africa Economic Research Consortium* no.237 (2011).

that the institutional environment that affects financial factors and regulatory factors explain venture capital activity in Africa. He reiterates that the differences in venture capital across countries can be further explained by financial and regulatory factors that affect technological opportunities and the entrepreneurial environment.[65] His findings contribute to the relatively under-explored research area of venture capital and provide insight into the factors that influence venture capital activity in Africa where limited.

By investigating venture capital activity in Africa, this paper contributes findings from a region that has not been explored in any of the previous, multi-country, empirical studies that have focused on analysing the determinants of venture capital activity. In addition, not all macroeconomic, financial or regulatory factors tested in previous empirical studies were found to determine venture capital activity.

In another article by Jonathan titled 'The Impact of the Legal Environment on Ventura Capital and Private Equity',[66] using a novel dataset, empirically assesses the impact of the legal environment on venture capital and private equity activity across fifty African countries between 2004 and 2010. Preliminary results indicated that a better legal environment increases market entry by investors and entrepreneurs. While seed, start-up or early stage venture capital increases with better rule of law, expansion stage venture capital decreases or is practically zero. In addition, venture capital increases where strength of property rights is weaker. These

[65] Ibid., 4.
[66] Adongo, Jonathan."The Impact of the Legal Environment on Venture Capital and Private Equity in Africa: Empirical Evidence." (PhD article, University of Middle Tennessee State University Murfreesboro, 2012).

findings suggest that venture capital substitutes for debt financing from other sources, for example, banks, in weaker legal environments. The study also shows the relationship between the legal environment and the different stages in financing a start up. However, this current thesis will advance further by identifying the determinants and variables of venture capital activity with specific reference to Kenya.

1.12 Conclusion

In the UK, the venture capital industry supports close to one in five private sector jobs. In the US venture capital backed companies employ one in ten jobs.[67] With the right policies, incentives and investments the Kenyan venture capital industry has the potential to create and support one in ten required private sector jobs. Like their counterparts in wealthy nations SMEs in developing countries are responsible for a disproportionate amount of innovation, growth and employment compared to the resources they consume. Yet they have little access to the long term capital they need to grow. Enterprises supported by venture capital investment are vital in bringing economic growth and sustainable development to African economies.

Venture capital financing can add significant advantages to the investment recipient, such as access to a national and international networks of suppliers, producers and consultants, gain of critical mass, attraction of world class management and facilitation of regional and international business expansion. Thus the study will explore the peculiar challenges that venture capital

[67] Ibid., 5.

companies face in Kenya and offer various recommendations in order to attract and promote venture capital investment in the country.

1.13 Chapter Breakdown

Chapter One: Introduction

Chapter one will lay the framework for the entire study. The chapter will contextualize the research problem. This chapter will discuss the background to the problem, statement of the problem, the theoretical framework, literature review, objectives of the research, research questions and the methodology that will be used to conduct this study. The chapter breakdown will also be covered by this chapter.

Chapter Two: Review of the Existing Legal and Regulatory Framework for Venture Capital in Kenya

Chapter Two shall discuss the policy framework and review the legal and regulatory framework for venture capital in Kenya.

Chapter Three: Findings and Data Analysis

Chapter Three will deal with Data Analysis. This thesis is based on qualitative research approach. Data will be collected qualitatively by conducting interviews using open ended questionnaires. The reason for the selection of this data collection method stems from the fact that it provides the researcher with the opportunity to have a deeper experience and understanding of the challenges facing venture capital in Kenya.

Chapter Four: International Examples and Best Practices

Chapter Four shall fully discuss thematically the general factors and best practices that have aided in the development of venture capital in various countries. The discussion shall take into account the best practices in developed countries and also less developed countries that have taken advantage of the use of venture capital.

Chapter Five: Summary of Findings, Conclusions and Recommendations

Chapter Five of the thesis will deal with the conclusions and recommendations by giving a proposal for a revised regulatory framework for the growth of the venture capital industry in Kenya based on the discussions in the various chapters. The proposals shall take into account the best practices around the world.

CHAPTER TWO

REVIEW OF THE EXISTING LEGAL AND REGULATORY FRAMEWORK FOR VENTURE CAPITAL IN KENYA

2.4.1 Introduction

Chapter One discussed the Background of the study, Objectives of the study, the Theoretical framework and the Literature Review. This chapter commences with an overview of the law as it is by reviewing the policy, legal and regulatory framework for venture capital in Kenya. The aim of the thesis is to consider the state of the current legislative framework governing VC whilst identifying the weaknesses in the regulatory framework.

The Kenyan legal and regulatory framework that deals with venture capital comprises of the Capital Markets Act[68] as the applicable law. Subsidiary legislation includes the Capital Markets (Registered Venture Capital Companies) Regulations, 2007 and the Income Tax Act (Venture Capital Company) Rules, 1997.[69] The Capital Markets Authority (CMA) is the state regulator.

2.4.2 Policy Framework for Venture Capital in Kenya

This part examines the policy framework for venture capital in Kenya. It can be clearly deduced that clear guidelines and policy statements are essential in order to make the current system work better for investors by increasing predictability and reducing discretionary powers. In 2007, the Government of Kenya reviewed its investment policy to attract investment. Kenya's

[68] Cap 485A of the Laws of Kenya.
[69] Cap 470 of the Laws of Kenya.

investment code, articulated in the Investment Promotion Act of 2004,[70] is designed to streamline the administrative and legal procedures to achieve a more effective investment climate. The objective of the Investment Promotion Act is to attract and facilitate investment by assisting investors in obtaining the licenses necessary to invest and by providing other assistance and incentives. [71]

The Foreign Investments Protection Act[72] gives protection to certain approved foreign investments. The Government of Kenya focuses its investment promotion on opportunities that earn foreign exchange, provide employment, promote backward and forward linkages, and transfer technology. The only significant sectors in which investment, both foreign and domestic are constrained are those where state corporations still enjoy a statutory monopoly. These are restricted almost entirely to infrastructure (e.g., power, posts, telecommunications, and ports) and the media, although there has been partial liberalisation of these sectors.

Infrastructure is a key foundation upon which science, technology and innovation activities are operationalised. Infrastructure encompasses a wide array of critical issues including intellectual property rights, information systems, banking, venture capital, standards and norms, innovation and business support system issues. Science, technology and innovation will be critical in addressing infrastructure challenges. One of the critical infrastructure is that of financing of Science, Technology and Innovation. The policy will facilitate multi-faceted

[70]Cap 485B of the Laws of Kenya.
[71] United Nations Conference on Trade And Development. Investment Policy Review, Kenya United Nations New York 2011.
[72] Cap 518 of the Laws of Kenya.

financing of Science, Technology and Innovation which will include venture capitalists, angel investors and angel investor networks in addition to the traditional methods of financing through access to credit in banks and development partners.[73]

The Government of Kenya aims to transform the economy into a modern, globally competitive, middle income country offering a high quality of life for its citizens by the year 2030.[74] To achieve this goal, the Government intends to put in place measures that will raise the national GDP growth rate to 10% by 2012,[75] create more employment opportunities, and bring more equitable development in all regions of the country. The Medium Term Plan of the Kenya Vision 2030 identifies the key policy actions and reforms as well as programmes and projects that the Government intends to implement in the period 2008-2012. In order to achieve the growth targets, the Government has identified six priority sectors namely financial services, tourism, agriculture, livestock and fishing, wholesale and retail trade, business process outsourcing and manufacturing here most of the resources will be concentrated.

The financial services sector is expected to play a key role in mobilising the savings and investment required to implement the Medium Term Plan with a view to facilitating higher savings and investments. The projects and programmes to be pursued in the medium term for the various components of the financial sector will aim at creating a vibrant and competitive financial sector and will include reviewing the legal, regulatory and supervisory frameworks

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[73]A Policy Framework for Science, Technology and Innovation. Ministry of Higher Education, Science and Technology .
[74]Kenya Vision 2030: A Globally Competitive and Prosperous Kenya.
[75] Sessional Paper No. 12 of 2012 on Kenya Vision 2030.

and consolidating the oversight function of the financial system. The central policy objectives of the long-term strategy for the financial sector will include among others; improved access and deepening of financial services and products for a much larger number of Kenyan households and small businesses and creating a better financial environment that will encourage stakeholder involvement in ways that allow for an attractive return on investment in order to make Kenya one of the best ranked financial centres by 2030.[76] The lack of a substantive government policy on VC is a factor that serves to reduce the effectiveness of VC as a development partner. Without such a policy, institutions charged with industry regulation are left to their own devices and are likely to lack precision as far as regulatory objectives are concerned.

2.4.3 Regulation of Venture Capital under the Capital Markets Act

The regulation of venture capital companies in Kenya is governed by the Capital Markets Act. The Capital Markets Act establishes the Capital Markets Authority (CMA)[77] for the purposes of facilitating the development of an orderly, fair and efficient capital markets in Kenya through effective regulation that encourages innovation and safeguards market integrity.[78] The CMA is empowered to make and issue regulations to regulate market intermediaries such as investment banks, stockbrokers and authorized securities dealers.[79] In accordance to this provision, the CMA issued the Capital Markets (Registered Venture Capital Companies) Regulations, 2007 to

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[76] Kenya Vision 2030: Second Medium term Plan 2013-2017.
[77] Capital Markets Act section 5(1).
[78] Capital Markets Authority Annual Report, 2013 (CMA Nairobi 2013) Mission statement.
[79] Capital Markets Act Section 12(1).

complement the role of the CMA in ensuring that the venture capital markets operate effectively.

A registered venture capital company is defined in the Capital Markets Act as a company approved by the Capital Markets Authority and incorporated for purposes of providing risk capital to small and medium sized businesses with high growth potential, whereby not less than 75% of the funds so invested consist of equity or quasi-equity investment in eligible enterprises.[80]

2.4 Capital Markets (Registered Venture Capital Companies) Regulations, 2007

The Capital Markets (Registered Venture Capital Companies) Regulations, 2007 are a set of regulations that prescribe the requirements for licensing and approval of VC companies. The regulations provide for requirements regarding eligibility, registration, investments, fund managers, continuing reporting obligations and deregistration of venture capital companies.

A registered venture capital company is defined in the Capital Markets (Registered Venture Capital Companies) Regulations, 2007 as a company incorporated under the Companies Act with the primary objective of providing substantial risk capital to small and medium size business in Kenya through equity, quasi equity investments or other instruments whether

[80] Capital Markets Act Section 2.

convertible into equity or not as well as managerial or technical expertise to such business entities.[81] Below, the various regulations are discussed.

2.4.1 Eligibility Requirements

Eligibility requirements are provided for in Rule 3 of the Capital Markets (Registered Venture Capital Companies) Regulations, 2007. For a VC company to be eligible to operate in Kenya under Rule 3, it must have been duly incorporated under the Companies Act as a company limited by shares.[82] Its principal object should be the provision of risk capital to small and medium sized companies. The VC company must have a minimum paid up share capital of one hundred million shillings (Kshs. 100,000,000) in addition to a minimum fund of one hundred million shillings (Kshs. 100,000,000) making a total of two hundred million shillings (Kshs. 200,000,000).[83] Audited financial statements and a demonstrable record as a VC company of at least three years are also required. The VC company must also engage the services of a duly licensed fund manager, an auditor who is member of the Institute of Certified Public Accountants of Kenya (ICPAK), a company secretary who is a member of the Institute of Certified Public Secretaries (ICPSK) and a board of directors where at least one third of the directors are independent directors.[84] The above regulations must be adhered to before a venture capital company can attempt to operate in Kenya.

