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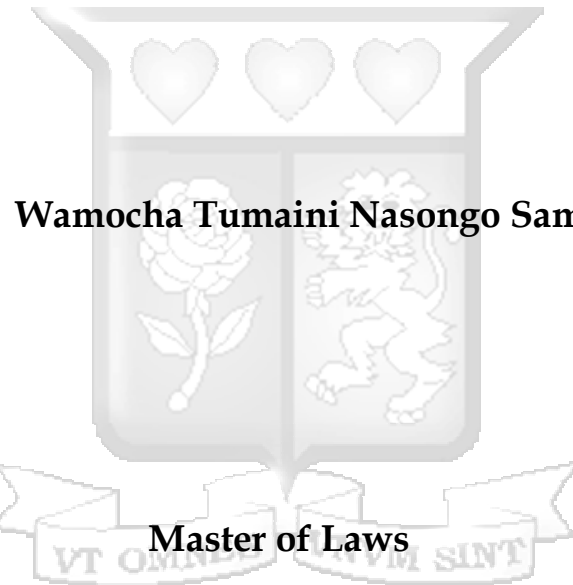
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Venture Capital in Kenya:

Restructuring the Competition Regulatory Framework to Aid Venture Capital Financing of Small and Medium Enterprises



2020

**Venture Capital in Kenya:
Restructuring the Competition Regulatory Framework to Aid
Venture Capital Financing of Small and Medium Enterprises**

Wamocha Tumaini Nasongo Samuel

**Submitted in partial fulfilment of the requirements for the Degree of
Master of Laws at Strathmore University**



Strathmore University

Nairobi, Kenya

November, 2020

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Wamocha Tumaini Nasongo Samuel

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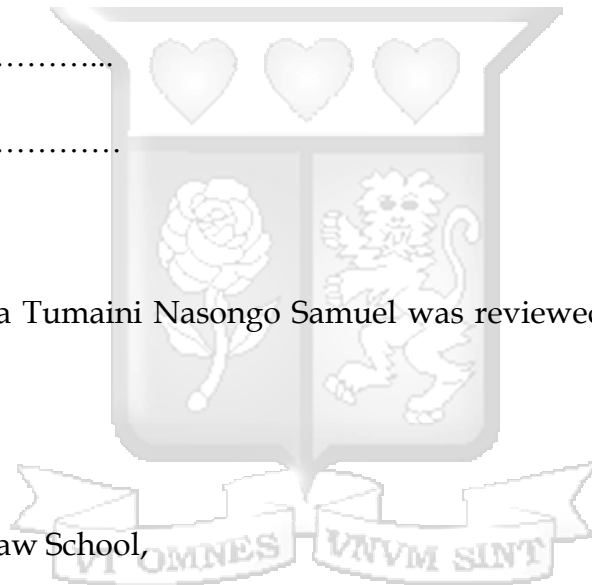
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ABSTRACT

In Kenya and around the globe SMEs have a proven track record as boosters of economic development by creating wealth and employment. They on the other hand face the major challenge of a lack financing since they have limited viable options where they can access financing, this study advances venture capital as a useful financing mechanism doubly beneficial to SMEs.

In advocating for venture capital, its association with SMEs in Kenya is negatively affected by merger provisions within the competition laws that regulate the aspect of control. This thesis effectively argues that the merger regulations as contained in the Competition Act of Kenya, fail to account for venture capital activity in relation to the financing of SMEs.

The thesis goes into detail expounding on the challenges the competition regulations raises that pertain to the venture capital sector. It finds that legal and regulatory competition policies that are scrutinized herein could possibly act as hindrances to the creation and development of venture capital companies in Kenya.

This finding reflects positively on the hypothesis of the study, leading to the conclusion that restructuring the competition regulatory framework to better suit venture capital transactions would arguably benefit the venture capital sector and in turn aid SMEs and their dire need to access the adequate financing they require to grow and expand.

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Competition Authority of Kenya Consolidated Guidelines on the Substantive Assessment of Mergers under the Competition Act, 2018.



LIST OF ABBREVIATIONS

(In Alphabetical order)

AIM	Alternative Investment Markets
CEO	Chief Executive Officer
CMA	Capital Markets Authority
EAVC	East African Venture capital Association
GDP	Gross Domestic Product
GEMS	Growth Emerging Market Segment
NSE	The Nairobi Stock Exchange
IP	Intellectual Property
IPOs	Initial Public Offers
OECD	Organization for Economic Co-operation and Development
RVCC	Registered Venture Capital Companies
SME(s)	Small and Medium Size Enterprise(s)
UK	The United Kingdom
US	The United States of America
VC	Venture Capital
VCs	Venture Capitalists
VCC	Venture Capital Company
VCFs	Venture Capital Funds
WESP	World Economic Situation and Prospects

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To the almighty God for his loving grace and strength that enables me to live a life of purpose.

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Many thanks to my dad, Dr Joseph Wamocha Nasongo and mum, Dr Lydia Wamocha who have set a high bar of academic excellence and motivate me to follow their example. We follow paths paved by those who came before us.

To my siblings: Tabitha Joy Wamocha, Abigael Arisi Wanami and Shalom Israel Wamocha, thank you for your continued friendship and support.

DEDICATION

To my dear dad, you are my role model. You lead by example and always inspire me to live a life that is positively impactful.

To my loving mum, you are one of a kind. You have always believed in me, supported me, and prayed for me. Your prayers and encouragement consistently strengthens me.

I love and cherish you both. I could never thank you enough.





CHAPTER ONE

INTRODUCTION

This chapter begins by discussing the three main tenets that capture the thesis. This highlight ensures that these principles are easily understood and as such appreciated, even before the contentious issues that arise in the study are explored. The main tenets of this study as espoused by the thesis title and weaved together by the ensuing chapters are; venture capital, small and medium size enterprises, and competition law. With this discourse formulating a background; the research problem, hypothesis and the research questions are stated in succession. The chapter also offers a literature review and a theoretical framework; the methodology and approach the study puts to use is contemplated. Some limitations and assumptions faced as a result of conducting the study are pointed out and finally, a chapter layout is given.

1.1 Background

I. Venture Capital

SMEs have served as major boosters of economic growth in developed countries and are widely recognized for it. In major economies around the world, this significant impact has come as a result of the key influence venture capitalism has held within the small business landscape.¹

In Kenya, SMEs control a key stake in the country's Gross Domestic Product (Roughly 34 per cent of the GDP)² and overwhelmingly account for the employment workforce

¹ Fannon I L, 'The Luck of the Irish or Just Plain Old Tax Regulatory Planning? The Success of Venture Capitalism in Ireland', 1(2), *Entrepreneurial Business Law Journal*, 2006, 231-256. *HeinOnline*, <https://heinonline.org/HOL/P?h=hein.journals/eblwj1&i=231>.

² Kenya National Chamber of Commerce & Industry, Kenya Business Guide and Strathmore Business School 'MSME Development Towards a Five-Point Policy Framework', Policy Brief Number 1, April 2018 on August 10, 2019.

(Employing over 14.9 million people thus, 78 per cent of the entire labor force)³. These are highly positive figures; however, this thesis points out that SME owners have not used venture capital to acquire finance to support their businesses. With the cultivation of a vibrant venture capital industry, the implications could totally shift the outlook of the SME sector and as a result have a huge impact on the country's economy.

Venture capital firms act as intermediaries with the goal of furnishing small business startups that are groundbreaking in terms of innovation and have the capacity for growth and profitability.⁴ Major emphasis being placed on the innovativeness of the business; that is, business that are pushing the bounds; exploring new ideas and means of offering services, producing goods and availing products to consumers by leveraging the incredible technology our modern world has to offer. In Kenya, the SME sector is seeing a revival with small business owners finding success in the areas of trade, provision of services and manufacturing.⁵ It is a safe assumption that coupled with the concurrent advancement in the Kenyan technological space, a springboard for innovativeness in the trade, service provision and manufacturing sectors of our SME economy is being set in place.

As it has been highlighted, "one important characteristic of many start-ups is the high risk due to the great uncertainty about returns, the lack of substantial tangible assets and the lack of a track record in operations."⁶ Small business entrepreneurs face poor earnings at the early stages of the enterprise before they start realizing profits and as such, banks are reluctant to lend money to such entities. Given that, SMEs should be able to acquire capital from venture capitalists who get involved as partners in a

³ Kenya National Chamber of Commerce & Industry, Kenya Business Guide and Strathmore Business School 'MSME Development Towards a Five-Point Policy Framework', Policy Brief Number 1,

⁴ Romain A, Pottelsberghe B, 'The Determinants of Venture Capital: Additional Evidence', Deutsche Bundesbank, Discussion Paper Series 1: Studies of the Economic Research Centre Number 19/2004, 1. - <https://www.researchgate.net/profile/Bruno_Van_Pottelsberghe/publication/23754893_The_Determinants_of_Venture_Capital_Additional_Evidence/links/0912f5105c7355b1a7000000.pdf> on 9 May 2019.

⁵ The Kenya National Bureau of Statistics, 'Micro, Small And Medium Establishments (MSME) Survey: Basic Report', September 2016, 3.

⁶ Mondher C, Elouaer S, 'Venture Capital Financing: A Theoretical Model', 8(1) *The Journal of Applied Business and Economics*, 2008, 56. -< <http://www.na-businesspress.com/Cherif.pdf>> on 9 May 2019.

business by “offering revenue sharing in the form of equity joint ventures in order to obtain necessary funding and to benefit from the venture capitalists’ experience in management and finance.”⁷

Financing from venture capital is usually short term. As Bob Zider states, “the idea is to invest in a company’s balance sheet and infrastructure until it reaches a sufficient size and credibility so that it can be sold to a corporation or so that the institutional public-equity markets can step in and provide liquidity.”⁸

Venture capital is an extremely high risk business.⁹ Venture capital investors usually take a gamble by investing their money in enterprises that are untried and do not have a proven track record of success and or profitability.¹⁰ When positioned against institutional financial lenders for comparison’s sake, venture capital is not secured by any form of collateral offered up by the borrower. “Viewed in this way, economic logic and historical precedent would suggest that venture capital is a derivative of the market rather than a product of public policy.”¹¹

Lawton concludes his work with a statement that is seminal to this study. He postulates that engaging in policy intervention through government by facilitating access to venture capital thus providing finance to SMEs can prove effective. As he puts it, “all capitalist models (including the US) are interventionist at this stage, driven by the desire to provide SMEs with access to a wealth creation cycle.”¹²

⁷ Wang S, Zhou H, ‘Staged Financing in Venture Capital: Moral Hazard and Risks’, 10(1), *Journal of Corporate Finance*, July 2002, 131-155.

⁸ Zider B, ‘How Venture Capitalism Works’, *Harvard Business Review*, November-December 1998 Issue. <https://hbr.org/1998/11/how-venture-capital-works> on 9 May 2019.

⁹ Mondher C, Elouaer S, ‘Venture Capital Financing: A Theoretical Model’, 56

¹⁰ Lawton C T, ‘Missing the target: Assessing the role of Government in Bridging the European equity gap and enhancing economic growth’, 4(1), *Venture Capital: An International Journal of Entrepreneurial Finance*, 2002, 7-23 <https://www.tandfonline.com/doi/pdf/10.1080/13691060110064246?needAccess=true> on 9 May 2019.

¹¹ Lawton C T, ‘Missing the target: Assessing the role of Government in Bridging the European equity gap and enhancing economic growth’, 11.

¹² Lawton C T, ‘Missing the target: Assessing the role of Government in Bridging the European equity gap and enhancing economic growth’, 21.

II. Small and Medium Size Enterprises

Small and Medium Enterprises are entities owned and operated privately as corporations, partnerships or sole proprietorships which fit the criteria as has been set up by a particular jurisdiction. Aspects of the criteria for categorization include: the annual turnover of the business entity, the number of people hired as employees and the total worth of the assets within the entity's portfolio.¹³ In Kenya, the classification of business enterprises is primarily done by looking at the number of employees engaged by firms and their turnover during a specific period of time.¹⁴

For the purpose of venture capital, strict emphasis is placed on the fact that the SMEs have to be registered and operated as corporate entities. This insistence on the corporate form of registration is rooted in the understanding that SMEs offer up equity in the company to venture capitalists in order to obtain the much needed funding and the benefit of the venture capitalists' experience in corporate finance and management.¹⁵

It is relatively easy to incorporate a company in Kenya.¹⁶ The administrative processes involved have been simplified.¹⁷ In the modern legal world, incorporation is no longer viewed as a privilege bestowed by the state.¹⁸ People who own and operate businesses can freely set up companies with little complication and even sub divide the businesses into many different companies as a group in order to enjoy the advantages the corporate form offers.¹⁹ The corporate form is the most chosen avenue for many businesses that want to raise capital because its features can be exploited in many different ways.²⁰

¹³ Inclusive Economic Growth (IEG) Unit of the United Nations Development Programme (UNDP) Kenya, *'Micro, Small and Medium-Size Enterprises (MSMEs) As Suppliers to the Extractive Industry'*, January 2015, 14.

¹⁴ Inclusive Economic Growth (IEG) Unit of the United Nations Development Programme (UNDP) Kenya, *'Micro, Small and Medium-Size Enterprises (MSMEs) As Suppliers to the Extractive Industry'*, January 2015, 14.

¹⁵ Wang S, Zhou H, *'Staged Financing in Venture Capital: Moral Hazard and Risks'*, 131-155.

¹⁶ World Bank Group, *Doing Business 2020: Economy Profile Kenya*, 8.

¹⁷ World Bank Group, *Doing Business 2020: Economy Profile Kenya*, 8.

¹⁸ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 2nd ed, Oxford University Press, Oxford, 2014, 11.

¹⁹ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 11.

²⁰ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 11.

One advantage is the shielding effect; those who run and or own businesses enjoy a shielding from financial exposure individually.²¹ This has the effect of supporting business innovation since it allows room for the type of risk taking needed to get businesses off the ground.²² To sum this up, the corporate form has the ability to allow business operators full benefit from the business' success and at the same time prevent them from absorbing the costs that arise from its failure.²³

This shielding effect is supported by two legal doctrines of company law, the first one is the doctrine of separate legal personality and the other one is the doctrine of limited liability.²⁴ Separate legal personality as pioneered by English law in 1897,²⁵ gives incorporated companies separate legal personhood and makes them distinct from its shareholders and managers.²⁶ As a result of this separation, 'affirmative asset partitioning'²⁷ is a possibility.²⁸ Asset partitioning shields the business' assets from the people behind the corporate veil that is the shareholders and the managers/directors and most importantly from the creditors of these people.²⁹ This feature of the corporate form makes it very attractive for financiers because they can focus all their risk assessment efforts only on the particular company that they are servicing with capital.³⁰

The doctrine of limited liability provides that shareholders in a corporate entity limited by shares have the obligation of contributing a limited amount to the company's assets.³¹ Shareholders gain protection by virtue of this doctrine because they do not have to contribute a single cent in excess of the amount they agreed to invest in the

²¹ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 11.