[81] The Capital Markets (Registered Venture Capital Companies) Regulations, (2007).
[82] The Capital Markets (Registered Venture Capital Companies) Regulations Rule 3 (a).
[83] The Capital Markets (Registered Venture Capital Companies) Regulations Rule 3 (b).
[84] The Capital Markets (Registered Venture Capital Companies) Regulations Rule 3 (g) to (j).

2.4.2 Registration Requirements

The requirements as stated in Rule 4 include a certified copy of the applicant's certificate of incorporation accompanied by a certified copy of the applicant's Memorandum and Articles of Association. Other details to be disclosed include; details of the investment policy in respect of each fund to be operated by the applicant setting out the investment objectives; minimum and maximum investment amounts in any single enterprise; investment rules; investment process; exposure limits to individual eligible venture capital enterprises; preferred mode of divestiture from eligible venture capital enterprises; disclose a clear strategy for the diversification of investments in eligible venture capital enterprises; policies on fees and charges; profile of companies invested in and details of risks factors that are specific to the chosen investment sectors.[85] A letter of acceptance of the appointment from the fund manager should also accompany the application together with the management agreement between the registered venture capital company and fund manager.[86]

In addition, a bank reference from a commercial bank; business references from at least two companies in which the applicant has invested in explaining the nature and duration of the investment; the contribution the applicant has made to the business of the company providing the reference accompanied with the prescribed application fee; and any further information that the Authority may deem necessary to determine the application must also be provided. Its only

[85] The Capital Markets (Registered Venture Capital Companies) Regulations Rule 4 (a) to (d).
[86] The Capital Markets (Registered Venture Capital Companies) Regulations Rule 4 (e) and (f).

after the CMA is satisfied that the applicant meets all the requirements will it issue a certificate of registration.[87]

2.4.2 Investments Regulations

Investment regulations are provided for in Rule 8. This prohibits the investments in which a VC company cannot finance. They include trading in real property, banking and financial services and retail and wholesale trading services.

2.4.3 Fund Managers Regulations

Fund managers are regulated in Part V Rule 9. The requirements provide that no person shall act or be appointed as a fund manager unless such person is duly approved by the Capital Markets Authority to manage venture capital funds.[88] The fund manager shall ensure that a prudent investment policy is in place in respect of each fund and that all fund investments are carried out in accordance with the disclosed investment policy and in compliance with the management agreement.[89]

2.4.4 Continuing Reporting Obligations

The fund manager is required under Rule 19 to keep all books of account and maintain records that accurately reflect the affairs of the funds under management. Every record shall be preserved for at least seven years after the completion of the transaction to which it relates. Each

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[87] The Capital Markets (Registered Venture Capital Companies) Regulations Rule 4 (h) to (m).
[88] The Capital Markets (Registered Venture Capital Companies) Regulations Part 4 Rule 9.
[89] The Capital Markets (Registered Venture Capital Companies) Regulations Part 4 Rule 10.

fund manager shall be required to file quarterly returns with the CMA detailing any investments made by each fund and the consideration paid. Further, details of any disposals of investments and any profits derived or loss incurred from those disposals.[90]

2.4.5 Deregistration Regulations

Deregistration regulations are provided for in Part VIII Rule 23. A VC company shall be deregistered if it ceases to meet the requirements for registration and fails to comply with the Capital Markets Act. If the directors of the registered venture capital company request that the venture capital company be deregistered, then their wishes will be granted.[91]

2.5 Regulation of Venture Capital under the Income Tax (Venture Capital) Rules, 1997

The Income Tax Act is an Act of Parliament that was enacted to make provision for the charge, assessment and collection of income tax for the ascertainment of the income to be charged and for the administrative and general provisions relating thereto. The Income Tax Act of Kenya under the Income Tax (Venture Capital Company) Rules, 1997 defines a venture capital company as a company incorporated in Kenya for the purpose of investing in a new or expanding venture enterprise."[92]

Rule 3 provides for registration of venture capital companies. It states that a venture capital enterprise shall be registered by the Commissioner for the purposes of this Act:

[90] The Capital Markets (Registered Venture Capital Companies) Regulations Part 7 Rule 20.
[91] The Capital Markets (Registered Venture Capital Companies) Regulations Part 8 Rule 23.
[92] The Income Tax (Venture Capital Company) Rules, 1997.

(a) if the Commissioner is satisfied that the company is incorporated in Kenya;

(b) it is incorporated for the purpose of investing in new or expanding venture capital enterprises;

(c) it is registered by the Capital Markets Authority;

(d) it is managed by a fund manager; and

(e) seventy-five percent or more of its portfolio of investable funds is invested by way of equity or quasi-equity investment in venture capital enterprise; and the primary activities of the venture capital enterprise in which it has invested are approved activities.

Rule 4 lists out the activities that a venture capital company cannot be involved in. The activities include banking and financial services; retail and wholesale business and trading in real property.[93]

Rule 6 deals with withdrawal of registration. The Commissioner is empowered at any time by notice in writing to the fund manager to withdraw the registration of a venture capital company if in the opinion of the Commissioner, the VC company no longer qualifies for registration.

2.6 Critical Analysis of the Legal Framework In Kenya

2.1 Eligibility Requirements

Venture capital companies are regulated through licensing which is viewed as a stricter means of ensuring that minimum requirements are met before a person or institution can be granted authorisation to provide a service. The eligibility requirements are far above the standard

[93]The Income Tax (Venture Capital Company) Rules, 1997.

requirements in many jurisdictions. For example, a number of the requirements, among other things are an auditor, a company secretary and a board of directors of which one third of the directors are independent directors all from Kenya. This simply means that majority of the management team is comprised of Kenyan citizens. This makes venture capitalists shy away as they also want to be included in the management of the company. Furthermore, the entire requirements make it very expensive for a venture capital company to operate in Kenya.

The minimum capital requirement is also quite high standing at two hundred million Kenya shillings. There is no criterion that has been used to set the minimum capital requirement. There should be a method of arriving at the minimum capital. This forces investors to prefer other favourable jurisdictions to Kenya. Comparing with South Korea, the venture capital regulations provided special regulations for venture capital companies to encourage investment in high technology ventures. To qualify to operate as a venture capital company, the company must receive the approval of the Ministry of Finance, specialize in making investments in foreign or domestic technological enterprises or in other enterprises and assist in the management or supervision of such enterprises. There is a minimum capital requirement of US$ 70,000 minimum capitalization (approximately Kshs. 6,000,000) requirement for venture capital companies and they must put at least 70% of their investments in technological enterprises such as telecommunications, information, consumer electronics, semiconductor, precision machinery and automation, aerospace, advanced materials, specialty chemicals and pharmaceuticals, medical and health care, pollution control, resources exploitation and advanced sensing systems.

The South Korean Venture Capital Regulations[94] grant the government certain information and oversight rights over VC companies. Prior to approval, a VC company applicant must provide a business plan, list of shareholders and articles of incorporation and the general managers' and deputy general mangers' educational and employment information must be submitted to the government. The consent of Ministry of Finance is required for certain actions, such as suspending business operations.

2.2 Registration Requirements

The legal entity in Kenya must be a company as opposed to many jurisdictions which allow for the formation of limited partnerships, which are the common international method of organizing venture capital entities.[95] The primary tax advantage of the limited partnership structure is that income and losses are taxed in the partners' hands (as capital gains/losses, interest payments, or dividends) and not in the partnership. The partners' liability, excluding that of the general partner, is limited to the amount subscribed, and the partnership can have a limited tenure.[96]

The registration process is long, cumbersome and very expensive. The application for registration is loaded with many requirements and various documentations making the process very lengthy. There are also fees to be paid at each stage of registration. This makes it expensive to register a venture capital company in Kenya. The costs of registering a venture capital

[94] Haksoo Ko, and Hyun Young Shin. "Venture Capital in Korea? Special Law to Promote Venture Capital Companies." American University International Law Review 15, no. 2 (1999): 457-480.
[95] Ibid., 460.
[96] Ibid., 461.

company are enormous and are eventually borne by the entrepreneur or investee company as a means of cost sharing with the venture capital company. It can be seen that the existing situation fails to agree with the basic requirement that regulatory provisions should be simple and encouraging rather than discouraging.

2.3 Investments Regulations

Industry players have observed that restrictions on investments without any reasons threaten the venture capital sector's survival.[97] From the above regulatory measures put in place, policy makers have only made lopsided rules regarding licensing, minimum capital requirements, rules for regulating fund managers and rules prohibiting certain activities of venture capital companies. Comparing Kenya's investment's regulations with those in countries discussed in chapter Two, investments were made across all development stages for both private and publicly listed companies.

In South Korea[98] and China[99] for example, the requirement is for VC companies to put at least 70% of their investments in technological enterprises such as telecommunications, information, consumer electronics, semiconductor, precision machinery and automation, aerospace, advanced materials, specialty chemicals and pharmaceuticals, medical and health care, pollution control, resources exploitation and advanced sensing systems.

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[97] Steve Mbogo, "New Laws Threaten Edge of Venture Capital Firms," *Business Daily* April 9, 2008, Business.
[98]Haksoo Ko, and Hyun Young Shin. "Venture Capital in Korea? Special Law to Promote Venture Capital Companies." American University International Law Review 15, no. 2 (1999): 457-480.
[99]Steve White, " China's Venture Capital Industry: Institutional Trajectories and Systems Structure", Prepared for the International Conference on Financial Systems, Corporate Investment in Innovation and Venture Capital, Brussels, (2007).

No rules have been made in Kenya for taxation of VC companies or incentives to foster their development. The only incentive provided for VC companies in Kenya are that dividends received by a registered VC company are tax exempt.[100] Comparing the legal and regulatory framework with a country like Israel, many incentives such as relaxation of existing regulations, lower entry requirements, tax benefits, tax holidays, government guarantees and subsidies were provided with the primary purpose of providing a more efficient and effective market environment for venture capital companies. The U.S. government generally practiced sound fiscal policies to foster the growth of the industry by, for example, reduction in the taxation on capital gains and reducing the private cost of early entrants to the VC industry.[101].

Kenya has only one incentive and this makes the venture capitalists to prefer other investment friendly jurisdictions. The policy makers are not keen on improving the regulatory framework in order to foster the growth of the venture capital industry in Kenya despite the fact that it has been fronted as a key driver in economic development in the Vision 2030 and the Millennium Development Goals.

Comparing the Export Processing Zones (EPZs) and the VC industry in Kenya, where the former is also said to contribute to economic development, and has been given huge and favourable tax concessions, the VC industry in Kenya has not been accorded the same privileges in order to find their footing. As venture capitalists also contribute to technical and managerial

[100] The Capital Markets Policies and Fiscal Incentives - Kenya
[101] Revenues Act of 1978 of United States of America

expertise which is mostly transferred to Kenyan entrepreneurs, they should be afforded more advantages given the fact that Kenya lags behind in managerial expertise.

Special incentives that are provided for enterprises operating in the Export Processing Zones under the Export Processing Zones Act, 1990 include procedural incentives such as exemption from certain licenses and facilitation services by the Export Processing Zones Authority.[102] Such incentives include: Exemption from all existing and future taxes and duties payable under the Customs and Excise Act and Value Added Tax Act on all export processing zone imports for use in the eligible business activities of the EPZ enterprise; Exemption from registration under the VAT Act; Exemption from the payment of income tax for the first 10 years from the date of first sale, followed by a rate of 25 per cent for the subsequent 10 years and the standard rate thereafter; Exemption from the payment of withholding tax on dividends and other payments made to non-residents for the first 10 years and exemption from stamp duty.[103]

Since Export Processing Zones are vehicles of economic development in Kenya just as VC is, players in the market are of the opinion that favourable incentives should also be extended to VC companies as well. At the moment, the only incentive that the VC companies enjoy is the tax exempt dividends.[104] Capital gains tax in Kenya was suspended in 1985. VC companies do not enjoy tax holidays neither are they charged tax at a lower rate. The market is therefore skewed with preference to the EPZ as opposed to the VC industry which is of equal, if not higher

[102] Kenya Economic Report 2009, "Building a Globally Competitive Economy," Kenya Institute for Public Policy Research and Analysis (2009).
[103] Ibid., 5.
[104] Capital Markets Policies and Fiscal Incentives.

importance in the economic development of Kenya through the financing of small and medium enterprises.

2.4 Fund Managers Regulations

Following the rules that have been enacted in relation to fund managers, in countries where the VC industry has grown rapidly and matured, its development has been advanced by a comprehensive, supportive web of institutions, practices, and attitudes that foster an enabling environment that can be referred to as a culture of entrepreneurship and VC. Among the lessons that more experienced countries have learned regarding creation of venture funds, is the need to hire experienced investment professionals to develop, invest and monitor the fund's program and this advice applies at every level of the VC chain, from entrepreneur, to fund manager, to intermediary organisations. Yet, the availability of trained venture finance professionals in Kenya is limited, and their numbers appear to be few compared with some other emerging market countries.

Regarding the prudent investment policy, low confidence in local laws and courts leads some fund managers to become more rigid with regard to investment terms or alter their investment strategies, or pull out of countries entirely. To remedy this, self-executing mechanisms worked into venture agreements are used to ensure the fulfillment of contractual matters that might otherwise be enforceable in the courts. In addition, a more relaxed investment policy would be another alternative.

2.5 Continuing Reporting Obligations

The fund manager is required to file quarterly returns with the CMA detailing any investment made by each fund, disposals of any investment and any profits derived or loss incurred from those disposals. The VC industry is a closed one bound by confidentiality contracts and non-disclosure agreements between the entrepreneur and the venture capitalists therefore making it hard to obtain data and information. Requiring the VC Company to disclose sensitive information would be a delicate situation. The transparency required to assemble an accurate picture of a business may be difficult and expensive to achieve, especially in smaller family owned businesses.

2.6 Deregistration Regulations

The regulations prescribe that a VC company shall be deregistered if the directors of the VC company request that the VC company be deregistered, it ceases to meet the requirements for registration or fails to comply with the Capital Markets Act. From the international examples earlier discussed, no country has the provision for deregulation. Most jurisdictions opt for exit options by initial public offering, mergers and acquisitions, management buyback and sale of the firm.

2.7 Conclusion

From the foregoing discussion and analysis, it can be deduced that the regulations governing VC in Kenya ran contrary to the best international practices in the world. It is also incomplete, patchy and dispersed.

Chapter Three of the thesis will discuss the findings of the research. Data collected will also be analysed.

CHAPTER THREE

FINDINGS AND DATA ANALYSIS

3.1 Introduction

Chapter Two discussed the current legal and regulatory framework in Kenya and the shortfalls in the current legal framework. The current Chapter will deal with Data Analysis, and how the same confirms the loopholes or short falls in the in the current legal and regulatory framework in Kenya. The role of VC in Kenya has been elaborately discussed in Chapter One of this thesis.

The study was an empirical investigation of the legal and regulatory framework for the development of VC in Kenya. It sought to meet the objectives of the study by establishing whether the legal and regulatory framework for the development of venture capital in Kenya is effective and how it influences the economic development process and also determine how diverse best practices on the role of VC in Kenya. In addition, it also sought to suggest laws and regulations in order to promote the development of VC in Kenya.

The researcher issued out ten questionnaires to the target respondents. The response rate was a hundred per cent. The breakdown of the responses is as tabulated in table 1 below. This was considered a good percentage to infer into challenges and/or problems, arising out of the legal and regulatory framework relating to VC in Kenya. The justification for issuing only ten questionnaires is based on the fact that there are approximately fourteen VC companies operating in Kenya. Therefore, the sample size was representative of the total population.

This study has been carried out based on qualitative method of data gathering. Primary data was obtained by conducting interviews by use of open ended questionnaires, which are attached as Appendix I. The questionnaires were administered personally by booking an appointment with the target respondents who were identified through a search at the registrar of Companies. The respondents were selected based on the number of years they have been in operation in Kenya and the type of businesses or enterprises they invest in. This method of choosing the target respondents is guided by the research objectives. The researcher wanted to get a balanced opinion based on the experience of those who had stayed for long and also the new entrants. The list of respondents is attached as Appendix II.

The data was analysed using SPSS, which provided tabular data with frequencies and presented using tables. The interviews were conducted between June and August 2012. The data was manipulated to bring out the relevant factors as shown in the data analysis section.

The data is analysed in two parts. The first part deals with general information. The second part, deals with the findings on specific information, based on the respondents' opinion on the role of VC in Kenya.

3.2 Findings and Discussion of the Findings

3.2.1 General Information

This section gives the general information of the respondents including the ownership of VC companies, duration for which they have operated in Kenya, experience of the venture capitalists and the recipients of the VC funds. Ten respondents were interviewed and the response rate was a hundred percent. Respondents comprised of venture capitalists and fund managers of VC companies and funds.

Table 1 Ownership of the venture capital companies

Form of Ownership	Frequency	Percentage
Foreign owned	9	90
Locally owned	1	10
Total	**10**	**100**

Table 1 shows ownership of the VC companies in Kenya. Majority, (90%) of the firms are foreign owned with subsidiaries or branches in Kenya with the least (10%) being locally owned.

Table 2 Operation of venture capital companies in Kenya

Duration in (years)	Frequency	Percentage
Less than 5	5	50
Between 5 and 10	4	40
More than 11 years	1	10
Total	**10**	**100**

Table 2 shows how long the respondent's organisation has been in operation in Kenya. Majority, (50%) of the respondents have been in operation in Kenya for a period of less than five years, with the least (10%) having being been in operation in Kenya for a period of more than eleven years.

Table 3 Experience of venture capitalists/ Fund Managers

Experience in years	Frequency	Percentage
Less than 5	0	0
Between 6 and 10	1	10
More than 10	9	90
Total	**10**	**100**

Table 3 shows the number of years of experience of venture capitalists/Fund managers. Majority, (90%) of the respondents have experience spanning more than ten years while the least (10%) has experience of less than ten years. This implies that the study was in a position to get reliable information on VC regarding the legal and regulatory framework in Kenya.

Table 4 Typical sizes of investments

Size of Investments in Kshs.	Frequency	Percentage
Below I00 million	1	10
Between 100 and 500 million	3	30
Between 600 and 1 billion	4	40
Above one billion	2	20
Total	**10**	**100**

Table 4 shows the size of investments that the VC company and funds invest in. Majority of the VC companies (40%) invest in enterprises that require funds between shillings six hundred million and one billion. This is line with the general rule of high risk high capital. The least investment of the VC funds is one which is below shillings one hundred million. Total VC funds in Kenya are about USD200million. Of this, about USD40m target early-stage SMEs.

Table 5 Recipients of venture capital funds

Types of recipients	Frequency	Percentage
Agricultural business	3	30
Science Innovation and Technology	6	60
Others	1	10
Total	**10**	**100**

Table 5 shows the recipients of VC funds from VC companies. Majority, (60%) of the respondents preferred investing in enterprises that are undertaking science, innovation and technology telecommunications, information, consumer electronics, specialty chemicals while the least (10%) preferred investing in other small and medium enterprises projects that include restaurants. Agricultural business is also attracting investments by the VC companies because of innovation of some entrepreneurs.

3.2.2 Specific Findings on Venture Capital in Kenya

This section gives specific findings on the legal and regulatory framework for VC in Kenya. It further sets out the regulatory measures and reforms that can be put in place to make VC more accessible in Kenya by promoting investment of VC companies in Kenya.

Table 6 Accessibility of venture capital in Kenya

Accessibility of venture capital	**Frequency**	**Percentage**
Not accessible	2	20
Fairly accessible	4	40
Very accessible	4	40
Total	**10**	**100**

Table 6 shows the accessibility of VC in Kenya, majority of the respondents (40%) are of the view that VC is fairly and very accessible while the least (20%) are of the view that VC is not accessible. This is because there is little knowledge on VC and that Kenya's risk capital market is still in the early stages of development, both on the demand and supply side. On the demand side, SMEs largely rely on internal and bank financing to finance operations. On the supply side, very few funds operate in Kenya to date, although the number is increasing.

Table 7 Whether the current legal and regulatory framework in Kenya encourages investment by venture capital companies

	Frequency	**Percentage**
Yes	0	0
No	10	100
Total	**10**	**100**

All respondents (100%) were of the view that the current legal and regulatory framework in Kenya does not encourage investment by VC companies. The law that regulates VC is not comprehensive leading to uncertainty. Currently, the industry does not have a well established regulatory body with the sole responsibility of VC operations. The industry is generally being regulated by the CMA which also has an oversight responsibility of the entire capital markets services sector which is generally regarded as too broad for a specialized body such as VC. The law governing VC does not provide for tax incentives which are considered as the main factor for VC operations. This can be deduced from the discussion in Chapter Two.

Table 8 Whether the respondents advocate for special laws to regulate the venture capital industry

	Frequency	Percentage
Yes	0	0
No	10	100
Total	**10**	**100**

All respondents (100%) advocated for the enactment of special VC laws. The justification offered was that the current legal and regulatory framework in Kenya offers piecemeal legislation in separate Acts and regulations. There are regulatory gaps and overlaps in the financial sector and especially for VC companies as various aspects are not captured in these regulations such as taxation and the various investment deductions for these peculiar type of companies. Lack of a clearly defined policy for VC companies brings about a cloud of confusion to the various stakeholders and investors thereby making the management of VC companies' problematic. The research reveals that the legislative framework must be underpinned by a sound regulatory framework to ensure effective and efficient development of the VC companies. These findings clearly suggest that key among the challenges facing venture capitalists in Kenya are lack of clear-cut policies and regulatory concerns. These findings also answer the research question of critique the current legal and regulatory framework for VC in Kenya

Table 9 Main obstacles to an efficient venture capital industry in Kenya

	Frequency	Percentage
Tax regime	4	40
Investment climate	1	10
Legal and regulatory environment	5	50
Total	**10**	**100**

Table 9 shows the main obstacle to an efficient VC industry in Kenya is the legal and regulatory framework (50%). Although all the factors are inter-related, majority of the respondents were of the view that the legal and regulatory environment for VC is one of the main obstacles hindering the development of the VC industry. While (10%) of the respondents were of the opinion that the investment climate hindered the development of venture capital the least. From the discussion in Chapter Four on the best international examples, it can be seen that the legal environment , the tax regime included, heavily influenced VC activities.