²² Ferran E, Ho C L, *Principles of Corporate Finance Law*, 11.

²³ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 11.

²⁴ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 12 and 15.

²⁵ *Salomon v Salomon & Co Ltd* [1897], The United Kingdom House Lords.

²⁶ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 12.

²⁷ A term described in Hansmann H, Kraakmman R R, 'The essential role of organizational law', 110, *Yale Law Journal*, 2000, 387.

²⁸ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 12.

²⁹ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 12.

³⁰ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 13.

³¹ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 16. Also lenders to companies are limited in their exposure because their liability is limited to the amount they contractually agreed upon.

company for their stipulated shares.³² This manner of shielding as achieved by limited liability has several positive ramifications.³³ One that is crucially important to this study is that as a result of the principle of limited liability, the transferability of shares in a corporate entity becomes a possibility.³⁴

Barring the fact that a company may choose to restrict the transferring of shares in its articles of association, the shares in that limited company can be transferred freely as fungible securities.³⁵ Venture capital transactions rely on the effective transfer of shares from the owner(s) of a company into the VCs docket. The SMEs therefore having a corporate form are in a position to offer up equity in exchange for the capital financing they require.

It is apparent that SMEs execute a big role in the creation of jobs and amassing of wealth.³⁶ Through the power of SMEs across the country run by Kenyans of diverse backgrounds socially, geographically and economically, Kenyans can gain access to affordable goods and services through its zealous and extremely resourceful entrepreneurs.³⁷

In Kenya, small and medium sized enterprise operations prevail in all sectors of our economy and play a part in sustaining the bulk of households.³⁸ The Kenya National Bureau of Statistics survey shows that small businesses flourish in the areas of trade, provision of services and manufacturing.³⁹ Therefore, there is an increase of production

³² Ferran E, Ho C L, *Principles of Corporate Finance Law*, 16.

³³ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 16.

³⁴ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 16.

³⁵ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 20.

³⁶ The Kenya National Bureau of Statistics, *'Micro, Small And Medium Establishments (MSME) Survey: Basic Report'*, September 2016, 1. See also, Inclusive Economic Growth (IEG) Unit of the United Nations Development Programme (UNDP) Kenya, *'Micro, Small and Medium-Size Enterprises (MSMEs) As Suppliers to the Extractive Industry'*, January 2015, 15.

³⁷ The Kenya National Bureau of Statistics, *'Micro, Small And Medium Establishments (MSME) Survey: Basic Report'*, September 2016, 3.

³⁸ The Kenya National Bureau of Statistics, *'Micro, Small And Medium Establishments (MSME) Survey: Basic Report'*, September 2016, 3.

³⁹ The Kenya National Bureau of Statistics, *Micro, Small And Medium Establishments (MSME) Survey: Basic Report*, published in September 2016.

of goods and readily available services. The increase in production of goods and services translates to a growing number of skilled and also semi-skilled members of the work force.⁴⁰

Following that highlight of SMEs and their essential task in Kenyan economic progression and industrial development, SMEs make important contributions in ameliorating the socio-economic sectors of our polity by encouraging massive employment, promoting the entrepreneurial spirit and innovativeness among Kenyans, and increasing production of goods to levels allowing for exports.

This thesis notes that an SME sector that is competitive and full of innovation holds substantial promise for developing nations like Kenya, when it comes to: higher income growth; attaining optimal use of domestic human resources; and having a more gainful alliance through regional economics and investment; and offering greater equity, dissemination and development.⁴¹ Therefore, to attain this level of competitiveness, Kenya must have an influx of support in the sector in terms of effective laws and particular regulations that seek to better the sector and protect the businesses from overreach, interference and exploitation by both the government and financiers.

Most importantly, this sector has to have access to capital.

Small and medium sized enterprises in Kenya require funds in the form of start-up capital and additional financial capital to be used as an economic resource essential to entrepreneurs and businesses which help them acquire what is needed in order to manufacture products and provide services to the economic sector they belong to.

⁴⁰The Kenya National Bureau of Statistics, *'Micro, Small And Medium Establishments (MSME) Survey: Basic Report'*, September 2016, 3.

⁴¹ The Kenya National Bureau of Statistics, *'Micro, Small And Medium Establishments (MSME) Survey: Basic Report'*, 73.

In accordance with statistics from the Kenya National Bureau of Statistics,⁴² approximately 72 per cent of licensed businesses reported using funds from family members and or their own personal funds as the main source of capital when starting their business.⁴³ The rest of the statistics show that 4.2 per cent of businesses received lending from family and friends to start-up. Bank financing accounted for 5.6 per cent towards the SMEs, *Chamas* (self-help groups) at approximately 1.4 per cent, with cooperatives at a rounded off figure of 0.5 per cent and governmental funds accounted for 0.1 per cent. Roughly 2.0 per cent of establishments reported their use of other origins of capital outside of those mentioned.⁴⁴

These are staggering figures considering that the SME sector has a pivotal stake in the country's workforce and economy. There is vast need for alternative sources of funding for such business entities.

The banking industry debacle

Institutional financiers such as banks are failing when it comes to this mandate, especially so for SMEs.⁴⁵ It has become common practice all over the world for banks to deny their small business clientele financial facilities.⁴⁶ Economists have attributed this to be a result of the tightening of finance and institutional regulations after the 2008 recession. Banks became extremely careful about the risks that they took, thus

⁴² A body instituted through an Act of Parliament, the Statistics Act, 2006, mandated under Section 4 to: Act as the principle agency Government for collecting, interpreting, analyzing and disseminating data in Kenya; be the Custodian of all official statistics and; conduct a census every 10 years among other functions.

⁴³ The Kenya National Bureau of Statistics, 'Micro, Small And Medium Establishments (MSME) Survey: Basic Report', 41.

⁴⁴ The Kenya National Bureau of Statistics, 'Micro, Small And Medium Establishments (MSME) Survey: Basic Report', 10. This Kenyan survey evokes similarities with the sources for corporate finance for SMEs in the UK as deduced by Ferran and Ho who find that SMEs in the United Kingdom rely heavily on internal financial avenues i.e. equity from owners, retained profits, loans from the directors and even shareholders (Ferran E, Ho C L, *Principles of Corporate Finance Law*, 57).

⁴⁵ International Finance Corporation (IFC), World Bank Group, 'MSME Finance Gap: Assessment of the Shortfalls and Opportunities in Financing Micro, Small and Medium Enterprises in Emerging Markets', 2017, 1.

⁴⁶ International Finance Corporation (IFC), World Bank Group, 'MSME Finance Gap: Assessment of the Shortfalls and Opportunities in Financing Micro, Small and Medium Enterprises in Emerging Markets', 2017, 1.

tightening their credit standards to exclude a majority of small businesses which are riskier than their larger counterparts.⁴⁷

Ferran and Ho make a point of noting that SMEs dependency on banks and their failure to subsequently furnish their financial needs is not just a post 2007-2009 financial crisis issue, but has been a matter of concern stretching over many years.⁴⁸ They opine that the 2007-2009 financial crisis led banks to undertake in massive deleveraging efforts exacerbating the problem of meeting the financial needs of SMEs thus bringing this issue to the fore front as a matter of political priority.⁴⁹ They hold the view that the underlying fundamental issues of bank lending and SMEs are hardly new.⁵⁰

The risk involved for banks includes less profits since SMEs take out smaller loans, banks are unwilling to transact with them given that they carry a much higher risk of default when they could earn more profits by lending large sums to big corporations taking out sizeable loans that are properly collateralized.⁵¹

Collateralization as understood in financial law as a result of its market usage requires that parties in a lending transaction appropriately determine their levels of exposure to each other under the transaction.⁵² It is identified that the debtor owes some amount to a party (“this is the secured party”). The debtor thus rightly has to put up assets in the nature of securities that equals the amount of their exposure.⁵³ This collateral may either involve the secured party having the collateral transferred to them or having the

⁴⁷ International Finance Corporation (IFC), World Bank Group, ‘MSME Finance Gap: Assessment of the Shortfalls and Opportunities in Financing Micro, Small and Medium Enterprises in Emerging Markets’, 2017, 1. See also, International Finance Corporation (IFC), ‘Alternative Data Transforming SME Finance’ May 2017, 3.

⁴⁸ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 57.

⁴⁹ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 57.

⁵⁰ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 57.

⁵¹ International Finance Corporation (IFC), ‘Alternative Data Transforming SME Finance’ May 2017, 1.

⁵² Hudson A, *The Law of Finance*, 2nd ed, Sweet & Maxwell, London, 2013, 1239.

⁵³ Hudson A, *The Law of Finance*, 1240.

secured party hold those assets and having the debtor retain proprietary claim in them.⁵⁴

In lending, banks require that the debtor provide 'security' for the credit forwarded to them to help assure the bank that the loan amount would be repaid.⁵⁵ The bank has 'security' when it has gained proprietary rights or possessory rights in the debtor's or a third party's property that it may use to ensure the loan would be repaid.⁵⁶ This property is what is referred to as collateral.

SMEs being high risk ventures given their likelihood to default on loan repayments have to make available to the lenders adequate collateral for the banks to sufficiently secure their interests and properly provide themselves cover for their exposure. Having this in mind, the challenge for SMEs to acquire financing from the banking sector because of a lack or poor collateralization is put into sharp focus.

The banking sector in Kenya has exercised exorbitance in terms of the interest rates they charge for a long time.⁵⁷ This is partly due to the oligopolistic nature of the sector,⁵⁸ where a few banks control close to half of the market share and therefore influence each other in pricing interest rates for their customers.

As a result, due to political pressure, the Government instituted interest rate capping,⁵⁹ against the recommendations of the Central Bank of Kenya Governor.⁶⁰ As one would

⁵⁴ Hudson A, *The Law of Finance*, 1240.

⁵⁵ Ellinger E P, Lomnicka E, and Hare C V M, *Modern Banking Law*, 5th ed, Oxford University Press, Oxford, 2011, 808.

⁵⁶ Ellinger E P *et al*, *Modern Banking Law*, 808.

⁵⁷ Ngunjiri N, 'The Shortcomings of Interest rate Capping in Kenya', *Business Daily*, 20 December, 2018, - <<https://www.businessdailyafrica.com/analysis/columnists/The-shortcomings-of-interest-rate-capping-in-Kenya/4259356-4904284-tjhbq/index.html>> on 10 August, 2019

⁵⁸ Ochieng J, 'Interest Rate Cap Two Years On: Outcomes for Kenya's Economy', *Kenya Institute for Public Policy Research and Analysis*, 18 February, 2019, -< <https://kippra.or.ke/interest-rate-cap-two-years-on-outcomes-for-the-kenyan-economy/>> On 10 August, 2019.

⁵⁹ Through the Banking (Amendment) Bill 2015 which went into effect in 14th September 2016 as The Banking (Amendment) Act No. 25 of 2016.

⁶⁰ Macharia K, 'Interest Rate Caps Have Caused more harm to SMEs, Economy: CBK study', *Capital Business*, 16 April 2018,-< <https://www.capitalfm.co.ke/business/2018/04/interest-rate-caps-cause->

expect, with lower interest rates, the lending to SMEs should increase because there is access to cheap funds but that is not the case. However, during that capping period, SME borrowers were still being dismissed by banks and more lending was afforded to government and large corporate firms, seeing a substantial reduction in credit to the private sector.⁶¹

The CBK Governor in lauding the efforts to change the interest rate capping regulation that has adversely affected the economy by strangling the SME sector maintained his stance that a complete overhaul of the system is appropriate to allow for a system where banks use risk based mechanisms to grant loans.⁶²

The President taking the advice of the Treasury Department, and the Central Bank of Kenya wanted to see the interest rate capping provision in the Finance Bill abolished.⁶³ In a memo to parliament, the president exercised his veto powers and urged the elected representatives to delete the interest rate capping clause.⁶⁴ His reasoning being that the capping failed to achieve its intended goal and instead ended up hurting SMEs by reducing their access to financing, also, the president pointed out that the capping led to a slowing down of economic growth and; rendered the CBK ineffective when it has to control monetary policy as a key aspect of its mandate thus making the CBK unable to adequately deal with economic shocks.⁶⁵

[more-harm-to-smes-economy-cbk-study/?doing_wp_cron=1565694352.6984210014343261718750](https://www.the-star.co.ke/news/2018-03-20-cbk-regrets-interest-rates-cap-due-to-negative-effects-on-economy/)> On 10 August, 2019.

⁶¹ Muhatia A, 'CBK Regrets Interest Rates Cap Due to Negative Effects on Economy', The Star, 20 March 2018, -<<https://www.the-star.co.ke/news/2018-03-20-cbk-regrets-interest-rates-cap-due-to-negative-effects-on-economy/>> on 10 August, 2019.

⁶² Ilako C, 'Repeal rate Cap to improve SME lending- Njoroge', The Star, 30 January 2019,-<<https://www.the-star.co.ke/counties/2019-01-30-repeal-rate-cap-to-improve-sme-lending-njoroge/>> On 10 August, 2019.

⁶³ Mutai E, 'Uhuru rejects rate Cap in Memo to Parliament', Business Daily, 17 October 2019 - <<https://www.businessdailyafrica.com/news/Uhuru-rejects-rate-cap-in-memo-to-Parliament/539546-5314344-142v3pt/index.html>> on 29 October 2019.

⁶⁴ Mutai E, 'Uhuru rejects rate Cap in Memo to Parliament'.

⁶⁵ Agutu N, 'Why Uhuru has rejected the interest rate cap in Finance Bill', The Star, 17 October 2019 - <<https://www.the-star.co.ke/news/2019-10-17-why-uhuru-has-rejected-the-interest-rate-cap-in-finance-bill/>> on 29 October 2019.