3.2.3 Other Findings on the Study

The respondents offered further opinion and insight on what ails the VC industry in Kenya. The consensus appeared to be that, the root cause of the problem is the limited legal and regulatory framework.

On the legal and regulatory framework, unnecessary barriers and lengthy processes distort competition; prevent required change, increase compliance costs and open avenues for corruption. The regulatory body has been overly concerned with issues regarding the stock market such as the collapsed stockbrokerage firms and has left the proper regulation of the VC companies unattended. No regulatory and oversight structure has been put in place to address specific issues that have hindered the growth of the VC industry.

Furthermore, even if there were any structures put in place, the Capital Markets Authority does not have the manpower to conduct the various on site supervision or inspection of the VC companies to find out what particular problems envelope VC companies in trying to set base in Kenya or to even confirm the level of compliance with the requirements that have been laid down in the Capital Markets (Registered Venture Capital Companies) Regulations. This therefore shows that the regulatory body concerned with the regulation of the VC industry in Kenya is distant as concerns the problems that hinder the growth of the industry in Kenya. Therefore, Kenya must try to make regulatory regimes simpler, less rigid and predictable in application.

The lack of an appropriate legal and regulatory structure in Kenya causes VC investment funds to incur high transaction costs in order to set base in Kenya. This limits the overall performance of the investment as this forces them to focus investment on large deals where the high costs of fund formation can be offset by high profits. SMEs, which may require only small investments and a high degree of investor oversight, are not attractive investment targets under these circumstances. Transaction costs arise from the need to adapt foreign business forms to the needs of Kenyan investments. Potential investors have to analyse laws that may be unfamiliar to them and gain assurance that their investment will be protected and properly applied.

According to the respondents, Kenya is considered one of the highly taxed, least friendly and complicated tax system in East Africa. Kenya's tax structure is marked by several government agencies, each with the authority to collect taxes at various times of the year. The nature of the tax system affects investors, venture capitalists and investees in the VC industry. Taxation substantially affects profitability and cannot be ignored. Tax policy affects the incentives of venture capitalists and thereby influences the survival rate of start up business.

The investment climate and macro economic factors are important pre-conditions if VC is to succeed in Kenya. To the extent that macroeconomic stability boosts this perception, it contributes to the vibrancy of a country's financial market, which is a key determinant of the level of returns from Initial Public Offer exits. Interest rates are also important for the VC industry at the macroeconomic level. They usually depend on prudent monetary policy. The level of short-term and long-term interest rates influences the relative level of VC through their influence on entrepreneurs seeking VC financing. The difference between long-term and short-term interest rates (spread) also influence the level of VC investment through their influence on venture capitalists, where the larger the spread, the less venture capitalists are attracted towards risky investments.

Political factors affect the perception about a country's stability. Also, politically motivated regulatory changes can create a lot of uncertainty. Due to a herd mentality among foreign investors, this can result in a reduction of foreign direct investment in Kenya in the form of VC. A common threat is posed by rent-seeking behaviour. Public VC funds can be subject to political manipulation, which can result in pressures to award funds to politically connected businesses. Political stability is a necessary condition for productive investment. When there is political uncertainty, investors adopt 'a wait and see' attitude, as there is little or no guarantee that they will reap returns on their investment. Political instability may also lead to capital flight.

The financial market was also mentioned as an obstacle to developing a VC industry because of the absence of a liquid initial public offering (IPO) market, which can provide venture capitalists with an exit mechanism to harvest their successful investments. The Kenyan securities market, is not vibrant, and does not offer VC funds an adequate vehicle for profitably exiting from their VC deals as in the case of other developing markets such as Ghana and that poses a great challenge in the use of IPO exiting.

On the recommendations to policy makers regarding the factors that hinder the growth of the VC industry, the respondents were of the view that the regulatory body should generally undertake a best-practice review of the existing regulatory and tax regime for VC funds in Kenya**.** The tax system which is a major challenge should undergo reforms to provide incentives that encourage the investments by VC companies in risky ventures and risk taking by entrepreneurs that result in the creation of new enterprises.

Assistance should be provided to the Capital Markets Authority (CMA) to examine further the environment for the establishment of VC companies in Kenya. This will entail an additional best-practice review of the existing rules as well as a broader examination of the incentive structure for establishing funds in Kenya vis-à-vis other destinations. Of particular concern is that most funds prefer to register offshore for tax and other reasons.

From the best practices that exist in other jurisdictions for the promotion of VC, as was discussed in Chapter Two, tax incentives have been used worldwide to stimulate VC investments. Many countries, including US, UK and China have used fiscal reforms to encourage the creation of new enterprises and the investment of new and existing monies in risky ventures. The three principal types of tax incentives are tax credits to investors for investments in the VC funds on the basis of simply making the investment. Second, the government may grant tax credits for losses. Third, the government may reduce tax rates on, or exempt from taxation altogether, capital gains arising from VC investments. Investment allowances and tax holidays, the loss-carry-forward provisions and the taxation of dividends are also good incentives. Moreover, customs tariff and excise duties affect the cost of investment and operating margins. Together these make up the overall fiscal regime that affects the cost of and return on investment.

On the implications of global trends on VC development, Kenya for the first time, has witnessed an increase in VC activity which is evident in both developed and emerging market economies alike. From the research carried out, the conclusion highlights that the VC industry in the region is still at an early stage of development. Kenya has yet to develop strong national VC markets or VC associations at national and/or regional levels.

In the international community, VC activities have been organized through umbrella organisations at both national and regional levels which have not been the case in Kenya. A good example being South Africa which has the South Africa Venture Capital Association (SAVCA). A key development in this regard, has been the establishment of the East African Community (EAC) formed by the five East African countries and professionals from across the region committed to supporting the growth of a strong VC and private equity industry within the Community. The key mission of the EAC should be to disseminate VC know-how and promote best practices in the region. The EAC will do so through organisation of conferences, industry-focused technology forums, and workshops where members can share experiences. Although the emergence of EAC represents a positive development for the industry, to what extent it will be able to involve Kenya in its activities, remains to be seen. The particular challenge which EAC will have to grapple with is the diversity of financing requirements and the differences in states of development of the VC companies in the region.

3.2.4 Conclusion

From the foregoing discussion, it is clear that the legal and regulatory environment in Kenya does not support the development of VC companies in Kenya. Kenya's current legal and regulatory framework is not properly structured and framework leaves a lot to be desired especially due to the regulatory gaps that have been identified which are to aid in the growth of the VC industry. If the local legal and regulatory environment is not supportive, venture capitalists will establish funds and operate in other regions.

From the respondents' views and the data analysis, Kenya has the most developed economy in the East Africa region, although it lacks the adequate framework to attract one of the best investment strategies in the world that has seen many countries go from one level of economic development to another. From the best practices around the world given in chapter two, it can be seen that there are general factors that aided in the development of the VC industry in the selected jurisdictions. Kenya's future competitiveness will depend heavily on decisions made today in these key policy areas that affect the country's economic environment.

Chapter Four of the thesis will encompass a review of the general factors and best practices that have aided in the development of VC in various countries.

CHAPTER FOUR
INTERNATIONAL EXAMPLES AND BEST PRACTICES

4.1 Introduction

Chapter Three gave a detailed discussion on the findings and the data analysis. This Chapter will discuss the general factors and best practices that have aided the development of VC in various countries. The current chapter shall fully discuss the general factors and best practices that have aided the development of VC in various countries.

4.2 Determinants of a Successful Venture Capital Industry

VC and venture capitalists have been the backbone of the development of new ideas and creation of the new business enterprises in many countries. There are significant differences across countries in the existence and functioning of such infrastructure. Having emerged from a series of fundamental institutional, macroeconomic, and market reforms, these countries sought to install and activate engines of solid economic development and job creation. From the following examples and best practices in the world, the factors that have played a great role in fostering the development of VC shall be discussed.

The countries that will be discussed include United States of America, United Kingdom, South Korea, China, Israeli and Ghana. The choice of countries ranges from their respective geographical location in order to ascertain whether regional characteristics matter and from the most developed to the least developed country that have endeavoured to develop their VC sector. The size and sophistication of the VC industry was also taken into account. United States of America and United kingdom, were selected because their economies have the largest and sophisticated VC investments. Compared to the size of the economy, Israeli was selected because it has the best VC industry in the world with VC funds under management amounting to 12.1 per cent of GDP. This compares to only 2.3 per cent of GDP in the UK or 1.3 per cent in the United States of America.[105] South Korea and China were selected because of their geographical locations and highly bureaucratized economies, avowed pursuit of socialism, still quite conservative social and business worlds, and a risk-averse financial system.[106] Ghana was selected because it is considered to be a developing country that has put in place specific legislation to regulate its VC sector in Africa. Herein are the determinants of a successful VC sector.

4.2.1 Tax Environment and Specific Fiscal Incentives

Tax incentives have been used worldwide to stimulate VC investments. As a general rule, incentives that favour successful investment and do not reward losses have been found to be most effective.[107] Many countries have used fiscal reforms to encourage the creation of new enterprises and the investment of new and existing monies in risky ventures. There are three principal types of tax incentives.[108]

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[105]See Gil Avnimelech, Venture Capital Policy in Israel.

[106]Haksoo Ko and Young Shin, "Venture Capital in Korea: Special Law to Promote Venture Capital Companies", *Columbia University School of Law*, (2004).

[107] World Bank, World Development Indicators, Washington DC: World Bank,(2007).

[108] Ibid., 400.

First, the government may grant tax credits to investors for investments in the VC funds on the basis of simply making the investment. Second, the government may grant tax credits for losses, if any, associated with VC investments. For example, in the United Kingdom, the government passed various laws and incentives to foster the VC industry. There is a deduction against corporation tax at 20% of the amount invested instead of the prevailing 30% tax rate, Deferral of corporation tax on any chargeable gains on disposal of investments if the enterprise is not making profits and capital loss relief against income for any capital losses on disposal of investments. [109] Third, the government may reduce tax rates on, or exempt from taxation altogether, capital gains arising from VC investments. The United States which has the oldest and most developed VC industry in the world has practiced this.[110] The U.S. government generally practiced sound fiscal policies to foster the growth of the industry by, for example, reduction in the taxation on capital gains and reducing the private cost of early entrants to the VC industry.[111]. The role of the government was that of a facilitator and enabler as is the case with the United Kingdom.

In South Korea, the government enacted the Special Law to Promote Venture Capital Companies (SLPVCC), a law envisioned to promote venture capital inVC Korea. The primary purpose of the law is to provide a more efficient and effective market environment for VC companies in Korea through direct and indirect subsidies, tax exemptions, and the relaxation of

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[109] Organisation for Economic Co-operation and Development, "Venture Capital Policy Review: United Kingdom, Working Paper," Organisation for Economic Co-operation and Development, Paris. (2003).
[110] Organisation for Economic Co-operation and Development, "Venture Capital Policy Review: Unites States of America", STI Working Paper, Organisation for Economic Co-operation and Development, Paris. (2003).
[111] Revenues Act of 1978 of United States of America.

existing regulations, protection against downside risks for entrepreneurs through special treatments, such as tax breaks.[112]

The tax burden on the investor depends on a number of factors and their interaction, including expenses allowed rates of capital allowances (tax depreciation), the availability of tax credits, investment allowances and tax holidays, the loss-carry-forward provisions and the taxation of dividends. Moreover, customs tariff and excise duties affect the cost of investment and operating margins. Together these make up the overall fiscal regime that affects the cost of and return on investment.[113] The nature of the tax system affects investors, venture capitalists and investees in the VC industry. Taxation substantially affects profitability and cannot be ignored. Tax policy affects the incentives of venture capitalists and thereby influences the survival rate of start up business.