As things stand, the interest rate capping provision was repealed by the 2019 Finance Act upon the President's assent to the Finance Bill.⁶⁶ Optimists expect that the repeal will signify good fortunes for the SME sector since they will be able to access credit from the banks.⁶⁷ The most likely scenario is that there will be a return to the status quo pre-capping of the interest rates, with banks taking advantage of the repeal and acting in a preposterous manner.

In Europe, the trend is similar. SMEs have faced problems in accessing funding.⁶⁸ The European Union and national governments have created initiatives seeking to help them by encouraging banks to offer loans through guarantees or even avail themselves of cheap funding which is serviceable but still not enough. Many banks claim that it's not cheap funding that they lack, but the required capital to back the loans they pitch with it.⁶⁹

In the United Kingdom particularly, solutions to this banking problem for SMEs remain elusive.⁷⁰ The problem is attributed to a lack of competition in a banking industry that is highly concentrated.⁷¹ Official interventions in the UK with the intended objective of easing SMEs' access to credit following the economic circumstances in the wake of the 2007- 2009 financial meltdown; sought to pressure banks to increase lending to small businesses, and also back businesses by granting public guarantees for this type of funding.⁷² They also created an alternative source of financing.⁷³ All these efforts however laudable have yielded limited success.⁷⁴

⁶⁶ PSCU, 'It's Official! The President signs Finance Bill 2019 into law', The Standard, 7 November 2019- <<https://www.standardmedia.co.ke/business/article/2001348472/interest-rate-cap-repealed-as-uhuru-assents-to-finance-bill-2019>> accessed on 10 January 2020.

⁶⁷ PSCU, 'It's Official! The President signs Finance Bill 2019 into law', The Standard, 7 November 2019.

⁶⁸ The Economist, 'Don't bank on the banks: Small businesses seek alternatives as banks leave them in the lurch' The Economist, 14 August 2014 - <<https://www.economist.com/finance-and-economics/2014/08/14/dont-bank-on-the-banks>> on 26 April 2019.

⁶⁹ The Economist, 'Don't bank on the banks: Small businesses seek alternatives as banks leave them in the lurch'.

⁷⁰ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 57.

⁷¹ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 57.

⁷² Ferran E, Ho C L, *Principles of Corporate Finance Law*, 57.

In noting the hardships experienced by small businesses when it comes to securing funding from banks, David Goldin, writing for *The Business Journal*,⁷⁵ states that: “It's nearly impossible these days to keep a small business running with money drawn from your own pocket. Whether it's purchasing inventory, hiring new employees, or opening additional locations, any type of expansion requires extra working capital.”⁷⁶

Accordingly, and for good reason, private-sector forms of financing which are more suitable for the modern day small business owner are growing.⁷⁷ Examples include; venture capitalism, angel investments, crowd funding through online platforms among many others.

So, when banks decline to offer loan facilities to SMEs, they should be able to access financing through alternative means, coming from other specialized private entities which exclusively furnish loans to small businesses with suitable terms conducive for their expansion. Venture capitalism provides such an avenue for small businesses.

III. Competition Law

At the core, competition law is made of rules designed to protect competition, prioritizing consumer welfare.⁷⁸ Competition law has experienced phenomenal growth in recent years because of the urgent need to respond to the massive changes in global politics and economic behaviour.⁷⁹

⁷³ National Loan Guarantee Scheme, a scheme of up to 20 billion British Pounds to invest in SMEs through non bank channels. See Ferran E, Ho C L, *Principles of Corporate Finance Law*, 57.

⁷⁴ Ferran E, Ho C L, *Principles of Corporate Finance Law*, 57.

⁷⁵ Goldin D, ‘Top 10 reasons banks won’t loan money to your business’ *The Business Journal*, 5 November 2014 - <<https://www.bizjournals.com/bizjournals/how-to/funding/2014/11/top-10-reasons-banks-wont-loan-to-your-business.html>> on 26 April 2019.

⁷⁶ Goldin D, ‘Top 10 reasons banks won’t loan money to your business’.

⁷⁷ *The Economist*, ‘Don’t bank on the banks: Small businesses seek alternatives as banks leave them in the lurch’.

⁷⁸ Whish R, Bailey D, *Competition Law*, 7th ed, Oxford University Press, Oxford, 2012, 1.

⁷⁹ Whish R, Bailey D, *Competition Law*, 1.

It is concerning that firms with market power have the ability to abuse consumer welfare by reducing production, increasing prices for commodities, offering low quality products to the market, snuffing out innovation and limiting consumers' ability to choose from a range of products.⁸⁰ The body of rules adopted to address these concerns cannot be tabulated and codified for precise application as is done with tax laws as an example.⁸¹ Matters of competition invariably require that market power be assessed on a case by case basis.⁸² Such assessment is conducted having in mind an understanding of economic concepts.⁸³

One has to be cognizant of both the law and economic principles.⁸⁴ Anecdotally, a story is told that a competition attorney at a competition law forum painstakingly stated that according to him lawyers should be at the driving seat of any competition law proceedings. In agreement a competition economist pointed out that he actually preferred that arrangement since he loved being chauffeured.⁸⁵ Hopefully, the suggestion that there is a conflict between competition lawyers and economists is outdated as it should be; they work in tandem each offering valuable insight from their field of expertise.⁸⁶

To capture the need for competition laws, briefly describing the behaviors that trigger competition issues is a good place to start. These behaviors and practices harmful to competitive processes raise the need for competition law systems. The practices include: Having in force, anti- competitive agreements; these are unlawful agreements between firms whose objective would be restricting competition.⁸⁷ Agreements to avoid competition between competing firms as such leading to an increase in prices, agreements to fix prices; impede entry into a market, divide up markets and restrict

⁸⁰ Whish R, Bailey D, *Competition Law*, 1-2.

⁸¹ Whish R, Bailey D, *Competition Law*, 2.

⁸² Whish R, Bailey D, *Competition Law*, 2.

⁸³ Whish R, Bailey D, *Competition Law*, 2.

⁸⁴ Whish R, Bailey D, *Competition Law*, 2.

⁸⁵ Whish R, Bailey D, *Competition Law*, 2.

⁸⁶ Whish R, Bailey D, *Competition Law*, 2.

⁸⁷ Whish R, Bailey D, *Competition Law*, 2.

output of products are examples that result in severe punishment of the offender with certain jurisdictions dictating imprisonment of the responsible parties.⁸⁸

Abusive practices by a monopoly or dominant firm is also condemned.⁸⁹ A firm which is large enough individually to raise their pricing by reducing output knowing that there won't be any repercussions from the markets since there is only a single firm and entry into the market is difficult or on the other hand for firms enjoying dominant positions, the firm is large enough absorb the meagre losses from their consumers defecting.⁹⁰ Alternatively, dominant firms may reduce prices to amounts less than cost so that competitors are unable to cope hence driven out of the market.⁹¹ In essence, true monopolies are rare thus the introduction of the aspect of dominance.⁹²

Among many other concerns, a major concern for competition regulation of particular interest to this study is the issue of mergers. Competition authorities are enabled to investigate mergers that could prove harmful to the competition process.⁹³ Horizontal mergers can demonstrate their anti-competitiveness if the firm that is formed has a monopoly/dominant market power, or the structure of the whole market which these two firms trade in becomes slanted; creating an oligopoly where only a few sellers have control over that market, making it very easy to coordinate on higher pricing.⁹⁴ In that, consumers would be denied choice and probably end up paying high prices because one firm acquired a major competitor.⁹⁵

Many systems with competition regulation, Kenya being one of them; stipulate that some mergers cannot be finalized until the competition regulators' approval is sought

⁸⁸ Whish R, Bailey D, *Competition Law*, 2. See also, Elhauge E, Geradin D, *Global Competition Law and Economics*, 2nd ed, Hart Publishing Ltd, Oxford, 2011, 2.

⁸⁹ Whish R, Bailey D, *Competition Law*, 3.

⁹⁰ Elhauge E, Geradin D, *Global Competition Law and Economics*, 2.

⁹¹ Whish R, Bailey D, *Competition Law*, 3.

⁹² Elhauge E, Geradin D, *Global Competition Law and Economics*, 2.

⁹³ Whish R, Bailey D, *Competition Law*, 3.

⁹⁴ Elhauge E, Geradin D, *Global Competition Law and Economics*, 3.

⁹⁵ Whish R, Bailey D, *Competition Law*, 3.

and they green light the merger after conducting thorough assessment.⁹⁶ Kenya by law has a set of principles and correlating guidelines that the regulator uses to determine the validity of merger proposals based on competition best practice. These regulations on mergers and how the aspect of control affects proposed merger transactions are tackled in the thesis and their negative effect for venture capital partnerships with SMEs is explored.

1.2 Statement of the Problem

SMEs in Kenya are a big boost to the economy even with the challenges that they face.⁹⁷ The key challenge facing SMEs is access to finance which helps the business owner to recapitalize and remain operational.

As it stands, private-sector financing which is arguably more beneficial to SMEs is growing all over the globe as an alternative for institutional financiers.⁹⁸ Private sector financing and in particular venture capital faces major hurdles in Kenya that are restrictive to its growth and prosperity.

The competition laws and regulations in Kenya as they are undermine the operation of venture capital funds when they seek to partner with SMEs. The regulatory authority demands a strenuous compliance process because the law inaccurately deems venture capital partnerships with SMEs as mergers due to the aspect of change of control in the entity.

The competition regulations enshrined read together with the regulator guidelines that have been issued as constructed capture SME and VC financing transactions in their

⁹⁶ Whish R, Bailey D, *Competition Law*, 3.

⁹⁷ PSCU, 'Uhuru Promises More Government Support for SMEs', *Business Daily*, 16 October 2018- <<https://www.businessdailyafrica.com/releases/Uhuru-promises-more-govt-support-for-SMEs/1941082-4808858-d981fbz/index.html>> on 16th April, 2019. See also, Kenya National Chamber of Commerce & Industry, *Kenya Business Guide* and Strathmore Business School 'MSME Development towards a Five-Point Policy Framework', , Policy Brief Number 1, April 2018 on August 10, 2019.

⁹⁸ *The Economist*, 'Don't bank on the banks: Small businesses seek alternatives as banks leave them in the lurch'.

ambit making them accountable for all intends and purposes to the competition regulator. Also, there is added strain to SMEs and venture capital funds because several regulators are involved, yet no action has been taken to harmonize the compliance processes.

1.3 Hypothesis

Restructuring the legal and regulatory framework governing mergers under the competition laws of Kenya and reviewing the provisions that unreasonably require notification of the regulator followed by a strenuous compliance process so as to make the regulatory landscape more responsive to the peculiarities brought about by VC financing of SMEs is a necessary step towards addressing the challenge of poor capitalization that SMEs face.

1.4 Research Questions

The main question that this thesis seeks to address is why a restructuring of the Kenyan competition regulatory landscape that negatively impacts venture capital funds and SMEs as they partner in business is necessary given the unique characteristics at play in these types of transactions. In doing so, the study asks the following essential questions:

- a) As things stand, what is the state of venture capital as a financial industry in Kenya?
- b) How does venture capital set itself apart with respect to financing of SMEs as opposed to other financial institutions?
- c) What are the specific competition laws and regulations that require modification to better suit venture capital financing of SMEs in Kenya?
- d) What are the recommendations based on the research that can stimulate the growth the venture capital sector in Kenya to boost venture capital financing of SMEs?

1.5 Literature Review

In making the case as to the impact venture capital has had on the transformation and development of the SMEs they finance, Kenyan Authors Memba, Gakure and Karanja in their article,⁹⁹ recognize the importance of the SME sector in the provision of goods and services and also as drivers of competition and innovation that the private sector needs to attain the levels of industrialization in the developed world.

They rightly point out that a need for credit constrains the growth and maturation of the sector. This is caused by an absence of collateral to act as security together with an inappropriate system of laws and regulations that fail to recognize alternative strategies for lending that are quite innovative and effective. They posit venture capitalism as a non-banking financial mechanism, expecting that these SMEs that have had their growth limited due to a lack of capital will have the availability of a different channel of capital.

The authors conclude that there is a twofold positive impact that venture capital helps realize within the SME sector. Economically, venture capital translates to growth in sales, profit, and even assets as well as an improvement in the management of finances in the business. Socially, venture capital impacting small businesses results in creation of more employment opportunities which improve lives and alleviate poverty.

Capturing the underlying importance of venture capital partnership with the small business sector and the transformation of the sector that is realized, the article states that, "Venture capital not only assists SMEs in the provision of funds but also in the internal operations of the business especially in policy formulation."¹⁰⁰ They further note that "Therefore venture capital has demonstrated the business case for SME

⁹⁹ Memba S F, Gakure W R, Karanja K, 'Venture capital (VC): Its impact on growth of Small and medium sized enterprises in Kenya', 3(6), *International Journal of Business and Social Science*, 2012, http://www.ijbssnet.com/journals/Vol_3_No_6_Special_Issue_March_2012/5.pdf on 9 May 2019.

¹⁰⁰ Memba S F, Gakure W R, Karanja K, 'Venture capital (VC): Its impact on growth of Small and medium sized enterprises in Kenya', 5.

investment. Nurturing them at crucial junctures in their development and laying the foundation for an emerging generation of locally owned large enterprises.”¹⁰¹

In a similar study from Ghana analyzing the significant influence of venture capital financing and the growth of small businesses, Christian Biney found that SMEs partnering with venture capitalists were more effective when it came to sales and growth of employment.¹⁰²

The study wisely proposes that the Ghanaian government should encourage small business entrepreneurs to opt for venture capitalism as an alternative source of financing and, make venture capital accessible to SMEs by giving incentives to their investors through deliberate policy decisions like tax breaks or tax exemptions, which in turn would enable more venture capital funds to register and locate their operations in the country and offer services to many small businesses.¹⁰³ This proposition should be applied in Kenya through reformations in the legal and regulatory structures to make the country a more conducive haven for venture capital investors. The particular reformations are addressed in the course of this thesis.

In a Working Paper commissioned by the African Development Bank and the OECD Development Centre,¹⁰⁴ Celine Kauffmann notes that private sector growth and development varies across Africa with SMEs thriving in South Africa, in Mauritius and in North Africa because of the modern financial systems at play in those countries

¹⁰¹ Memba S F, Gakure W R, Karanja K, ‘Venture capital (VC): Its impact on growth of Small and medium sized enterprises in Kenya’ , 5.

¹⁰² Biney C, ‘The impact of venture capital financing on SMEs growth and development in Ghana’, 9(5), *Business and Economics Journal*, 2018, - < <https://www.omicsonline.org/open-access/the-impact-of-venture-capital-financing-on-smes-growth-and-development-in-ghana-2151-6219-1000370.pdf>> on 9 May 2019.

¹⁰³ Biney C, ‘The impact of venture capital financing on SMEs growth and development in Ghana’

¹⁰⁴ Kauffmann C, ‘Financing SMEs in Africa’ The African Development Bank and The OECD Development Centre, Policy Insight Number 7, 2005 -<https://www.oecd.org/dev/34908457.pdf> on 9 May 2019.

coupled with favourable policies towards the private sector as compared to other countries within the continent.¹⁰⁵

According to her, Senegal and Kenya have constituted productive conditions to stimulate the enlargement of the private sector but similarities to do with the issue of lack of finances faced by small businesses arise.¹⁰⁶ A resolution to this issue is increasing the availability of funds through private equity.

Kaufmann identifies that Africa's small businesses have limited "access to finance, which thus hampers their emergence and eventual growth. Their main sources of capital are their retained earnings and informal savings and loan associations (*tontines*), which are unpredictable, not very secure and have little scope for risk sharing because of their regional or sectoral focus."¹⁰⁷ The working paper encourages use of non-financial private sector institutions to expand the pool where small businesses can acquire funding.

Professor Fannon studies the growth of venture capital in Ireland between the years 1990 to 2006 in her article.¹⁰⁸ The significant growth of venture capital investment into SMEs is pointed out and factors that led to the same are identified. She sets out that the economic growth in Ireland goes hand in hand with an increase in venture capital activity fanned by a flexible and responsive regulatory environment.

Ireland and the United Kingdom are considered to be among the most advanced countries in terms of having taxation and legal environments that favour the

¹⁰⁵ Kauffmann C, 'Financing SMEs in Africa' The African Development Bank and The OECD Development Centre, Policy Insight Number 7, 2005.

¹⁰⁶ Kauffmann C, 'Financing SMEs in Africa' The African Development Bank and The OECD Development Centre, Policy Insight Number 7, 2005

¹⁰⁷ Kauffmann C, 'Financing SMEs in Africa' The African Development Bank and The OECD Development Centre, Policy Insight Number 7, 2005. 1

¹⁰⁸ Fannon I L, 'The Luck of the Irish or Just Plain Old Tax Regulatory Planning? The Success of Venture Capitalism in Ireland', 1(2), *Entrepreneurial Business Law Journal*, 2006, 231-256.

development of private equity, venture capital and entrepreneurship in Europe.¹⁰⁹ For the third time in a row according to a study by the European Private Equity and Venture Capital Association,¹¹⁰ Ireland held a comparatively favourable climate for private equity and venture capital because among other factors, the country offers a suitable fund structure and incentives for investors thus retaining its high ranking position in Europe.¹¹¹

The same conclusions are drawn by Professor Fannon. A comparative imperative is offered in her study acknowledging that the same conditions intrinsic to Ireland's success in venture capital may not work if transplanted to a different country.¹¹²

There is hope though, given that she concedes that the regulatory framework in Ireland is flexible on matters of corporate law. She adds that the creation of innovative investment mechanisms that create an advantageous position for Ireland is significantly aided by "...a strong English speaking common law base..."¹¹³ and a young and educated workforce are necessary for similar prosperous results if the Ireland method is to be adopted internationally.¹¹⁴

Therefore, having a common law base, combined with the modernized corporate laws modelled after English laws, coupled with a young and educated workforce, Kenya could emulate the Irish model.

¹⁰⁹ European Private Equity and Venture Capital Association, Benchmarking European Tax and Legal Environments, December 2006, 14 -<https://www.investeurope.eu/uploadedFiles/a1_benchmark06.pdf> on 9 May 2019.

¹¹⁰ European Private Equity and Venture Capital Association, Benchmarking European Tax and Legal Environments, December 2006, 14.

¹¹¹ European Private Equity and Venture Capital Association, Benchmarking European Tax and Legal Environments, December 2006, 69.

¹¹² Fannon I L, 'The Luck of the Irish or Just Plain Old Tax Regulatory Planning? The Success of Venture Capitalism in Ireland' 26.

¹¹³ Fannon I L, 'The Luck of the Irish or Just Plain Old Tax Regulatory Planning? The Success of Venture Capitalism in Ireland' 26.

¹¹⁴ Fannon I L, 'The Luck of the Irish or Just Plain Old Tax Regulatory Planning? The Success of Venture Capitalism in Ireland' 26.

Some authors like Haksoo and Shin have expressed differing opinions when it comes to government policy incentivizing venture capital firms to increase investment.¹¹⁵ In their paper discussing the passing of a law that sought to promote venture capital companies by Korean law makers,¹¹⁶ advocate for an evolutionary process in the development and growth of a venture capital market, highlighting the venture capital market development in the United States as an example.

They argue that enactment of laws that encourage venture capitalism on its own will not mirror the standards of success experienced by other countries. They opine that it is necessary for the government to simply be limited to providing infrastructural facilities necessary for a booming economic sector as opposed to being an active player in the private equity and venture capital sector. Further, they opine that governments should have a good grip on the complexities and multifaceted association that exists between venture capitalists and small business entrepreneurs.

Their paper however, allows room for an eventuality where change in the form of revamping extant institutional frameworks, labour practices and policies making incentive structures operational are essential in order to promote innovation in a venture capital market.¹¹⁷

1.6 Justification for the Study

The literature surveyed creates justification for this research. It justifies the fact that government can and should initiate policy and make legal resolutions that favour development of venture capital.

¹¹⁵Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 15(2), *American University of International Law Review*, 1999, 457-480.

HeinOnline, <https://heinonline.org/HOL/P?h=hein.journals/amuilr15&i=471> .

¹¹⁶ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies',

¹¹⁷Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 480.

There is ample proof from an abundance of studies conducted by other researchers that indicates the major problem for SMEs to be lack of financial capital. It is also evident that small businesses experience growth as a result of partnering with venture capital funds and so does the economy of a country.

With that in mind, doing all that is humanly possible to rethink age old patterns and trends that have encumbered the SME sector is a necessity and approaching alternative sources of capital which SMEs can exploit should be a foregone conclusion. With venture capital featuring as the alternate source of capital for SMEs in this scenario, paving the way by easing undue regulatory encroachment into the sector is crucial.

This study therefore, offers guidance and assistance to policy makers and lawmakers as they formulate laws and regulations that will hopefully prove to be conducive to venture capital financing in Kenya for the benefit of SMEs.

1.7 Theoretical Framework

I. The Competition Theory

In beginning to understand this theory, some suppositions with their foundations in basic economics are made. Suppose that we lived in a world of perfect competition, and everything worked out well.¹¹⁸ Businesses can enter and leave markets at will with no cost, products are similar and the consumers are sufficiently informed.¹¹⁹ The economy is filled with so many businesses that none of them is big enough to influence market prices by altering production of goods; and the firms act independently of each other.¹²⁰ Competition among the businesses to make their sale numbers therefore pushes the

¹¹⁸ Elhauge E, Geradin D, *Global Competition Law and Economics*, 2nd ed, Hart Publishing Ltd, Oxford, 2011, 1.

¹¹⁹ Elhauge E, Geradin D, *Global Competition Law and Economics*, 1. See also, Whish R, Bailey D, *Competition Law*, 7th ed, Oxford University Press, Oxford, 2012, 7.

¹²⁰ Elhauge E, Geradin D, *Global Competition Law and Economics*, 1. See also, Whish R, Bailey D, *Competition Law*, 7.

prices for goods and services down.¹²¹ Businesses that charge exorbitantly for products would be undercut by others that charge less.¹²²

In such a utopian economy,¹²³ when demand for a product increased or the cost of making such product decreased leading to a situation where its suppliers made supra-normal profits with their costs remaining constant, then; wanting a share of those profits, the suppliers would expand and entry into that market by other firms would escalate as well, increasing the supply of those products until the prices were driven down towards costs.¹²⁴ With the vice versa being true, a delightful result would be that resources would be allocated towards markets that can efficiently provide value to consumers.¹²⁵ Even better, such a market will do away with businesses that are not of value to buyers.¹²⁶

The situation in reality is rather different.¹²⁷ Competition is imperfect; aspects such as entry and exit into a market or even expansion take time and are pricey.¹²⁸ The products on offer by the suppliers are different because of differing brands or their attributes.¹²⁹ Also, information is limited.¹³⁰ Economies of scale therefore, dictate that a market cannot have numerous firms thus leaving each other without reason to consider how their decisions affect market prices.¹³¹

¹²¹ Elhauge E, Geradin D, *Global Competition Law and Economics*, 1.

¹²² Elhauge E, Geradin D, *Global Competition Law and Economics*, 1.

¹²³ Elhauge E, Geradin D, *Global Competition Law and Economics*, 1.

¹²⁴ Elhauge E, Geradin D, *Global Competition Law and Economics*, 1.

¹²⁵ Elhauge E, Geradin D, *Global Competition Law and Economics*, 1.

¹²⁶ Elhauge E, Geradin D, *Global Competition Law and Economics*, 1.

¹²⁷ Elhauge E, Geradin D, *Global Competition Law and Economics*, 1. See also, Whish R, Bailey D, *Competition Law*, 8.

¹²⁸ Elhauge E, Geradin D, *Global Competition Law and Economics*, 1.

¹²⁹ Elhauge E, Geradin D, *Global Competition Law and Economics*, 1. See also, Whish R, Bailey D, *Competition Law*, 8.

¹³⁰ Elhauge E, Geradin D, *Global Competition Law and Economics*, 1. See also, Whish R, Bailey D, *Competition Law*, 8.

¹³¹ Elhauge E, Geradin D, *Global Competition Law and Economics*, 1. See also, Whish R, Bailey D, *Competition Law*, 8.

This reality creates a 'workably competitive'¹³² market whose results create a state of affairs that is close enough to those achieved by markets deemed to have perfect competition.¹³³ This is where competition laws come into play.¹³⁴ The ideal state of having achieved perfect competition standards is used as a useful benchmark to help our markets identify inappropriate conduct and patterns that interfere with the market forces, creating a foundation and need for competition law.¹³⁵

Armed with this grasp of competition and the theory that undergirds it, granting it a necessary function in our society; is useful for purposes of this thesis because as the study progresses, this thesis seeks to demarcate venture capital transactions with small businesses from the application of certain competition rules and regulations as enshrined in Kenyan legislation.

II. Public Interest Theory

The global financial crisis of 2007 showed that the financial world is filled with dangers rising mainly from instability in the global economy and sometimes from human error and misjudgement.¹³⁶ In order to ensure a degree of safety for the financial markets, regulation and supervision is imposed on financial service providers like banks and the likes because failure achieves catastrophic results for the customers and consumers of financial services.¹³⁷ A bank failure can have disastrous effects on its clientele whether individuals with their personal savings or businesses.¹³⁸ Their livelihoods are at stake. The collapse of a small or mid- sized bank let alone large bank could have a ripple effect

¹³² As already discussed, perfect competition requires reliance on some assumptions that are rather unlikely to be achieved and observed in markets. Given the unattainably high standards of perfect competition, economists settle for a more prosaic alternate. Labeling it 'workable competition, they recognize limitations of perfect competition and see the value in trying to find the best competition disposition that is more practical and attainable. See, Whish R, Bailey D, *Competition Law*, 16.

¹³³ Elhauge E, Geradin D, *Global Competition Law and Economics*, 1.

¹³⁴ Also termed as Antitrust law in some jurisdictions.

¹³⁵ Elhauge E, Geradin D, *Global Competition Law and Economics*, 1.

¹³⁶ Ellinger E.P *et al*, *Modern Banking Law*, 26.

¹³⁷ Ellinger E.P *et al*, *Modern Banking Law*, 27.

¹³⁸ Ellinger E.P *et al*, *Modern Banking Law*, 27.

on the market causing financial panic.¹³⁹ Financial regulation is therefore a serious issue of public concern.

Regulation is always considered when discussing reforms in service sectors.¹⁴⁰ There are many theories that inform how governments regulate to achieve development of an economy.¹⁴¹

The public interest theory is of significance to this study.¹⁴²

The public interest theory as interpreted by Posner,¹⁴³ is born out of the understanding that regulation is implemented retroactively responding to a public crisis in order to correct “inefficient or inequitable market practices.”¹⁴⁴ Proponents of this theory aim for public benefit as their goal. Is the public well served by a regulation? Does the regulator inflict injury to the public with certain regulations?¹⁴⁵ These are the questions that public interest theorists grapple with.

Rooted in the notion that government can get involved and intervene to regulate market and sector inadequacies, public interest theory flourishes. The assumption is that, economic markets are really fragile and are prone to operate inefficiently if left to

¹³⁹ Ellinger E.P *et al*, *Modern Banking Law*, 27.

¹⁴⁰ Nyang’era A, ‘Accessing Venture Capital: assessing the legal and regulatory framework for the growth of the venture capital industry in Kenya, published, University of Nairobi, Nairobi, 2009, 12.

¹⁴¹ Nyang’era A, ‘Accessing Venture Capital: assessing the legal and regulatory framework for the growth of the venture capital industry in Kenya, published, University of Nairobi, Nairobi, 2009, 12.

¹⁴² Posner R, ‘Theories of Economic Regulation’, *The Bell Journal of Economics and Management Science*, 1974, 335. <http://links.jstor.org/sici?sici=0005-8556%28197423%295%3A2%3C335%3ATOER%3E2.0.CO%3B2-A> on 20 November 2019.

¹⁴³ Posner is not the original source of this theory. The theory is usually assumed and not articulated. As he puts it was coined by a previous generation of economists and gifted to present lawyers. He relies on sources such as Bonbright J C, *Principles of Public Utility Rates*, New York: Columbia Univ. Press, 1961, Davis K C, *Administrative Law Treatise*, St. Paul: West, 1958 and 1970 supplement, and Friendly H J *The Federal Administrative Agencies: The Need for Better Definition of Standards*, Cambridge: Harvard University Press, 1962.

¹⁴⁴ Posner R, ‘Theories of Economic Regulation’, 335.

¹⁴⁵The word Regulator is a catch-all phrase to include actors such as legislators, commissioners, or bureaucrats. As informed by Crowley S, ‘Theories of Regulation: Incorporating the Administrative Process’ *Colombia Law Review*, 1998, 66 <http://www.jstor.org/stable/1123396> on 20 November 2019.

their own devices, intervention through government regulation/deregulation at virtually no cost is all-important.¹⁴⁶

This theory within the confines of this study encourages government bureaucracies to assess the venture capital market and offer support by easing the competition regulatory environment that is burdensome for venture capital funds and SMEs.