In the year 1993, the China government passed legislation providing attractive tax incentives to individuals who were willing to invest in professional VC companies. The core of the 1993 legislation was a tax rebate of up to 20 percent for individuals who maintained an approved VC investment for at least two years. The tax rebate was by far the most important incentive. To qualify, the investment had to be made by a VC fund approved by the Ministry of Finance. The other incentives included making 80 percent of the VC firms' investment income tax exempt in the current fiscal year, providing a grace period of one year to investors to not pay taxes. Also,

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[112] Haksoo Ko and Young Shin, "Venture Capital in Korea: Special Law to Promote Venture Capital Companies", *Columbia University School of Law*, (2004).
[113] World Economic Forum Report (2008).

those choosing to reinvest the earnings garnered from a VC investment were allowed to deduct the VC income from their tax return in that year. This provision encouraged the investors to reinvest their earnings, thereby increasing the capital pool.[114]

In Ghana, the Ghana Venture Capital Fund, and with input of the Venture Capital Management Company, have prepared guidelines with regard to taxation issues. Concessions are granted to VC investment on losses incurred on the disposal of shares, agro-processing, tourism and information technology industries from the year 2006. Further, the income of a person from the industry is exempted from tax for a period of five years. VC financing companies are exempt from corporate tax for a period of five to ten years.[115]

4 .2.2 Strong Legal and Regulatory Framework

As was discussed in Chapter One, the legal framework under which VC investors operate will certainly influence their attitudes towards investments. In many countries where VC has flourished, specific legislation relating to VC has been promulgated to aid in its development.

Special venture capital VC laws are major initiatives that institute relatively comprehensive legal frameworks to create, legitimise and regulate VC funds as specific entities. The laws can be prompted initially by a variety of policy objectives. The special VC laws, besides creating a

[114] Steven White, "China's Venture Capital Industry: Institutional Trajectories and System Structures," International Conference on Financial Systems, Corporate Investments in Innovation and Venture Capital, (2002): p 7, 9.
[115] Lawrence Morse, *Final Evaluation of the Ghana Venture Capital Fund (United States Agency for International Development,* 1996) p100.

country specific legal vehicle for VC activity, can serve related VC purposes.[116] For example, such a law and the vehicle it creates can channel or act as a gateway for VC tax incentives. As was discussed above, in the United Kingdom, the government passed various laws and incentives to foster the VC industry. For example there is a deduction against corporation tax at 20% of the amount invested instead of the prevailing 30% tax rate, Deferral of corporation tax on any chargeable gains on disposal of investments if the enterprise is not making profits and capital loss relief against income for any capital losses on disposal of investments. [117]

Provisions of a special VC laws can also set the conditions and create a channel for greater inflows of institutional investment funds. For example, allowing pension funds and insurance institutions to invest in VC funds. In Israeli for example, the government passed specific laws allowing pension and insurance funds to invest in the VC funds. This was previously expressly forbidden by the laws.[118] In some instances, a special VC law can serve to eliminate ambiguities in other laws, or serve as a tactical platform for enactment of special exemptions in other laws that are crucial to VC activity.

With regard to this, the increased awareness about the importance and special needs of small and medium enterprises in the United States, led to the passage of the Small Business Investment Company Act which provided the basis for the creation of the Small Business Investment Companies (SBIC) as vehicles for small business financing under the assistance and

[116] Fernan Ibanez, "Venture Capital and Entrepreneurial Development," Working Paper Series 53. Washington, D.C.: World Bank, (1989) p 20.
[117] Organisation for Economic Co-operation and Development, Venture Capital Policy Review: United Kingdom, Working Paper, Organisation for Economic Co-operation and Development, Paris, (2003).
[118]See Avnimelech, Venture Capital In Israel.

regulation of the Small Business Administration.[119] Another key legislation in the U.S from this period was Section 1244 of the Internal Revenue Code,[120] allowing US$ 25,000 invested in new small businesses to be written off against ordinary income. It has served to encourage informal investments by individuals in private ventures.

The National Assembly in South Korea recently passed the Special Law to Promote Venture Capital Companies (SLPVCC), a law envisioned to promote VC in Korea. Putting the substance of the promotional measures aside, the government apparently intended the enactment to emulate the success of the VC market in the United States and several other countries.[121] In 1996 Korea enacted several laws related to VC, including the Law to Promote Small and Medium Size Companies and the Law to Assist the Financing of New Technology Ventures.[122] Later on, the laws were changed to the Small and Medium-Size Enterprise Start-up Support (SMESS) Act to support the establishment and growth of small enterprises. After these laws were enacted, the industry grew rather quickly. The development of Korean venture sector was not just an outcome of the government's policy to bring up venture business. Rather it was the result of the restructuring efforts from the whole Korean economy sector that tried to survive throughout the 1990.[123]

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[119] Supra note 17 at 5.
[120] The Internal Revenue Code is published as Title 26 of the United States Code (USC) of 1986.
[121] Ibid.
[122] Vicente Arana, "Venture Capital Company." Asian Institute of Management, Makati, Philippines. Accessed June 12, 2012 at http://www.aim.edu.ph/homepage/ABS2000/varana.htm.
[123] Hoe Hoon Chung, "Lesson From The Korean Venture Industry Development," *Pacific Rim Law & Policy Journal Association* (2010).

In China, the National Development and Reform Commission promulgated the Provisional Measures for the Administration of Venture Capital Enterprises in November 2007.[124] This is the first national statute governing VC investment in China. Regulations for the Administration of Venture Capital Enterprises with Foreign Investment Venture capital enterprises with foreign investment which have been established according to law are eligible for the policy support which the measures offer to VC enterprises. Further, new legislative regulations recently passed in 2005 in Shenzhen, served to approve VC investments for start up companies. The document entitled "Shenzhen Tentative Regulations Governing Venture Capital" was approved in the Shenzhen Economic Special Zone and was enacted into law. It is also known as "The Provisional Regulation on Investment Trust Fund of Shenzhen".[125] The passing of this law created the much needed catalyst for VC funding and innovation in China. Without question, China has quickly become the new economic growth frontier. Pursuing investment opportunities in China have become far easier as a result of recent changes in China's law.

Back in Africa, Ghana has made significant leaps in promoting VC development process because VC form of financing has been in government policies and regulations. The Ghana government established The Ghana Venture Capital Fund, (GVCF), a non-bank finance institution to hold the funds for investing in small and medium enterprises and a management company, Venture Fund Management Company (VFMC) to make investment decisions.[126] The promulgation of the Financial Institutions (Non Banking) Law of 1998, and the subsequent

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[124]Steve White, " China's Venture Capital Industry: Institutional Trajectories and Systems Structure", Prepared for the International Conference on Financial Systems, Corporate Investment in Innovation and Venture Capital, Brussels, (2007).
[125] Jack Fensterstock and Aimin Li, "Status of Venture Capital in China," Beijing Venture Capital Association, (2000).
[126] Laurence Morse, "Final Evaluation of the Ghana Venture Capital Fund, "United States Agency for International Development" (2000).

publishing of 'The Draft Operating Guidelines for the Venture Capital Funding Companies by the Bank of Ghana, with input by the Venture Capital Management Company, (VCMC) which manages the Ghana Venture Capital Fund, constitute a clear signal from the government of its intent to create a regulatory environment conducive to the growth and development of institutional VC finance in Ghana.[127] The draft operating guidelines are designed to rationalise the regulation of VC companies and regulate them in a more effective manner. The guidelines outline policies on the type of investments a fund is allowed to make, the necessary qualifications of the Fund Manager, exposure limitations and minimum capital requirements of the fund. The guidelines are helpful in that they are written with more understanding of the activities of a venture fund than the more general Financial Institutions (Non-Banking) Law.[128]

The legal and policy environment as it pertains to VC and fund management companies has developed in part, due to the establishment of the Ghana Venture Capital Fund and Venture Capital Management Company. The mandate of the Venture Fund Management Company focuses on staffing, training, operating procedures and deal flow generation from start-up.[129] To date, the regulatory and policy environment has been supportive in the establishment and operations of Ghana Venture Capital Fund. In January 2010, Ghana passed the Venture Capital Trust Fund Act, 2004 (Act 680) which is the operative law on VC. The objective of the trust fund is to provide low cost, long term financing to small and medium scale enterprises. The government's mission in setting up the Venture Capital Trust Fund was to promote and

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[127]Ibid., 200.
[128]Ibid., 201.
[129] Ibid., 202.

support the private sector as the engine of economic growth and an equal partner to achieve the country's developmental growth.[130]New business rules were also promulgated. These new business rules group Non Bank Financial Institutions into four categories of licensed institutions for differential treatment, for which a separate legal, regulatory and supervisory framework has been adopted for the VC companies. The broad policy objective of the government of Ghana appears to be designed to encourage the development of VC funds through the drafting of appropriate laws and regulations.[131]

4.2.3 Stock Market Operations

Active stock markets facilitate IPO exits and therefore active VC markets. Equally crucial for the industry development has been the presence of an active stock market, offering a lucrative exit route for VC backed companies at critical junctions of the industry development, thereby spurring further VC fundraising and investing. Well-functioning capital markets play a great role in resource mobilization and remain particularly important to a country's long-term financing needs. In conjunction with the banking sector, capital markets are a central component of efficient financial markets. The exit strategies for a VC investment generally fall into one of four categories if the investment is successful.

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130 The Venture Capital Trust Fund Ghana Annual Report, (2007).
131 Ibid., 10.

4.2.3.1 Initial Public Offering (IPO)

Exit through an IPO happens when the shares of the invested firm are sold to the public on a stock or securities exchange. This is the most common method as it is very profitable.

4.2.3.2 Mergers and Acquisition (M&A)

The most frequent avenues for divestment in most of countries were, and still are, mergers and acquisitions by other investors since secondary stock markets are not developed in most countries. M&A are done by selling of shares, through private placements (to institutional investors) or through the use of informal brokers, for example, lawyers, accountants and financial consultants. Mergers are considered a second best when compared to public issues through a regular stock market.

4.2.3.3 Management Buyback

This happens when the firm's management buys the company's shares from the VC investors or a corporation's repurchase of stock or bonds it has issued.

4.2.3.4 Sale of the firm

This only happens if the investment is a failure. The venture capitalists opt to sell the firm in order to recover their initial outlay.