This study posits the idea that restructuring legal frameworks and regulatory policies that govern venture capital in Kenya will be productive and result in the increase of venture capital investors in the Kenyan market to service SMEs' financial needs.

Therefore, adjustments will have to be made addressing how venture capital firms are unnecessarily subjected to undergo cumbersome regulatory checks and procedural hoops that are time wasting because competition laws deem them necessary as they seek compliance from the competition authority in their efforts to partner with SMEs.

With the necessary modifications to the laws and regulations, Kenya will become a destination for venture capital investors who will seek to carry out business locally and also open up and explore the wider East African market.

1.8 Methodology and Approach

The methodology applied in this thesis is qualitative in nature. Desk-based research with library facilities and online academic repositories were engaged. This study depends mainly on the exploration and analysis of primary and secondary sources of data. Primary sources contain direct and firsthand evidence of an occurrence or an idea. They may include historical documents and surveys conducted by individuals and organisations. In this research the primary sources used are Acts of Parliament forming part of the Laws of Kenya and surveys carried out by organisations. Secondary sources of literature have the aspect of interpretation, that is, say the primary sources have been

¹⁴⁶ Posner R, 'Theories of Economic Regulation', 336.

analyzed and commented upon an example being articles in scholarly journals. This thesis makes use of secondary sources such as books, journal articles, working papers, reports, other theses and, news articles.

In terms of approach, the study adopts a case study, historical, normative and theoretical approach. The theoretical approach analyses existing theories of economics and governance posited over the years by influential writers and scholars; the theories applied in this thesis are theories that favour the objectives of the study being undertaken.

The thesis delves into the subject by utilizing the case study approach, that is, the focus for the study is limited within specific geographical confines with its jurisprudential system. Particular effort is made to contextualize the discussions in this thesis and offer analysis that is relevant to Kenya.

The study uses the historical approach in tracing the account of venture capital as it developed and its existence in Kenya to become a viable method of financing SMEs. This approach is called upon all through the thesis but heavily features and is relied upon in chapter 2 of the study. The normative approach appearing mainly in chapter 3 is used in discussing the competition legal and regulatory framework that threatens and undermines the growth and expansion of the venture capital sector in Kenya.

1.9 Limitations and Assumptions

The main limitation faced in conducting this research was a lack of local data to work with. Internationally, topics like Venture capital, competition and SMEs have been widely researched and for many years now. One can trace developments, challenges and changes in these subsets easily. In Kenya, that is not the case. As is pointed out, venture capital is not yet a developed financing mechanism; data showing numbers in monetary terms injected into the Kenyan market is either regionalized and or compounded with figures typifying classical private equity financing. The competition

laws in Kenya were enacted less than a decade ago and as a result of that, certain aspects of the laws with wildly different implications given the same set of facts and laws like the ones considered in this thesis have not been challenged before courts of law to test their application.

This study is limited in terms of scope since focus will be placed only on a single country that is Kenya, detailing the journey of venture capital and looking at the legal and regulatory measures together with regulatory policies that have been initiated over the years. Therefore, any effort to transplant the ideas espoused and conclusions arrived at to a different country with a different legal system could prove to be futile.

The study assumes that venture capitalism is the best way to go in addressing the issue of financing that is of major concern to SMEs. The researcher acknowledges that there are other sources of capital financing in existence. During the course of the study, the thesis will endeavour to put up reasons to support the concept that encouraging venture capitalism is the best possible approach.

An assumption can be made that this is a quick fix approach to aid the growth of SMEs and that once the laws and regulations dealing with the subject of venture capitalism are retrofitted, everything changes leading to an instantaneous gains. This mindset is deceptive since the idea of venture capital is by far and large a foreign concept to many small business owners qualifying for such financial investment. They may not be receptive to the idea at first. Therefore, a labour intensive awareness campaign may have to be put into effect targeting SMEs and relaying the benefits that come across as a result of venture capitalism.

1.10 Chapter Breakdown

The goals of this study are satisfied within five unique chapters, this chapter being introductory in nature. It gives the background to the problem by tackling the main tenets setting up the thesis. The research problem, hypothesis, research questions,

literature review, theoretical framework, methodology, approach, some limitations, assumptions and finally, the chapter layout follow in that succession.

The Second chapter pointedly discusses the development of venture capital in Kenya, contextualizing the problems faced by venture capital funds. Some efforts that have been made by the government to enhance the sector are considered in the chapter as well.

The third chapter very briefly gives historical background to the growth of venture capital as an alternative means by which SMEs access financing. The chapter for the purposes of this study specifically looks at the aspect of control in venture capital. The chapter is informed by the wealth of knowledge that exists since the pioneering of venture capitalism.

Chapter four interrogates competition regulations that are inconsistent with how venture capitalism works in financing SMEs in respect of the question of control previously raised in the preceding chapter. This chapter contemplates some of the laws and regulations in Kenya that are unappealing to venture capital operations with SMEs.

In the fifth chapter, conclusions to the study are made, the research questions are answered, and the thesis is signed off by confirming the hypothesis and offering a few recommendations.

CHAPTER TWO

A SYNOPSIS OF VENTURE CAPITAL IN KENYA

2.1 Introduction

In this chapter, the state of venture capital in Kenya is analyzed; the analysis employs the use of regional data to some extent since the Kenyan VC scene is still in its sophomore stages thus unable to produce sufficient data that can be researched to give an adequate glimpse into the VC industry. The development of VC or lack thereof is scrutinized; this scrutiny involves assessing the legal and regulatory framework that has been installed to undergird venture capital activity, and, pointing out factors that make Kenya an attractive destination for venture capital investment. Some of the main challenges facing the VC industry are also discussed.

2.2 The Kenyan Venture Capital Story

Sub-Saharan Africa has been an unattractive region for investments from western countries and corporations.¹⁴⁷ This sentiment is cultivated by factors such as poor infrastructure, unstable political environments, low levels of educated persons among the populace, and poor purchasing power in the region due to the high levels of poverty.¹⁴⁸ As a result, the likelihood of private investors finding worthwhile investment opportunities is curtailed.¹⁴⁹

While attracting private investments was difficult, developed nations injected a massive amount of financial aid to the sub-Saharan region with the aim of lifting the African

¹⁴⁷ Hain S D, Jurowetzki R, 'Silicon savanna? Local competence building and international venture capital in low income countries. The emergence of foreign high-tech investments in Kenya', The Global Network For Economics of Learning, Innovation, and Competence Building System (GLOBELICS), Working Paper Number 2015-09, 3, -< <https://papers.globelics.org/wp-content/uploads/2018/07/GWP2015.09.pdf>> on 28 January 2020.

¹⁴⁸ Hain S D, Jurowetzki R, 'Silicon savanna? Local competence building and international venture capital in low income countries. The emergence of foreign high-tech investments in Kenya', 3.

¹⁴⁹ Hain S D, Jurowetzki R, 'Silicon savanna? Local competence building and international venture capital in low income countries. The emergence of foreign high-tech investments in Kenya', 3.

continent out of poverty and hopelessness.¹⁵⁰ The financial aid was dedicated to alleviate the levels of poverty that brings with it malnutrition, inadequate health care, housing and sanitation.¹⁵¹

At the beginning of the previous decade, Africa started to emerge.¹⁵² There was steady growth economically that led to an emergence of a substantial continental middle class.¹⁵³ Profitable private sector investment became a real possibility particularly so in the information, communications and technology sector in Nigeria and Kenya.¹⁵⁴

Consequentially, private investments were made in the region intended to exploit the accelerating growth in the economy by copying business models that had proved successful in the advanced economies.¹⁵⁵ In turn, the private investments made into the region surpassed the financial aid that had been granted by the developed nations.¹⁵⁶

The term “developed nation/world/economies” is used in this chapter to refer to countries that fit into the criteria set up by the *World Economic Situation and Prospects* (WESP).¹⁵⁷ WESP categorizes nations/economies into three broad classes: developed, developing and transitional economies;¹⁵⁸ for countries that can be classified as either

¹⁵⁰ Hain S D, Jurowetzki R, ‘Silicon savanna? Local competence building and international venture capital in low income countries. The emergence of foreign high-tech investments in Kenya’, 3.

¹⁵¹ Hain S D, Jurowetzki R, ‘Silicon savanna? Local competence building and international venture capital in low income countries. The emergence of foreign high-tech investments in Kenya’, 3.

¹⁵² Hain S D, Jurowetzki R, ‘Silicon savanna? Local competence building and international venture capital in low income countries. The emergence of foreign high-tech investments in Kenya’, 4.

¹⁵³ Hain S D, Jurowetzki R, ‘Silicon savanna? Local competence building and international venture capital in low income countries. The emergence of foreign high-tech investments in Kenya’, 4.

¹⁵⁴ Hain S D, Jurowetzki R, ‘Silicon savanna? Local competence building and international venture capital in low income countries. The emergence of foreign high-tech investments in Kenya’, 4.

¹⁵⁵ Hain S D, Jurowetzki R, ‘Silicon savanna? Local competence building and international venture capital in low income countries. The emergence of foreign high-tech investments in Kenya’, 4.

¹⁵⁶ Hain S D, Jurowetzki R, ‘Silicon savanna? Local competence building and international venture capital in low income countries. The emergence of foreign high-tech investments in Kenya’, 4.

¹⁵⁷ Economic Analysis and Policy Division (EAPD), the Department of Economic and Social Affairs of the United Nations Secretariat (UN/DESA), *World Economic Situation and Prospects*, 2019, - <https://www.un.org/development/desa/dpad/wp-content/uploads/sites/45/WESP2019_BOOK-ANNEX-en.pdf> on 10 March 2020.

¹⁵⁸ Economic Analysis and Policy Division (EAPD), the Department of Economic and Social Affairs of the United Nations Secretariat (UN/DESA), *World Economic Situation and Prospects*, 2019, 167.

developing or developed based on the evaluation of characteristics they present.¹⁵⁹ The classification is based on the level of development countries have achieved determined by gross national income per capita levels set up by the standardized World Bank threshold;¹⁶⁰ thus qualifying counties/economies as low income, low middle income, upper middle income and high income.¹⁶¹

A decade ago, the newcomer; venture capital and private equity industry in Africa was confined to the southern region of Africa.¹⁶² Most of the venture capital and private equity investments into Sub-Saharan Africa went to South Africa,¹⁶³ with Kenya and Nigeria trailing behind.¹⁶⁴ Post the 2008 global financial crisis, Africa's resilience and continued economic growth led to an increase in private equity investment, with a much wider focus beyond South Africa.¹⁶⁵

Kenya offers regulatory stability for a thriving business environment that makes possible the comparatively impressive economy led by the private sector within East Africa.¹⁶⁶ For this reason, Kenya has become a desirable destination for private equity

¹⁵⁹ Economic Analysis and Policy Division (EAPD), the Department of Economic and Social Affairs of the United Nations Secretariat (UN/DESA), *World Economic Situation and Prospects*, 2019, 167.

¹⁶⁰ Economic Analysis and Policy Division (EAPD), the Department of Economic and Social Affairs of the United Nations Secretariat (UN/DESA), *World Economic Situation and Prospects*, 2019, 168.

¹⁶¹ Economic Analysis and Policy Division (EAPD), the Department of Economic and Social Affairs of the United Nations Secretariat (UN/DESA), *World Economic Situation and Prospects*, 2019, 168.

¹⁶² Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', Finance, Competitiveness and Innovation Global Practice- World Bank Group, Policy Research Working Paper number WPS 8598, October 2018, 3, -<
<http://documents.worldbank.org/curated/en/820451538402840587/Survey-of-the-Kenyan-Private-Equity-and-Venture-Capital-Landscape>> on 28 January 2020.

¹⁶³ Mentions of private equity in this chapter are an all encompassing term for venture capital coupled with private equity in its strict sense.

¹⁶⁴ Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 3.

¹⁶⁵ Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 3.

¹⁶⁶ Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 3.

investment.¹⁶⁷ It is noteworthy that for a country its size, with its population; Kenya ranks third in alternative investment behind South Africa and Nigeria.¹⁶⁸

In contemplating regulatory stability, this chapter views that regulatory stability is not achieved when there is a ban on any changes to current regulations.¹⁶⁹ Regulatory stability envisions that there is in place substantive and procedural measures in the regulatory sphere that allow a country to make trustworthy commitments with investors.¹⁷⁰

This translates to having law making procedures that are not shrouded in secrecy, affording public participation in the making of laws and regulations before they are implemented and removing the arbitrariness that is usually employed by the regulatory machine.

With such measures in place, countries are less likely to renege on their commitments to investors instituted through policy and regulations.¹⁷¹ The upside being that they enjoy investments at a higher rate.¹⁷² For purposes of this thesis, this chapter accedes that for the most part, Kenya reasonably enjoys regulatory stability. Said regulatory stability is complemented by adherence to the rule of law critical to enforcement of contracts as is explained later on in this chapter.

¹⁶⁷ Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 3.

¹⁶⁸ Ibid. Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 3.

¹⁶⁹ Bellantuono G, 'What Investors (Really) Want: Regulatory Stability in the Italian Energy Sector', Univerity of Oxford, Faculty of Law Blog, 28 June 2016, -<<https://www.law.ox.ac.uk/business-law-blog/blog/2016/06/what-investors-really-want-regulatory-stability-italian-energy-sector>> on 10 March 2020.

¹⁷⁰ Bellantuono G, 'What Investors (Really) Want: Regulatory Stability in the Italian Energy Sector'.

¹⁷¹ Bellantuono G, 'What Investors (Really) Want: Regulatory Stability in the Italian Energy Sector'.

¹⁷² Bellantuono G, 'What Investors (Really) Want: Regulatory Stability in the Italian Energy Sector'.

Kenya and more specifically Nairobi city offers an advantage to investors who seek to penetrate the East African Market.¹⁷³ Based on factors such as; good quality of life, availability of human capital, adequate transportation and competent service providers like lawyers and accountants, Nairobi by merit makes for a good investment hub, serving the entire East African region.¹⁷⁴ For the same factors, Nairobi boasts as home to the private equity association- the East African Venture capital Association (EAVC) an organization set up in early 2013, to conduct advocacy on behalf of venture capital and private equity investors.¹⁷⁵

The private equity landscape in Africa has seen Kenya play a significant role in terms of transaction size.¹⁷⁶ According to the survey on private equity and venture capital conducted by Finance, Competitiveness and Innovation Global Practice, as part of the World Bank Group,¹⁷⁷ the number of private equity deals rising by twenty nine percent for the time period between 2010 to 2014 from zero in the period before 2007, and the size of the transactions shows that the Kenyan market has matured.¹⁷⁸

Venture capital investment in Kenya has less capital compared to private equity.¹⁷⁹ This is because of the more specialized fashion in which venture capital funds have to operate in provided that there are high risks of partnering with start up businesses coupled with the macroeconomic risks that come with operating within the African

¹⁷³ Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 3.

¹⁷⁴ Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 3.

¹⁷⁵ Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 3.

¹⁷⁶ Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 5.

¹⁷⁷ Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 5.

¹⁷⁸ Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 5.

¹⁷⁹ Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 8.

territory.¹⁸⁰ As such, when contrasted, venture capital funds have less capital than private equity firms. Still, even with the challenge of capital, helped by massive technological companies like *Safaricom* and *mPesa*, Kenya maintains its status as a nerve centre for venture capital in Africa.¹⁸¹

Lingelbach indicates in his doctoral thesis that the case is similar in South Africa.¹⁸² He suggests that the venture capital sector is not as flourishing compared to private equity leaving the future of venture capital highly uncertain.¹⁸³ He further points out that the success of private equity is driven by availability of credit which supports buyouts;¹⁸⁴ investors seek to purchase entire enterprises that they find have a promising potential for quick growth and profitability. He also suggests that the high returns occasioned by the profitability involved in private equity plays a role in crowding the start-up financing sector leaving little room for venture capital presence.¹⁸⁵

2.3 Foundational legal and regulatory framework for venture capital

Currently, Kenya lacks comprehensive laws/regulations that encompass venture capital. Regulation for venture capital is dispersed in different legislations. This lack of an all inclusive piece of legislation specifically for VC is not catastrophic to the industry. However, it creates redundancies and regulatory disarray. The main applicable law for VC is the Capital Markets Act.¹⁸⁶ Secondary legislations are; the Capital Markets

¹⁸⁰ Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 8.

¹⁸¹ Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 8.

¹⁸² Lingelbach D C, 'Neither Pirates nor Politicos: The Emergence of Venture Capital in Weak Institutional Environments', Published PhD Thesis, University of Exeter, Exeter, 2009, 132.

¹⁸³ Lingelbach D C, 'Neither Pirates nor Politicos: The Emergence of Venture Capital in Weak Institutional Environments', Published PhD Thesis, University of Exeter, Exeter, 2009, 132.

¹⁸⁴ Lingelbach D C, 'Neither Pirates nor Politicos: The Emergence of Venture Capital in Weak Institutional Environments', Published PhD Thesis, University of Exeter, Exeter, 2009, 132.

¹⁸⁵ Lingelbach D C, 'Neither Pirates nor Politicos: The Emergence of Venture Capital in Weak Institutional Environments', Published PhD Thesis, University of Exeter, Exeter, 2009, 132.

¹⁸⁶ *The Capital Markets Act*, (Chapter 485A of the Laws of Kenya).

(Registered Venture Capital Companies) Regulations,¹⁸⁷ 2007 and the Income Tax Act (Venture Capital Enterprise) Rules, 1997.¹⁸⁸

I. The Capital Markets Act

The Capital Markets Authority (CMA) in Kenya acts as the main regulator for VC funds.¹⁸⁹ The Capital Markets Authority (CMA) is an autonomous public agency chartered by Chapter 485A Laws of Kenya (the Capital Markets Act). The CMA is responsible for the supervision, monitoring and licensing of the activities of market players.

The functions that the CMA carries out include:¹⁹⁰ Developing the capital markets with emphasis on removing impediments and incentivizing long term investments in profitable enterprises,¹⁹¹ enabling the public to have greater participation in the capital markets by facilitating a nationwide system of securities exchange,¹⁹² creating, maintaining and regulating a fair, orderly and efficient market where securities are issued and traded in and participants in the system are practically for all intends and purposes self regulating their activities,¹⁹³ protecting investor interests including by facilitating a compensation fund to cater for financial loss investors suffer when dealers/brokers fail to meet their contractual obligations,¹⁹⁴ and facilitating the development of electronic commerce within the capital markets.¹⁹⁵

¹⁸⁷ Legal Notice 138, the Capital Markets (Registered Venture Capital Companies) Regulations, 2007, (Chapter 485A of the Laws of Kenya).

¹⁸⁸ *The Income Tax Act* (Chapter 470 of the Laws of Kenya).

¹⁸⁹ Note; the Act and subsidiary legislations use the term 'company' instead of 'fund' stressing the fact that venture capital vehicles have to be incorporated (Capital Markets Act Section 2).

¹⁹⁰ Section 11(1), *The Capital Markets Act*, (Chapter 485A of the Laws of Kenya).

¹⁹¹ Section 11(1) (a), *The Capital Markets Act*, (Chapter 485A of the Laws of Kenya).

¹⁹² Section 11(1) (b), *The Capital Markets Act*, (Chapter 485A of the Laws of Kenya).

¹⁹³ Section 11(1) (c), *The Capital Markets Act*, (Chapter 485A of the Laws of Kenya). The CMA is the regulator of the capital markets. This provision speaks to promotion of ethical conduct and eradication of mischief by players in the securities exchange thus boosting public confidence and raising trust in the system which elevates the stature and repute of the capital markets.

¹⁹⁴ Section 11(1) (d) & (e), *The Capital Markets Act*, (Chapter 485A of the Laws of Kenya).

¹⁹⁵ Section 11(1) (f), *The Capital Markets Act*, (Chapter 485A of the Laws of Kenya).

The Capital Markets Act (RVCC) Regulations, 2007

The Capital Markets (Registered Venture Capital Companies) Regulations, 2007 were created by the CMA in exercise of their mandate under Section 12 of the Capital Markets Act.¹⁹⁶ The Capital Markets Act defines a registered venture capital company to be a company that has been certified by the Authority, being duly incorporated with its business model being the provision of risk capital to SMEs in Kenya that have a high potential for growth.¹⁹⁷ The threshold of not less than 75% of the fund is stipulated to be invested in eligible enterprises in equity or quasi- equity form.¹⁹⁸ The Capital Markets (RVCC) Regulations, 2007 prescribes a checklist of requirements on matters of eligibility, fund managers, registration, deregistration, reporting standards and obligations, and investments that venture capital funds have to meet.

I. The Income Act (Venture Capital Enterprise) Rules, 1997

The Income Act (Venture Capital Enterprise) Rules, 1997 defines a VCC as a company duly incorporated in Kenya whose purpose is investing in new or growing venture enterprise.¹⁹⁹

Rule 3 Mandates that venture capital companies be registered by the Commissioner for income tax.²⁰⁰ Such registration is effective once the commissioner is satisfied that certain requirements have been met.

These requirements include:²⁰¹ Having gained proper incorporation in Kenya as envisaged by the directives of the Companies Act;²⁰² the purpose for incorporation as stipulated in the corporations' articles of association should be to invest in new and

¹⁹⁶ Section 12 empowers the Authority to issue regulations, guidelines and notices considered necessary to promote the functions that the Authority has in regulating the capital markets and ensure effective operations.

¹⁹⁷ Section 2, *the Capital Markets Act* (Chapter 485A Laws of Kenya).

¹⁹⁸ Section 2, *the Capital Markets Act* (Chapter 485A Laws of Kenya).

¹⁹⁹ Rule 2, *the Income Act (Venture Capital Enterprise) Rules, 1997*.

²⁰⁰ *The Income Act (Venture Capital Enterprise) Rules, 1997*.

²⁰¹ Rule 3, *the Income Act (Venture Capital Enterprise) Rules, 1997*.

²⁰² Act Number 17 of 2015 Laws of Kenya.

expanding enterprises; stipulation that before the commissioner approves registration; the company should be already registered by the Capital Markets Authority; stipulations as to management of the company by a fund manager whose qualifications are expounded upon by the Capital Markets (RVCC) Regulations, 2007; Similar to the Capital Markets (RVCC) Regulations there is provided that 75% or more of the fund be invested in enterprises; and, stipulation that the company only invests in enterprises conducting approved activities.

At any given time, when a VCC fails to meet the prescribed qualifications, the Commissioner has the authority to give notice in writing to the fund manager signalling the withdrawal of registration of the VCC.²⁰³

There are activities that are explicitly prohibited. A VCC cannot be involved in banking and financial service activities; retail and wholesale trade services and carrying out real property trading.²⁰⁴

The eligibility clause presents a challenge for foreign VCFs because it requires that there must be independent directors making up a third of the board of directors,²⁰⁵ and that the appointed auditor and secretary of the VCC must be a member of the Institute of Certified Public Accountants of Kenya and the Institute of Certified Public Secretaries of Kenya respectively.²⁰⁶ This requirement is restrictive thus making it difficult for foreigners to engage in VC operations in Kenya. Leeway should be given and exemptions made to this provision.

II. The Companies Act, 2015

Some other key laws such as the Companies Act, 2015 are also applicable to VCFs since the Capital Markets (RVCC) Regulations require that venture capital funds be

²⁰³ Rule 6, the Income Act (Venture Capital Enterprise) Rules, 1997.

²⁰⁴ Rule 4, the Income Act (Venture Capital Enterprise) Rules, 1997.

²⁰⁵ Part II, Section 3 (h) the Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

²⁰⁶ Part II, Section 3 (i) and (j) the Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

incorporated under the Companies Act; a requirement that should be re-examined and changed since VC funds are typically registered as partnerships in most jurisdictions,²⁰⁷ and considering also that incorporation has taxation implications that are unfavourable to investors. The tax implication that arises when the vehicle of registration is a partnership is advantageous because a corporate tax is not charged to the partnership. The partners are taxed individually based on the income they gain from the partnership venture.

Additionally, the registration process for VCFs is unnecessarily lengthy and repetitive. It also raises cost implications that are expensive. The application process to accomplish registration is based on the fulfilment of many requirements relying on a variety of documentation from different offices/registries. Payment of fees is done at the multiple stages of registration some of which are needlessly repetitive.

For example, conducting registration with CMA and also with the Commissioner for income tax under the Income Tax Act rules presents a redundancy especially since the requirements to be met by a VCF mandated by both offices are similar. Such redundancies accomplish the task of making the registration of VCFs in Kenya a highly expensive and cumbersome endeavour.

The CMA has failed in its mandate to by failing to completely remove impediments and incentivize long term investments in profitable enterprises in the case of venture capital investment.²⁰⁸ Combing through the VC legal and regulatory framework, one finds that it is marred with impediments and inconsistencies harmful to the VC sector.

²⁰⁷ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 462.

²⁰⁸ Section 11(1) (a), *The Capital Markets Act*, (Chapter 485A of the Laws of Kenya).

2.4 Exit options for venture capital investors

A major challenge that exists for the venture capital industry in Kenya is the absence of commercially feasible exit options.²⁰⁹ As explored in detail in the next chapter, exit is crucially important in venture capital arrangements. Venture capitalists plan beforehand to recover their investment plus any forthcoming returns.²¹⁰ As D. Gordon Smith writes,²¹¹ “Before venture capitalists invest, they plan for exit.” Exit enables venture capitalists to reallocate funds paired with the non-monetary contribution like management expertise that accompanies their activity by reinvestment into other start-up businesses in need of capital.²¹²

Without viable exit options, venture capitalists are not able after investing; to return the investment, plus returns to their investors proving the validity of their thesis on investment in start-ups within their portfolio with legs to stand on when they ask for more funds to invest based on their record of generating returns.²¹³ It is an attractive prospect to start venture capital funds with the knowledge that other funds have successfully enhanced the growth of early stage companies and managed to make profitable exits for the benefit of their limited partners.²¹⁴

The public markets which usually offer venture capitalists an avenue for achieving liquidity in the developed world are underutilized in Kenya.²¹⁵ Investors recognize the absence of IPOs in certain countries when considering making investments into those

²⁰⁹ Divakaran S, McGinnis P, Schneider S, ‘ Survey of the Kenyan private equity and venture capital landscape’, 18.

²¹⁰ Smith D G, ‘The exit structure of venture capital’, 53(2), *UCLA Law Review*, 2005, 316.

²¹¹ Smith D G, ‘The exit structure of venture capital’, 316.

²¹² Smith D G, ‘The exit structure of venture capital’, 316.

²¹³ Divakaran S, McGinnis P, Schneider S, ‘ Survey of the Kenyan private equity and venture capital landscape’, 18.

²¹⁴ Divakaran S, McGinnis P, Schneider S, ‘ Survey of the Kenyan private equity and venture capital landscape’, 18.

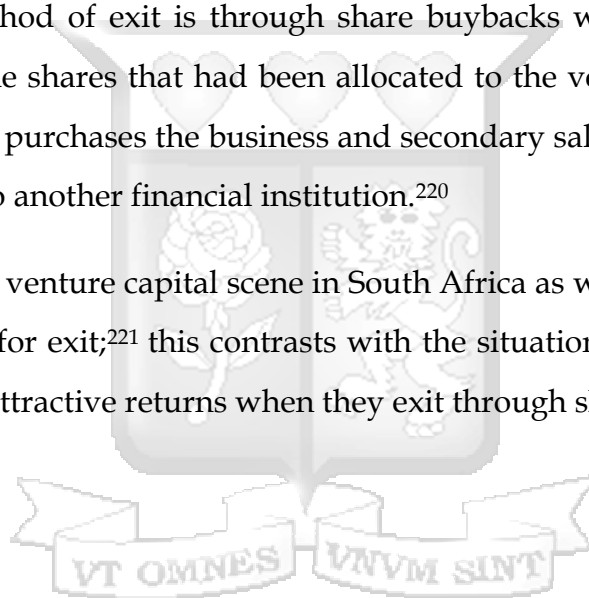
²¹⁵ Divakaran S, McGinnis P, Schneider S, ‘ Survey of the Kenyan private equity and venture capital landscape’, 18.

countries through private equity.²¹⁶ For instance, to explain the gravity of the situation, the Kenyan capital market (the NSE) had no Initial Public Offers (IPOs) for the years 2016 and 2017.²¹⁷ This fact does not isolate Kenya alone, in Africa; the trends are similar across the continent. Most capital markets in African countries are not developed to a point where the actors have deep financial reservoirs thus making the market liquid.²¹⁸

In South Africa, a nation that has broad and deep capital markets among the emerging markets saw rapid growth in IPO activity competing with major capital market players like the United Kingdom and then dwindled thereafter.²¹⁹

The most utilized method of exit is through share buybacks when entrepreneurs are able to acquire back the shares that had been allocated to the venture capitalists, trade sales when an investor purchases the business and secondary sales when a venture firm sales off the business to another financial institution.²²⁰

The private equity and venture capital scene in South Africa as well places little reliance on IPOs as an avenue for exit;²²¹ this contrasts with the situation in developed markets where VC funds gain attractive returns when they exit through share sales.²²²



²¹⁶ Divakaran S, McGinnis P, Schneider S, 'Survey of the Kenyan private equity and venture capital landscape', 18.