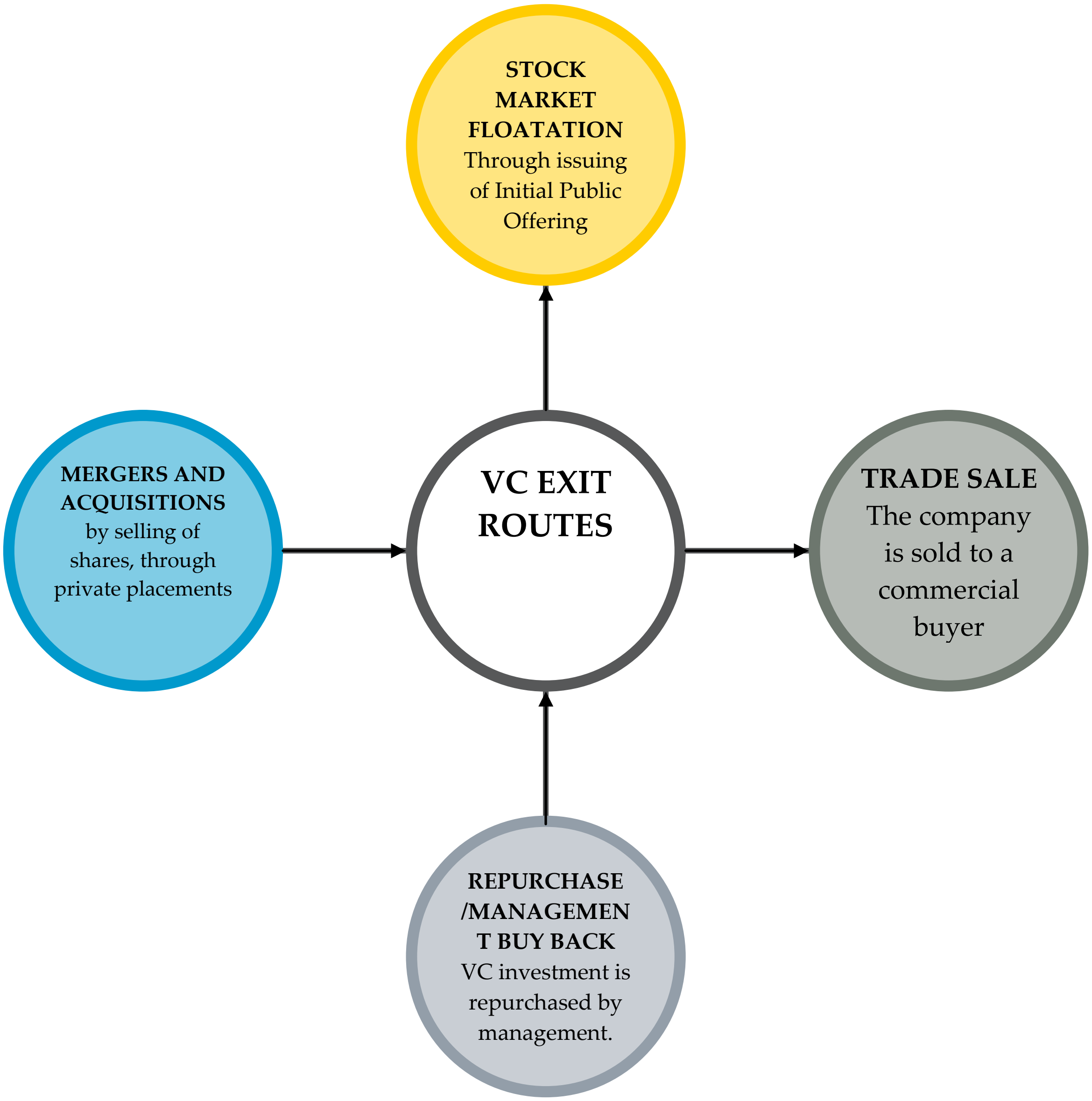

Figure 1Venture Capital Possible Exit Routes: Source: Coyle

The UK is home to the most active second-tier stock market, the Alternative Investment Market (AIM).[132] It was established in 1995 to attract and serve young, high growth companies with less stringent admission requirements and lower initial and continuing costs. UK's first major policy response toward venture finance came with the establishment of the Industrial and Commercial

[132]Organisation for Economic Co-operation and Development, "Venture Capital Policy Review: United Kingdom, "STI Working Paper, OECD, Paris, (2003).

Finance Corporation (ICFC), in 1945.[133] Though the UK Government's small business initiatives date back to the early 1980s, the VC industry has grown exponentially and the benefits to the economy are enormous.

In Israeli, the emergence of the VC industry was immediately preceded by globalisation of capital markets enabling Israeli companies to raise capital on the National Association of Securities Dealers Automated Quotation in the US. Against this background, the Israeli Government implemented several programmes aimed at fostering the development of a VC industry and increasing the stock of start-up enterprises.[134] On the investor side, the VC fund offered new channels for diversifying risks and opportunities for higher returns as well as a longer term investment vehicle.

Development of the Korean venture sector started in mid 1990s when the Korean government had established the new stock market, the Korean Securities Dealers Automated Quotations, KOSDAQ, in 1996. The government also legislated a special Act to foster the venture firms in 1997, and various deregulation acts, had all taken in place in the mid 1990. Because U.S. VC contracting techniques are well developed and highly effective, the appeal of adopting such techniques in VC transactions outside the US is enormous to globally minded investors and legal practitioners. In response to its burgeoning VC industry, however, South Korea has continued to adopt US VC techniques in transactions governed by Korean corporate law. Such

133 Ibid., 5.
134 See Avnimelech supra note19.
134 Ibid.

transactions can benefit the South Korean VC industry, leading to more profitable investments and financially successful companies operating on Korean soil. The Korean Commercial Code (KCC) provides a sufficient legal framework under which virtually all of the contracting techniques commonly used in U.S VC transactions are implemented with varying degrees of success. [135]

Venture capital exit from China investments to the public equity market was extremely difficult in China in the 1990s. The two domestic stock exchanges in China, the Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE), are oriented toward state-owned companies. Furthermore, to be considered for listing on SHSE or SZSE, companies have to post three consecutive years of profits, which creates a serious barrier for private equity to exit. Since 1999, foreign VCs have setup offshore Special Purpose Vehicles (SPVs) in tax havens such as Cayman Islands, British Virgin Islands, and Bermuda that allow them to exit their investments on a China VC-backed company through an IPO on a foreign stock exchange. The use of offshore SPVs controlled by domestic enterprises involves transfers of assets or capital from China to offshore, and reinvestments or loans back into China. It has served as a popular way of structuring foreign VC investment in recent years. Through such structure, foreign VCs gain greater flexibility and liquidity in the exiting of VC to overseas public equity capital, and also enjoy substantial tax break on the investment returns.[136]

[135] Eugene Kim, "Venture Capital Contracting Under The Korean Commercial Code: Adopting United States Techniques in South Korea Transactions," *Pacific Rim Law & Policy Journal Association*, (2004): p 1.
[136] Eleanor Xiaoqing, "Venture Backed IPOs and the Exiting of Venture Capital in China," *Journal of Entrepreneurial Finance and Business Ventures*, (2006). http://www.econstor.eu/bitstream/10419/55935/1/663198607.pdf<accessed 3 October 2013.

In addition to overseas listing, China's domestic listing environment has also been substantially improved. The long awaited secondary board for the listing of high-tech enterprises was finally launched in Shenzhen Stock Exchange in May 2004. The new trading board, called "Small and Medium Enterprises Board" is an important capital market for the listing of high-tech private enterprises that would otherwise have been excluded from the consideration of domestic listing. The SME board is currently a segment within Shenzhen Stock Exchange with a more tailored supervisory system, with the possibility of developing into a National Association of Securities Dealers Automated Quotations (NASDAQ) style new market in the future. The development of the Shenzhen SME board has broadened the choices for VC exiting in China as a number of VC backed companies have chosen to list their IPO shares on the new Board. It is widely expected that more Chinese firms will choose domestic listing due to the higher overseas listing cost and improved domestic listing environment.[137]

Exiting investments is one of the major challenges of VC investing in developing markets like Ghana.[138] With relatively unsophisticated capital markets, the option of exiting from an investment through an IPO is seldom available to VC companies in Africa. Firms in Ghana are therefore forced to turn to the even more insipid mergers and acquisitions market in order to unlock value from their investments. This makes it difficult and costly for VC companies to exit investments and has stifled VC development. The nascence of the capital markets in the region limits the IPO options available to investors. Most use alternative exit strategies such as sale to

[137] Ibid., 5.

[138] Global Investment Advisers, "Impact Investing in Ghana," Rockerfeller Foundation.

sponsors, self-liquidating structures, and trade sales. Fund managers negotiate liquidity and exit options prior to investment as part of the investment due diligence.[139]

4.2.4 Development of Business Incubators and Programs

Over the last two decades, the UK government has implemented programmes to mobilize VC in support of newly established, innovative firms, with the objectives of remedying funding gaps in private capital markets, leverage private sector financing and fostering the creation and growth of technology based companies.[140] The oldest programme supporting small businesses is the Small Firms Loan Guarantee Scheme by the Department of Trade and Industry. It was established in 1981 to help meet the gap in the market, where small businesses with viable business proposals are unable to raise finance because of lack of security.[141] The Enterprise Investment Scheme was introduced in 1994 to help certain types of small higher-risk unquoted trading companies to raise capital. It provides income and capital gains tax reliefs for investors in qualifying shares of such companies.[142]

The Venture Capital Trust (VCT) scheme began in April 1995. VCTs are quoted companies, which attract funds from individual investors and invest these funds in qualifying companies. The individuals who invest in the VCTs receive various income tax and capital gains tax reliefs. For individual investors, the income tax relief pertains to both the dividends received from the

[139] Ibid.
[140] Constantin Christofidis and Debande Olivier, "Financing Innovative Firms Through Venture Capital," European Investment Bank. (2001).
[141] Ibid., 50.
[142] United Nations, "Financing Innovative Development: Comparative Review of the Experiences of United Nations Economic Commission for Europe Countries in Early Stage Financing," Geneva (2007): p 72.

VCT shares and a relief against tax equal to 20% of the amount invested in a VCT, provided that the shares are held for at least three years.[143] The Community Development Venture Fund (CDVF) was launched in May 2002. It aims to increase private investment in enterprises in disadvantaged communities and expects to stimulate the provision and benefits of VC to viable and potentially high-growth SMEs located in the 25% most deprived wards in England.[144]

Parallel to its programmes aimed to improve the financing conditions for innovative enterprises, UK has devoted significant effort to increase the supply of innovative enterprises. For example, the Science Enterprise Challenge was established in 1999 to fund the creation of enterprise centres at UK universities with the following three main goals: to foster the commercialization of high quality research and new ideas; to help stimulate a culture of scientific entrepreneurship within British universities, and to incorporate more centrally the teaching of enterprise into the UK science and engineering curricula.[145] In 2005, the remit of the programme was changed to cover entrepreneurship education across all curriculum areas.

In Israeli, a programme known as the Fund of Funds Yozma Program[146] was formed in 1992 which was significant at stimulating VC. Yozma Program, with its mission to create a viable VC industry resulted in a dramatically positive change in the perception of foreign VC investors

[143] Ibid., 73.
[144] Supra note 94.
[145] United Nations, "Financing Innovative Development: Comparative Review of the Experiences of United Nations Economic Commission for Europe Countries in Early Stage Financing," Geneva (2007) p 71.
[146]The Yozma Program-which began operating in 1993, had as an explicit objective the creation of a solid base for a competitive VC industry in Israel. It provided for or assured attainment of critical mass for the VC industry; a successful learning process; and a network of international contacts. Yozma received $100 million from the Israeli government. It invested $8 million in ten funds that were required to raise another $12 million each from "a significant foreign partner," presumably an overseas venture capital firm. Yozma also retained $20 million to invest itself. These "sibling" funds were the backbone of an industry that grew to the point where in 1999 in excess of $1 billion was invested in Israeli.

and their attitude towards investing in Israel.[147] The programme mainly focused on various policies to increase the flow of VC to Israel such as reduction of capital gains tax, tax benefits, preferred loans, government guarantees and the establishment of technological incubators.[148] Another programme, the Heznek Fund was launched in 2002 with a budget of $2 million to provide support for start-up companies. It provides up to 50% of the funds necessary for operation of a start-up company for a period of two years. The Technological Incubators Programme was launched in 1991 to support novice entrepreneurs at the earliest stage of technological entrepreneurship and help them implement their ideas by turning them into viable commercial products.

4.2.5 Government Intervention

Countries have mixed experiences with direct government involvement in the VC industry. As has been discussed earlier, many governments around the world have been deeply involved in the development of the VC industry at the early stages and beyond. The efficacy of direct government engagement in the sector is paramount for the success of the VC industry. Many government programs have been successful in promoting the VC industry while others have resulted in a substantial waste of public resources and have put the VC industry on a worse footing than before. Despite significant public involvement in recent years, the role played so far by governments is highly controversial. An efficient VC industry is not guaranteed through public intervention, nor does it necessarily develop by market forces alone. Undoubtedly, there

[147] Gil Avnimelech, "Venture Capital Policy in Israel: A Comparative Analysis and Lessons for Other Countries," *The Hebrew University, Mount Scopus, Jerusalem* (2002).
[148] Ibid., 10.

is an important need for governments to reflect and, in many cases, rethink their positions. On the one hand, the public sector plays a role in supporting and fostering technical progress. At the same time, it should be able to identify market failures in order to justify intervention. Hence, to be efficient in policymaking, governments must ask questions such as: In which ways are various policies hindering or enabling VC activity? Why intervene in venture capital markets? and What ways are most effective when doing so?[149]

Through policy choices, the government affects the size and structure of the VC industry. Government actions fall into three broad categories. First, the government can have a creative function. In UK, for example, the VC industry is the result of a series of promotional measures taken by the government. Virtually every government has some program of subsidies or other help to small enterprises. Second, government policies such as tax policies and regulations of venture investments directly affect the VC industry. Third, laws and regulations governing pension funds, stock markets, labour markets, patents, and other areas affect the VC industry indirectly. Concrete policy questions include the appropriate level of the capital gains tax and the kind of programs the government might use to encourage entrepreneurial activity.

In the US, the government provided good governance for businesses of all sizes without favouring one particular group. They focused on promotion of innovation and entrepreneurship and provided incentives for growth. Government activity in fundamental

[149] Ibid., 12.

research as well as improving the effectiveness of the technology transfer programmes that exist, particularly through the small business innovation research programmes.

According to the British Venture Capital Association (BVCA), the United Kingdom has the largest VC industry in Europe, The United Kingdom Government has gone some way towards this, for example with the introduction of Venture Capital Trusts and the Enterprise Investment Scheme. The UK government has facilitated the development of stock markets, determined a favourable fiscal treatment for equity investments, supported entrepreneurship, favoured networking among entrepreneurs and investors.[150]

In the years since 1993, the Israeli VC industry has flourished and gained a leading position in the world. The strong growth of the Israeli VC market was sustained by favourable policies brought about by government intervention. The policies include tax legislation: foreign venture funds which had tax-free status in their home country were granted tax exemption on their investments in Israeli VC In addition, the government has implemented favourable taxation laws for individual investors too.[151] Perhaps the main conclusion and policy lesson from the Israeli experience is that, while government can certainly play a major role in the development of a VC industry, specific policies targeted towards the VC sector can be effective only to the extent that favourable background conditions exist or are created.[152]

[150]Supra note 100.
[151]Supra note 99.
[152] Supra note 101.

In South Korea, the administration by different government agencies over VC companies has produced varying results, dependent upon VC operating environments. For example, the Ministry of Finance and Economy administers the Law to Assist the Financing of New Technology Ventures; the Ministry of Science and Technology regulates the operation of the Korea Technology Banking (KTB);' and the Ministry of Commerce, Industry and Energy administers the Law to Promote Small and Medium Size Companies. Most of the private VC companies are registered under this latter law.[153]

Thus VC operations are subject to different regulations that lead to different investment activities. Preliminary conditions are required to register under the Law to Assist the Financing of New Technology Ventures. For example, VC companies must be in operation for a minimum of two years to register under this law-a difficult condition to satisfy. Due to the poor performance of the Korean stock market in recent years and the fact that the market for initial public offerings was not well developed, equity investments by these companies were minimal.[154] Instead, their investments were mostly in the form of corporate lending. The Korea Technology Bank has the capacity to conduct the same range of businesses as those companies registered under the Law to Assist the Financing of New Technology Ventures. Venture capitalists may only invest in small companies, as defined by the law, and such companies must be within seven years of the start of the business. In addition, restrictions limit investments by VC companies to certain types of industries.

[153] See Haksoo, "Venture Capital in Korea?"
[154] Paul Gompers, “The Rise and Fall of Venture Capital,” *Business and Economic History* 23(2):1-26.

In China, the Chinese government allowed the formation of the first VC firm in the late 1980's, which was a government-foreign joint venture. It was followed in the early 1990s by a proliferation of VC operations backed by state and local government.[155]

Although policies and programmes will vary with the economic and institutional characteristics of countries, the following are actions which governments can undertake to foster VC markets:

(a) **Creating an investment environment -** Governments can create a fiscal and legal environment for stimulating the supply of VC, including measures to encourage longer-term VC investments by pension and insurance funds and tax incentives for VC investments by individuals or business angels.

(b) **Reducing risks for investors -** Governments can stimulate the creation of VC funds oriented to technology investments through appropriate tax incentives, seed financing schemes, coverage of a proportion of investment losses, and funding pre-finance technology appraisals and audits.

(c) **Increasing liquidity -** Governments can take steps to ease exit by institutional investors in start-up ventures through, for example, facilitating reinvestment and encouraging the creation of active secondary stock markets favouring high-growth technology-based companies.

(d) **Facilitating entrepreneurship** - Governments can implement initiatives to encourage new high-technology start-ups, including risk-bearing tax regimes, royalty-linked loan schemes, information and counselling services and support for VC networks.

[155] Zhang Chunlin and Zeng Douglas, *Promoting Enterprise –Led Innovation in China, (*Washington D.C: The International Bank for Reconstruction/ The World Bank,(2009) p 100.

4.2.6 Corporate Governance

Agency law governs the Venture Capitalist – Entrepreneur relationship and how VC companies operate and attribute VC activities to economically driven investment decisions.[156] VC firms need to operate under legal guidelines that allow the investee companies and the investments to be structured to align the interests of VC funds and the companies they invest in.

Agency relationship is defined by Jensen and Meckling in their article 'Theory of the Firm' as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.[157] If both parties to the relationship are utility maximisers, there is good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In addition, in some situations, it will pay the agent to expend resources to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions.

However, it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint. In most agency relationships, the principal and the agent will incur positive monitoring and bonding costs (non-pecuniary as

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[156] Harry Sapienza, and Anil Gupta, "Impact of Agency Risks and Test for Uncertainty on Venture Capitalist – Chief Executive Officer Interactions," *Academy of Management Journal* 37(2005) p 20.

[157]Micheal Jensen and William Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure", *Journal of Financial Economics* 3 (1979) p 305, 310.

well as pecuniary), and in addition there will be some divergence between the agent's decisions and those decisions which would maximize the welfare of the principal.[158]

In the United States, the Economic Recovery and Tax Act of 1981 established Incentive Stock Options (ISO) as a tool for aligning the interests of venture capitalists and the entrepreneur which forms a fundamental part of the relationship between entrepreneurs and VC managers.[159] The Sarbanes Oxley Act also forms part of the VC regulation in that it includes a code of ethics provision with a disclosure requirement. Under this Act the US Securities and Exchange Commission rules require certain publicly traded companies to disclose whether they have a code of ethics for the officers in the company to guard against director liability.[160]

4.2.7 Investment climate/Macro economic factors

Different surveys and studies about VC suggest that local and national governments can play important roles in creating the right conditions for VC development in promoting VC activities. Indeed millions of company foundations occur in the world every day despite recession, inflation, high interest rates, economic uncertainties and fear of failure. The fact that they occur in spite of such obstacles should not preclude governments from taking every possible action to remove the obstacles. The governments can contribute not only by improving the macroeconomic environment but also by providing infrastructure, by improving educational

[158] Ibid., 306.
[159] Economic recovery Tax Act of 1981 Section 422 and 423.
[160] Sarbanes Oxley Act of 2002 Section 406 and 407.

attitudes towards risk and entrepreneurship, by improving information, and by providing and promoting the availability of VC sources.

Macroeconomic stability is an important pre-condition if VC is to succeed and in promoting foreign direct investment. To the extent that macroeconomic stability boosts this perception, it contributes to the vibrancy of a country's financial market, which is a key determinant of the level of returns from Initial Public Offer exits. The main focus of macroeconomic stability is prices. Price stability is important because erratic prices create uncertainty which hinder the efficient functioning of financial markets. Under high and accelerating or volatile inflation, even inflation indexed financial instruments tend to break down because they are designed to mitigate problems caused by moderate inflation.[161]

In addition, interest rates are also important for the VC industry at the macroeconomic level. They usually depend on prudent monetary policy. The level of short-term and long-term interest rates influences the relative level of VC through their influence on entrepreneurs seeking VC financing. The difference between long-term and short-term interest rates (spread) also influences the level of VC investment through their influence on venture capitalists, where the larger the spread, the less venture capitalists are attracted towards risky investments.[162]

[161] Sarbanes Oxley Act of 2002 Section 407.
[162] Ibid.

4.3 Conclusion

From the above international examples, it can be seen that small and medium enterprises in most developed countries have flourished because of the critical role that VC has played together with government support, coupled with favourable tax policies and incentives. To this end, there is an increased awareness among these countries that policy initiatives to support innovation and competitiveness need to address the particular challenges that innovative enterprises face in raising finance. Bringing VC markets into developing countries could help ensure the sustainability of the companies in which they invest. This realization is forcing developing countries to start reforming their VC policies and systems.[163]

Chapter Five of the thesis will deal with the conclusions and recommendations by giving a proposal for a revised regulatory framework for the growth of the VC industry in Kenya based on the discussions in the various chapters. The proposals shall take into account and highlight the ways and means of domesticating and institutionalising the best practices around the world.

[163]African Venture Capital Association, "Unlocking Venture Capital," Africa Venture Capital Association response to United Kingdom Commission for Africa Report, (2005).

CHAPTER FIVE

SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.1 Summary

The objectives of the study were: to critique the current legal and regulatory framework for VC in Kenya; to make a comparative analysis on the legal framework governing VC in Kenya and a few selected jurisdictions with best practices; and to make recommendations for the reform of the legal and regulatory measures that can be put in place to attract or foster the development of the VC industry in Kenya.

The hypothesis of the study was that the current legal and regulatory framework governing the VC industry in Kenya is inadequate and does not promote nor attract investment in the country, hence unable to achieve its economic development goals.

The research methodology used in the study was mainly desktop research given that most of the materials and literature are available as secondary data in the Internet, books, journal articles, reports and relevant studies in the area. However, target respondents interviews were used in order to obtain the opinion of the key stakeholders in the VC sector.