²¹⁷ Ngunjiri J, 'No offers in two years as NSE suffers IPOs drought', *Business Daily*, 7 March 2018 -< <https://www.businessdailyafrica.com/markets/capital/No-offers-in-two-years-as-NSE-suffers-IPOs-drought/4259442-4332336-1394vli/index.html/>> on 29 January 2020.

²¹⁸ Oteh A, 'Making capital market work for SMEs in Africa', 5. <https://cmauganda.co.ug/files/downloads/Capital%20Markets%20and%20SMEs%20Blog%20article%202.pdf> on 29 January 2020.

²¹⁹ Lingelbach D C, 'Neither Pirates nor Politicos: The Emergence of Venture Capital in Weak Institutional Environments', Published PhD Thesis, University of Exeter, Exeter, 2009, 152.

²²⁰ Divakaran S, McGinnis P, Schneider S, 'Survey of the Kenyan private equity and venture capital landscape', 19. *See also*, Otuki N, 'Huduma Centres push Kenya up in ease of doing business index', *Business Daily*, 28 October 2015.

²²¹ Lingelbach D C, 'Neither Pirates nor Politicos: The Emergence of Venture Capital in Weak Institutional Environments', Published PhD Thesis, University of Exeter, Exeter, 2009, 152.

²²² Lingelbach D C, 'Neither Pirates nor Politicos: The Emergence of Venture Capital in Weak Institutional Environments', Published PhD Thesis, University of Exeter, Exeter, 2009, 153.

2.5 Ease of doing business in Kenya

Remarkable improvements have been seen in the ease of doing business index.²²³ Kenya has improved in the rankings by 28 positions from being ranked at number 136 in 2014 to 108 in 2015, the start of an impressive climb.²²⁴ Kenya has made advancements because of its push to reform how business and property registration is conducted, making it easier to start businesses in the country.²²⁵ Specifically, the World Bank notes that the launch of *Huduma Centres* which brings together a variety of government services under one 'roof' catalyzed the performance in the Doing Business index.²²⁶ At the moment, Kenya ranks at number 56, with a score of 73.2,²²⁷ this ranking attracts venture capital investment.²²⁸

An aspect that influences the ease of doing business index ranking in Kenya's favour is its enforcement of contracts.²²⁹ It takes 465 days to resolve contractual disputes judicially in Kenya compared to the average of 654.9 days for countries in the Sub-Saharan Africa region.²³⁰ Quality of the judicial processes index in Kenya is at 9 out of 18 comparatively, in Sub-Saharan Africa the average is at 6.9.²³¹

Enforcement of contracts grounded in a stable rule of law environment is vital for the venture capital industry. Investors understand that this factor can affect the operations

²²³Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 19. *See also*, Otuki N, 'Huduma Centres push Kenya up in ease of doing business index', Business Daily, 28 October 2015.

²²⁴ Otuki N, 'Huduma Centers push Kenya up in ease of doing business index', Business Daily, 28 October 2015 -< <https://www.businessdailyafrica.com/news/It-is-easier-to-do-business-in-Kenya-World-Bank/539546-2933230-blmhcx/index.html>> on 29 January 2020.

²²⁵ Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 19.

²²⁶ Otuki N, 'Huduma Centres push Kenya up in ease of doing business index'.

²²⁷ World Bank Group, Doing Business 2020: Economy Profile Kenya, 2020, 4. <https://www.doingbusiness.org/content/dam/doingBusiness/country/k/kenya/KEN.pdf>

²²⁸ Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 19.

²²⁹ World Bank Group, Doing Business 2020: Economy Profile Kenya, 52.

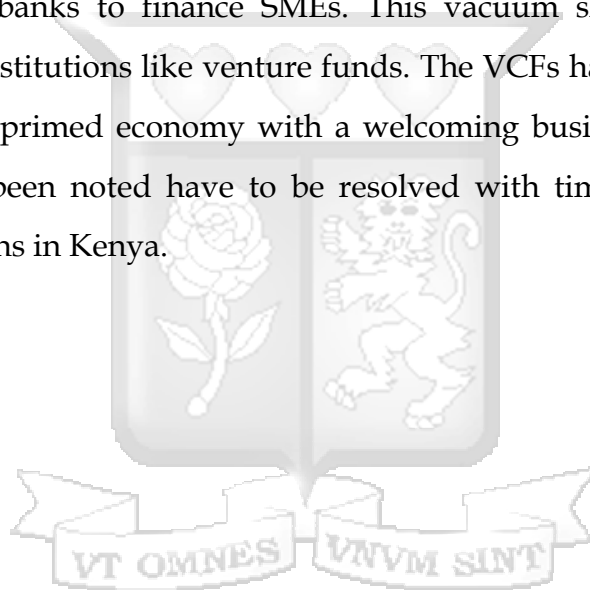
²³⁰ World Bank Group, Doing Business 2020: Economy Profile Kenya, 52.

²³¹ World Bank Group, Doing Business 2020: Economy Profile Kenya, 52.

of a business as a going concern until the point of exit for the venture capitalist.²³² Therefore, venture capitalists will not invest in countries where contracts cannot be enforced and such enforcement takes a lengthy period of time and costly price implications for conflicts to be resolved.²³³

2.6 Conclusion

This overview of venture capital in Kenya offers insight into the potential that the industry has for further growth that would end up being beneficial to SMEs not only in Kenya but also possibly for the wider East African region. There is a vacuum created by the unwillingness of banks to finance SMEs. This vacuum should be occupied by specialized financial institutions like venture funds. The VCFs have the ability to thrive given the benefit of a primed economy with a welcoming business environment. The challenges that have been noted have to be resolved with time in tandem with the growth of VC operations in Kenya.



²³² Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 22.

²³³ Divakaran S, McGinnis P, Schneider S, ' Survey of the Kenyan private equity and venture capital landscape', 22.

CHAPTER THREE

CONTROL IN VENTURE CAPITAL TRANSACTIONS

3.1 Introduction

This chapter seeks to analyse how venture capital works. In doing so, venture capital is explained with the aim of giving further insight into the aspect of control. Control can be deduced from understanding what venture capital is all about. Venture capital contracts have characteristics that differ from other forms of financing available in the financial markets, thus implying negative consequences when confronted with the competition regulatory provisions. The chapter tackles how those connotations arise.

3.2 Fundamental insights of venture capital

Preliminarily, it is important to establish that venture capital has no standard or fixed definition.²³⁴ Features attributed to venture capital provides some clues in understanding venture capital, and in that way a functional definition of venture capital can be coined.²³⁵

The attributes of Venture Capital

Venture capital investment strategy is characterised by attributes such as:²³⁶

A keen interest in new technological industries, products, and techniques characterize VC investment. Because VCs fund small companies having the potential to quickly grow, they look for industries that have large markets and businesses that have some kind of technological advantage over other entities in that same market.²³⁷

²³⁴ Korsmo C R, 'Venture Capital and Preferred Stock' 78(4), *Brooklyn Law Review*, 2013, 1169.

²³⁵ Korsmo C R, 'Venture Capital and Preferred Stock', 1169.

²³⁶ Korsmo C R, 'Venture Capital and Preferred Stock', 1169.

²³⁷ Metrick A, Yasuda A, *Venture capital and the finance of innovation*, 2nd ed, John Wiley & Sons, Inc., Hoboken- New Jersey, 2011, 15. See also, Zider B, 'How Venture Capital Works', Reprint 98611, *Harvard Business Review*, 1989, 133. (Where Zider argues that; venture capitalists invest in good industries, and not

VCs emphasize that there be active and even in some instances controlling participation in the affairs and daily operations of the business entity that they have invested in; they offer technical assistance in the form of corporate governance- they make investments in outstanding entrepreneurs in order to build their capacity to capably run the business inasmuch as they invest in the business plans signifying outstanding future prospects.

VC financing comes in at the early stages of development of a business but crucially, not before intellectual property rights have been secured by the business. These IP rights are inherently valuable for companies in the information technology and health sector industries that are preferred by VCs.²³⁸ Having these IP rights secured offers SMEs an advantage in their quest to acquire VC financing.

Additionally; VC funding is typically offered for a period ranging from one year to a period of about ten years, then the exit follows through the securities markets by offering an IPO or sale of the whole enterprise by way of mergers and acquisitions

VC investments are made where the VCs have assessed the business and have ascertained that they can be of value to the business by offering their technical, financial, and managerial skills and expertise. In modern times, the possibility of financiers providing SMEs with more services than just capital has been examined.²³⁹ The VC industry offers other financiers a glimpse into what that world might look like. VC firms are institutions that 'nurse' companies as opposed to simply financing them.²⁴⁰

It is common practice in the VC industry for VCs to offer financing in rounds, additional capital is injected into the business in various stages. The stages progress from the seed stage to the mezzanine round/stage when successful exit is attainable.

in good people or even good ideas. He calls the notion of VCs investing in good people and good ideas a myth.)

²³⁸ Metrick A, Yasuda A, *Venture capital and the finance of innovation*, 16.

²³⁹ Hellmann T, 'The Allocation of Control Rights in Venture Capital Contracts', 29(1), *The RAND Journal of Economics*, 1989, 57.

²⁴⁰ Hellmann T, 'The Allocation of Control Rights in Venture Capital Contracts', 57.

From these attributes discussed, a definition of venture capital can be deduced. In essence therefore, venture capital can be defined as “equity or equity-linked investments in young, privately held companies, where the investor is a financial intermediary who is typically active as a director, an advisor, or even a manager of the firm.”²⁴¹

3.3 Venture Capital Financing of SMEs

Venture capital at its onset developed because of market factors, there was a demand for high risk, high return investments which is a key feature of venture capital investment.²⁴² Venture capital contracting aligns when profitability is coupled with control mechanisms.²⁴³ Venture capitalists want to invest in businesses that are more likely to create economic incentive for them and also require that they monitor the business to safeguard their investment.

Players in the VC industry principally comprise of; entrepreneurs who start small businesses, venture capitalists and investors who are willing to take the risk involved in VC by placing their investment into a venture capital fund.²⁴⁴ Entrepreneurs after a while face the challenge of capital to expand business operations and therefore seek financing from investor-backed venture capitalists.

Presently, institutional investors as opposed to individual investors, make for a large percentage of the investor base in the VC industry.²⁴⁵ Institutional investors comprise of other financial institutions such as hedge funds, pension funds, and investment banks just to mention a few; these are institutions that have funds and specialize in investment

²⁴¹ Kortum S, Lerner J, ‘Assessing the contribution of venture capital to innovation’, 31(4), *The RAND Journal of Economics*, 2000, 676.

²⁴²Haksoo K, Shin Y H, ‘Venture Capital in Korea- Special Law to Promote Venture Capital Companies’, 461.

²⁴³Haksoo K, Shin Y H, ‘Venture Capital in Korea- Special Law to Promote Venture Capital Companies’, 461.

²⁴⁴ Haksoo K, Shin Y H, ‘Venture Capital in Korea- Special Law to Promote Venture Capital Companies’, 461.

²⁴⁵ Haksoo K, Shin Y H, ‘Venture Capital in Korea- Special Law to Promote Venture Capital Companies’, 462.

of those funds for themselves or for their clientele. Individual investors account for extremely wealthy individuals with funds to spare who would not mind having that money tied up in a venture capital fund for a number of years.

Venture capitalists are able to operate by pooling funds from investors and invest them in businesses carried out by entrepreneurs making the businesses a part of the portfolio managed by venture capitalists.²⁴⁶

Venture capitalists identify young companies (SMEs) and invest funds in them hoping that the value of those SMEs might increase greatly in the future; they earn their profits some years down the line when the business enters the public market through issuing a share offer or other exit strategies when the company is sold for more than the amount that was invested.²⁴⁷

Such description of functions creates similarities between venture capitalists and other professional investors who are experts in identifying, buying and selling equities in the financial markets. ²⁴⁸ However, despite the similarities shared, venture capital distinguishes itself in a manner that makes it more appealing, especially so for SMEs.

Venture capital combines access to financing with active managerial supervision over the SMEs with the aim of achieving gains on the capital invested justifying the high financial risk undertaken by the venture capitalists.²⁴⁹

To further elaborate, once an initial investment is made into a small business, a venture capitalist also stakes their expertise, time, managerial skills and leverages their connections in guiding and nurturing the business into success and profitability.²⁵⁰

²⁴⁶ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 462.

²⁴⁷ Rosenberg D, 'The Two Cycles of Venture Capital', 28(3), *Journal of Corporation Law*, 2003, 419.

²⁴⁸ Rosenberg D, 'The Two Cycles of Venture Capital', 419.

²⁴⁹ Shwartz L W, 'Venture abroad: Developing Countries Need Venture Capital Strategies', 14.

²⁵⁰ Rosenberg D, 'The two cycles of venture capital', 419.

The best VC firms derive their success from accurately profiling and earmarking promising young businesses and from actively inculcating measures that add value in the day-to-day running of those businesses.²⁵¹ In this manner, venture capital is less like a speculation on the future prospects of a company by venture capitalists, and more like active involvement in creating said future prospects that will reflect positively on their bottom line.²⁵² The VCs do so by relying on their talents and connections.²⁵³

It is important to revisit the fact that venture capital is integral to the aspect of job creation in the SME sector.²⁵⁴ This is because early venture investment in SMEs focuses exclusively on businesses that intend to grow rapidly.²⁵⁵ Fast growing companies will have the capacity to hire employees to fit the needs of a growing outfit. According to research,²⁵⁶ many entrepreneurs start small businesses that do not get to a point where they employ more than one employee,²⁵⁷ the self-employed entrepreneur.²⁵⁸ Only a small percentage of SMEs get to a point where they hire more than five employees.²⁵⁹ From such statistics and for contemplation in a different study, questions can be asked as to whether or not creation of new SMEs creates a significant number of jobs for a vibrant economy.²⁶⁰

A major driving force for the job creation element awarded to SMEs is venture capital. SMEs that have a proven rapid growth track as signified by aspects such as the number of employees are fodder for venture capitalists. More employees indicate the demand

²⁵¹ Rosenberg D, 'The two cycles of venture capital', 419 - 420.