The study was divided into five chapters. Chapter one lay the framework for the entire study. The chapter contextualised the research problem. This chapter discussed the background to the problem, statement of the problem, the theoretical framework, literature review, objectives of the research, research questions and the methodology that was used to conduct this study. The chapter breakdown was also be covered in this chapter.

Chapter Two discussed the policy framework and reviewed the legal and regulatory framework for VC in Kenya. A critical analysis of the legal and regulatory framework was done and it was deduced that the legal and regulatory framework was not conducive in attracting investment in Kenya.

Chapter three dealt with Data Analysis and how the same confirmed the loopholes or shortfalls in the regulatory framework for VC. The discussion involved data findings, analysis, interpretation and presentation from venture capitalists and fund managers in Kenya. The data was analysed and presented using tables. The data was analysed in two parts. The first part dealt with general findings. The second part, dealt with the findings on specific information, based on the respondents' opinion on the development of VC industry in Kenya.

Chapter Four thematically discussed and analysed the general factors and best practices that have aided in the development of VC in various countries. The discussion shall take into account the best practices in developed countries like United States of America, United Kingdom, Israeli, South Korea and also less developed countries like China and Ghana that have taken advantage of the use of VC. In particular, the following thematic issues were analysed; tax incentives, legal and regulatory framework, stock market operations, government intervention, corporate governance, investment climate and macro economic factors, development of business incubators and programs. The analysis showed the extent to which some factors promote the development of VC in the selected countries.

The findings in this chapter showed that the legal and regulatory framework for VC in Kenya is inadequate and therefore stifles the development of VC in Kenya. Indeed, the general conclusion was that the state of VC regulation is wanting. It was argued that for Kenya to take advantage of the opportunities and advantages of VC, it was necessary to overhaul the current legal and regulatory framework. The economic development is exceedingly dependent on the implementation of good policies and building of strong and effective institutions. VC has proven an effective means of fostering growth of small businesses in industrialised countries but is still a nascent industry in Kenya. The findings from previous chapters indicate that the current legal and regulatory framework is neither sufficient nor adequate to foster its growth.

The legal framework and regulatory institutions have fallen short of promoting the growth of VC sector. Kenya has dramatically underperformed in attracting VC and does not currently have a genuine strategy to harness VC to aid national development. Its laws are fragmented and general making it ambiguous, hard to understand and interpret. Proposals were also made for the enactment of specific VC laws to foster the industry as was done in the countries discussed in Chapter Two like the United States of America, United Kingdom, South Korea, China, Israeli and Ghana.

5.2 Conclusions

Given Kenya's wish to attain its millennium development goals, it is necessary to keep improving the environment by simplifying the policy and regulatory structures. As is has been confirmed by the study, an institution as complicated as VC cannot grow without a minimally supportive environment. The role of the government cannot be avoided, it must address tax, legal, regulatory, and related policies since many of these affect both VC firms and the companies that they invest in.

The development of a VC market in a developing economy comes with peculiar set of challenges both from within the industry and the economic environment. Therefore, there is the need to do careful analysis of the challenges in order to find possible solutions to address them. Thorough analysis of the data collected in Kenya suggests that lack of a clear policy and regulatory framework for the VC industry are very inimical to their operations due to lack of governmental policies and a clear cut regulatory framework. Clearly, these findings run contrary to the recommended VC policies. Environmental challenges such as exit limitations and weak microeconomic environment are also very deterring to capital venturing in Kenya. For example, the IPO environment in Kenya was unanimously described as not very active. These findings do not support evidence from the industry in the US, UK and Israeli where the IPO environment was reported to be very active The purpose of this thesis has been achieved because general conclusions of this thesis points to varied challenges facing VC companies in Kenya.

5.3 Recommendations

To remain relevant and competitive regionally and globally, Kenya must plan for the future. It must chart a new road map that learns from its past failures, builds on its strengths and confronts the realities of poverty, unemployment and globalisation. A Kenyan VC industry is emerging, but it may not thrive in the current investment environment. Any business institution requires policy framework as a guiding principle for the operations of such an institution. VC investment, being such a specialised investment class, requires clear-cut industry specific policies and regulatory framework for efficient investment operation. The emerging trends of the creation of a viable VC industry in developing countries has called for a critical analysis of the policy and regulatory framework needed to steer firms in these business environments. The following recommendations will ensure the development of the VC industry in Kenya.

First and foremost, legislative changes should centre on an urgent review of the current laws and restrictions in the Capital Markets Act, focusing on the original intention to facilitate the growth of VC. These laws should deal in particular with the establishment of a fiscally transparent vehicle for VC investing. The regulatory, tax and legal environment should play an enabling role. This also underscores the facilitating and promotional role of regulation. Internationally, venture funds have evolved in an atmosphere of structural flexibility, fiscal neutrality and operational adaptability. For example as was the case with UK, USA, South Korea, China, Israeli and Ghana, where fiscal incentives such as tax credits to investors for simply making the investment, tax credits for losses and reduction of tax rates arising from VC investments. Kenya needs to provide regulatory simplicity and structural flexibility on the same lines.

The immediate enactment of special VC laws will serve to remove the regulatory gaps and overlaps in the financial sector. This is because the current legal and regulatory framework in Kenya offers piecemeal legislation in separate Acts and regulations.

Another recommendation levied is that venture capitalists should work with the Government of Kenya to develop an appropriate framework that will support the development of the VC industry. Venture capitalists can work together with the government to identify the scope and potential for establishing a structure that can finance the growth of early-stage funds for SMEs. A starting point could be the one similar to the United States SBA and their SBIC. This would entail exploring further the existing fund of funds at the Ministry of Trade and Industry to see whether it can be expanded appropriately. A key recommendation is that government should attempt to foster the development of the VC sector by becoming a provider of capital and should work in partnership with private investors.

Further, the setting up a self regulatory mechanism for existing VC companies in order to instill confidence would be appreciated by the few players in the market. The self regulatory organisation could develop a vetting process and standards for members to instill confidence in potential investors. A strong SRO with a code of conduct be encouraged for evolution of standard practices, creating awareness by dissemination of information about the industry. A

Kenya Venture Capital Association will enhance the impact of VC and fuel the development of the VC sector as was the case in the UK and Ghana.

Further, a working group or task force comprising relevant policy makers, legal advisers and VC industry leaders who would work towards finalizing the law be formed under the Ministry of finance or trade. The Ministry of Finance will need to enact reforms that address the most pressing concerns about tax matters generally. Enactment of these reforms is critical to facilitate investment by venture capitalists and to demonstrate political will on part of the Kenyan government to move forward in creating the right policy framework for VC.

There is also a need to review business regulations and the legal framework with a view to facilitate investment by foreign VC firms as part of the investment program. Efforts should be made to put the necessary infrastructure in place to help indigenous skills, entrepreneurship and innovation to flourish. With the establishment of a strong VC industry, the scope for Kenya's economic growth and success is unlimited.

In addition the following were also touted as supporting the development of VC companies in Kenya:

(a) An OTC market for SMEs would help to improve the exit options for VC companies.

(b) Support capacity building of existing funds by providing support to the existing funds to build a credible track record and structure that appeals to institutional investors.

(c) Support additional education of trustees by providing support through fund managers and the Retirement Benefits Authority for the education of trustees on the merits of diversification.

(d) Support financial education of SMEs many SMEs are not aware of the benefits of different forms of financing and will need to receive education in this area.

Clamouring for technology transfer from the West will not put Kenya on the path to economic success. Instead, efforts should be made to put the necessary infrastructure in place to help indigenous skills, entrepreneurship and innovation to flourish. With the establishment of a strong VC industry, the scope for Kenya's economic growth and success is unlimited. Infrastructure development needs to be prioritized using government support and private management of capital through programmes similar to the Small Business Investment Companies in the United States, promoting incubators and increasing university and research laboratory linkages with venture-financed start up firms like it was done in Israeli and which is the best jurisdiction to borrow from. This would spur technological innovation and faster conversion of research into commercial products.

VC has made a significant contribution to the growth and dynamism of other economies. It has devised distinctive ways through which entrepreneurs, innovators and venture capitalists work together in pursuit of their common interests. The objective for the government to engineer a market for VC by designing a legal framework for the establishment of certain kinds of financial intermediaries to engage in VC and by itself providing risk capital as an investor. Plainly, a precondition for VC is the existence of legal and organisational structures that allow the VC process to proceed. The legal structures used to conduct VC business must be robust and flexible in order to address the problems discussed.

The need to regulate VC is not without justification, regulation that provides rules that govern economic activity and strengthen supervision and oversight of market actors can have the effect of creating better market efficiency thus providing a better business environment for VC companies. Laws and regulations that provide for the efficient operation of a country's financial infrastructure and financial system support the development of its private sector.

APPENDIX I

The University of Nairobi
Faculty of Law
Commercial Law Department
The Research Questionnaire

Introduction Letter

Dear Respondent,

I am a student of The University of Nairobi undertaking a Thesis on venture capital. This research study is a partial requirement for the Degree of Master of Laws – Public Finance and Financial Services Law. Your contribution will provide an invaluable contribution to my Thesis.

Please note that all information will be accorded utmost confidentiality and will be used for academic purposes only.

This questionnaire consists of two parts. Part A deals with general information and Part B deals with the regulatory issues. Your honest response will be greatly appreciated.

Thank you in advance for your cooperation.

QUESTIONNAIRES TO BE ADMINISTERED TO FUND MANAGERS/VENTURE CAPITALISTS

PART A

GENERAL INFORMATION

1. Is the company foreign or locally owned? ____

2. For how long has the firm been operational in Kenya? __________________________________

3. What management position do you hold in the company? ______________________________

4. How many years experience do you have as a venture capitalist? ________________________

5. What is the typical size of your investment? ____

6. Who are the major recipients of venture capital funds? __________________________________

PART B

REGULATORY AND POLICY ISSUES

1. How accessible is venture capital in Kenya?

2. Does the current legal and regulatory framework governing the venture capital companies in Kenya encourage investment?

3. How is venture capital viewed as a means of raising capital in a developing country like Kenya?

4. In your opinion, is venture capital more obtainable and attractive than a bank loan? Explain.

5. What are the main obstacles and challenges to an efficient venture capital industry in Kenya?

6. What recommendations to policy makers can be made with regard to the challenges facing the venture capital industry?

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7. What tax incentive schemes exist to encourage growth of venture capital companies in Kenya?

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8. What initiatives or programmes has the Kenyan government put in place in order to promote the venture capital industry in Kenya?

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9. From your experience, what are the best practices that exist in other jurisdictions for the promotion of venture capital?

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10. What are the implications of global trends on venture capital development in Kenya?

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11. Would you advocate for special laws to regulate the venture capital sector? If so, why?

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12. From the foregoing, what reforms, regulatory and otherwise, can be implemented to establish a well functioning and inclusive venture capital environment in Kenya?

Thank you for your cooperation

APPENDIX II

LIST OF TARGET RESPONDENTS

1. Aureos East Africa Fund.
2. Ajibu Venture Group.
3. Business Partners Limited.
4. DSGVen Cap Group.
5. Fanisi Capital.
6. Fusion Capital.
7. Kenya Equity.
8. Kenya Management Company Limited.
9. Olympia Capital Holdings.
10. TBL Mirror Fund.

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