²⁵² Rosenberg D, 'The two cycles of venture capital', 420.

²⁵³ Rosenberg D, 'The two cycles of venture capital', 420.

²⁵⁴ Warren D M, 'Venture Capital Investment: Status and Trends', 7(1), *Ohio State Entrepreneurial Business Law Journal*, 2012, 2. Note: the fact that VC is integral in job creation in the SME sector has been extensively deliberated in the first chapter. Its mention in this chapter aims at providing the same perspective from a different angle by offering some nuance.

²⁵⁵ Warren D M, 'Venture Capital Investment: Status and Trends', 2.

²⁵⁶ Warren D M, 'Venture Capital Investment: Status and Trends', 1-2.

²⁵⁷ Warren D M, 'Venture Capital Investment: Status and Trends', 1-2.

²⁵⁸ Warren D M, 'Venture Capital Investment: Status and Trends', 2.

²⁵⁹ Warren D M, 'Venture Capital Investment: Status and Trends', 2.

²⁶⁰ Warren D M, 'Venture Capital Investment: Status and Trends', 2.

for the goods or services that are offered by that business.²⁶¹ This requires the hiring of personnel to provide said goods or services to meet the demand.²⁶² Such a trend encourages VC firms to offer early stage investment to the businesses because VC firms look for company profiles that signify rapid growth to the benefit of both the VC investors and the entrepreneurs. Also, the fact that there is a demand for goods or services offered by a business galvanizes VC investment given that VC firms will anticipate a big market to be penetrated if the business can acquire adequate capital to expand their operations.²⁶³

3.4 How venture capital works

The principle of partnerships applies in venture capital funds in most countries across the globe; VC funds are created as limited partnerships, the investor base forms the passive/silent limited partners while the venture capitalists automatically become the general partners.²⁶⁴ In their function, the limited partners provide funds to be invested in expectation of high returns while the general partners exercise control and management of companies in the venture capital portfolio.²⁶⁵

The venture capital industry relies on reputation,²⁶⁶ as the reputation of a VC fund grows; there is an increase in the demand for their services. Investors increasingly want to pool their resources and back the VCs behind that fund. Notably then, as a result of the increased demand for their services, venture capitalists are able to negotiate partnership agreements that have fewer legally restrictive impositions on their functions.²⁶⁷

²⁶¹Warren D M, 'Venture Capital Investment: Status and Trends', 3.

²⁶²Warren D M, 'Venture Capital Investment: Status and Trends', 3.

²⁶³Warren D M, 'Venture Capital Investment: Status and Trends', 3.

²⁶⁴Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 462.

²⁶⁵ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 462.

²⁶⁶ Rosenberg D, 'The two cycles of venture capital', 420.

²⁶⁷ Rosenberg D, 'The two cycles of venture capital', 420.

The passive partners (investor base backing the VCF) enter into these types of imbalanced agreements because of the profitability involved in turning massive valuations from yet unproven and unprofitable businesses.²⁶⁸

Incidences of conflict that lead to require resolution in this sort of arrangements between the limited/passive partners and general partners (the VCs) are rare.²⁶⁹ There is little motivation for the limited partners to sue their counterparts when they are regularly enjoying good returns on their investment.²⁷⁰ The absence of substantial litigation in the VC industry can also be explained by the fact that both the limited and general partners have developed a working relationship that relies on reputation.²⁷¹ Like businesses that rely on repeat clientele, VC firms operate in a manner designed to encourage their investor partners to invest in future funds.²⁷² The motivation to maintain good working relationships with the general partners is replicated by the limited partners because they hope to be involved in future partnerships.²⁷³ Therefore, they agree to contracts giving their partners the appropriate discretion needed in order to act effectively as managers and advisors of the SME companies they have funded.²⁷⁴

The practice is that, general partners, invest 1% of the capital and yet receive absolute control of the partnership, the rest of the funding comes from limited partners.²⁷⁵ There seems to be an overriding imbalance in play when the capital contribution is considered. It is explained away however by the fact that, the general partners contribute principally through their financial expertise and experience in running VCFs as opposed to monetarily.²⁷⁶ They manage, consult, and monitor extensively the SME

²⁶⁸ Rosenberg D, 'The two cycles of venture capital', 421.

²⁶⁹ Rosenberg D, 'The two cycles of venture capital', 421.

²⁷⁰ Rosenberg D, 'The two cycles of venture capital', 421.

²⁷¹ Rosenberg D, 'The two cycles of venture capital', 421.

²⁷² Rosenberg D, 'The two cycles of venture capital', 421.

²⁷³ Rosenberg D, 'The two cycles of venture capital', 421.

²⁷⁴ Rosenberg D, 'The two cycles of venture capital', 421.

²⁷⁵ Rosenberg D, 'The two cycles of venture capital', 421.

²⁷⁶ Rosenberg D, 'The two cycles of venture capital', 421.

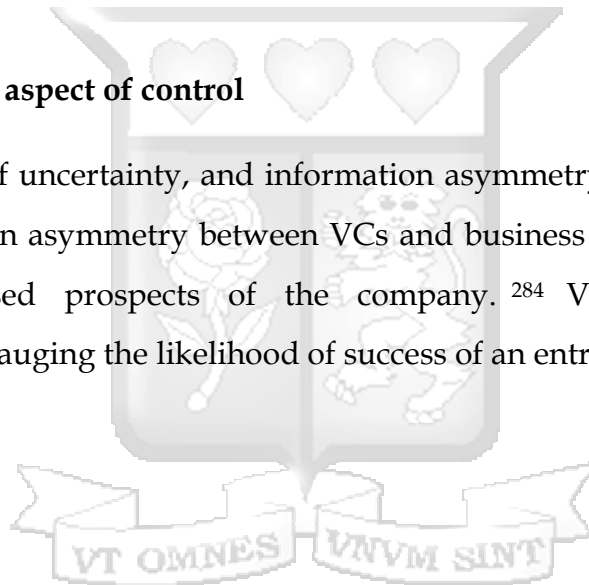
companies' performance to ensure proper use of the funds allocated by the investors through the VC firm.²⁷⁷

Venture capital makes use of unique financial contracts that align their priorities of gaining economic incentive and implementing control.²⁷⁸ These two aspects dictate the relationship between venture capitalists and SME owners.²⁷⁹

The investor base is relegated to a passive role.²⁸⁰ They do not participate in affairs such as the day-to-day management of the venture firm or the SMEs that have received investment.²⁸¹ Venture capitalists exercise control and management of the company in their portfolio.²⁸²

3.5 Understanding the aspect of control

There is a great deal of uncertainty, and information asymmetry between young firms and VCs.²⁸³ Information asymmetry between VCs and business owners has to do with the issue of proposed prospects of the company.²⁸⁴ Venture capitalists are disadvantaged when gauging the likelihood of success of an entrepreneurs' proposal.²⁸⁵



²⁷⁷ Rosenberg D, 'The two cycles of venture capital', 421.

²⁷⁸ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 462.

²⁷⁹ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 462.

²⁸⁰ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 462.

²⁸¹ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 462.

²⁸² Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 462.

²⁸³ Gompers P, Lerner J, 'The Venture Capital Revolution', 15(2) *Journal of Economic Perspectives*, 2001, 154.

²⁸⁴ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 463.

²⁸⁵ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 463.

On the other hand, the entrepreneurs are reluctant to reveal critical information before terms have been agreed and a contract signed.²⁸⁶ Financial contracts are drafted with the specific intent of assisting in satisfying the commercial needs of both parties.²⁸⁷

The challenges that exist for SMEs seeking access to finance have been discussed at length by this point.²⁸⁸ VC funds offer a viable solution that can address the challenge of information gaps.²⁸⁹ The tools VC funds have as remedy is their intensive scrutiny of firms before availing funding and thorough monitoring afterwards.²⁹⁰

VCs monitor using tools such as offering financing in stages over a period of time, taking up seats in the company's board of directors, and offering stock options as part of compensation arrangements for senior staff.²⁹¹

Staged financing is the most potent avenue by which VCs exercise their control over the company.²⁹² The owner of the business is kept in line thus reducing losses from bad managerial decisions. They are held accountable by the VCs and decisions they make or changes they want to implement have to fit in with the business strategy for that stage of financing.

The use of equity as a substantial part of compensation packages for managers and critical staff is used by VCs to exert influence.²⁹³ As a control mechanism, the vesting of stocks to managers and critical staff ensures that they cannot leave the company and take the stocks especially so for inventors.²⁹⁴ This measure gives venture capital investors the confidence they need in the enterprise for the period of time that they will

²⁸⁶ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 463.

²⁸⁷ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 463. Also, see generally Sahlman A W, 'The Structure and Governance of Venture-Capital Organizations', 27, *Journal of Financial Economics*, 1990, 473.

²⁸⁸ Gompers P, Lerner J, 'The Venture Capital Revolution', 154.

²⁸⁹ Gompers P, Lerner J, 'The Venture Capital Revolution', 155.

²⁹⁰ Gompers P, Lerner J, 'The Venture Capital Revolution', 155.

²⁹¹ Gompers P, Lerner J, 'The Venture Capital Revolution', 155.

²⁹² Gompers P, Lerner J, 'The Venture Capital Revolution', 155.

²⁹³ Gompers P, Lerner J, 'The Venture Capital Revolution', 156-157.

²⁹⁴ Gompers P, Lerner J, 'The Venture Capital Revolution', 157.

be a part of the enterprise. It limits a scenario where the key players in the enterprise being funded decide to abandon the venture short-changing the VC investors.

VCs can as well elect to dilute the shares of the entrepreneur when granting subsequent financing as repercussions for the failure by the company to reach its expected targets.²⁹⁵ Each layer of financing offered by VC funds has attached to it milestones to be achieved as a prerequisite for further funding increasing the potency of staged financing as control tool for VCs. Therefore, entrepreneurs will work hard to meet targets in order to keep a sizeable stake of the company stock they worked hard to build.²⁹⁶

It is for the sake of monitoring efforts that VC contracts allow for the retention of complete control of companies by VCs to an extent where VCs can choose to terminate the entrepreneurs.²⁹⁷ The composition of top management raises a lot of contention for VCs and entrepreneurs, VCs find that professional top management would be more valuable to the enterprise because founders can act in their own interest as opposed to the interests of the company.²⁹⁸ Entrepreneurs do not want to leave management because of the attachment that they have developed.²⁹⁹ VCs who have attained complete control of an enterprise may then easily opt to dissolve the business or restructure it in a way that keeps them from incurring further losses in case the business ends up in failure, contrary to their projections.³⁰⁰ Concurrently, the entrepreneurs are usually in dire need of capital therefore making them amenable to relinquishing certain aspects of their control to the VCs in exchange for funding the business.³⁰¹

²⁹⁵ Gompers P, Lerner J, 'The Venture Capital Revolution', 157.

²⁹⁶ Gompers P, Lerner J, 'The Venture Capital Revolution', 157.

²⁹⁷ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 463.

²⁹⁸ Hellmann T, 'The Allocation of Control Rights in Venture Capital Contracts', 57.

²⁹⁹ Hellmann T, 'The Allocation of Control Rights in Venture Capital Contracts', 57.

³⁰⁰ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 463.

³⁰¹ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 463.

Control of the company is returned to the entrepreneurs if the venture is a success and the investors gain hefty investment returns.³⁰² Entrepreneurs are as well greatly incentivized by the handsome returns to work hard on the novel ideas they required funding for.³⁰³ Monitoring by the VCs is done with extra efforts because of the extremely risky nature of this type of investment expecting to gain the promise of high returns if the investment goes as planned.³⁰⁴

VCs do not disburse funds to the businesses being funded in lump sums; the financing is staged where funds are made available in order.³⁰⁵ The first stage, the seed/startup stage a small amount of financing is granted to the inventor/entrepreneur to help them prove the concept or create a prototype.³⁰⁶ Mid stage offers financing to companies for purposes of expansion, the venture capitalists' role now switches from a support function to a strategic role, coming up with workable plans that involve marketing or the creation of an improved product.³⁰⁷

After each round of financing, the VCs will examine the project's success in order to forward further funding.³⁰⁸ The terms of later rounds of financing are negotiated after each stage.³⁰⁹ The bargain is tilted towards the VCs at this point because they can opt to stop funding the business after a stage ends.³¹⁰ VCs use this to bargain for more control

³⁰² Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 464.

³⁰³ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 464.

³⁰⁴ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 464.

³⁰⁵ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 464.

³⁰⁶ Metrick A, Yasuda A, *Venture capital and the finance of innovation*, 15.

³⁰⁷ Metrick A, Yasuda A, *Venture capital and the finance of innovation*, 15.

³⁰⁸ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 464.

³⁰⁹ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 464.

³¹⁰ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 464.

in monitoring the company. The control mechanism is therefore complemented by the staging of the investment.³¹¹

The right to control management of the company offers VCs a reinforced mandate to execute monitoring efforts.³¹² VCs have the ability to choose a majority of the company's directors even when their shareholding in the company is in the minority.³¹³ Their effective control of the board making them able to appoint a new CEO, and other such actions is gotten from a board majority vote and in certain instances it is explicitly contracted before any form of financing relationship is off the ground.³¹⁴

When VCs detect problems with a founding CEO, they engage in a search for a new one and exercise their control over the board to appoint him/her forcing the founder out of management. There is very little recourse for the CEO because VC agreements by their nature give venture capitalists strong control rights and give the entrepreneurs little to no protection.

Further, the company enters into several negative covenants with the VCs in their contracts which end up requiring that the VCs must offer approval before any big business decisions are made.³¹⁵ Failure to keep the covenants results in default. An event of default in financial law contracts carries heavy consequences that entrepreneurs strive to avoid.

As discussed, VCs enter into financial contracts with entrepreneurs to provide capital for a period of time, hopefully achieve profitability before they exit with returns on their investment. Venture capitalists plan their exit strategy before they invest in a

³¹¹ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 464.

³¹² Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 465.

³¹³ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 465.

³¹⁴ Hellmann T, 'The Allocation of Control Rights in Venture Capital Contracts', 58.

³¹⁵ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 465.

company, they need the ability to determine their exit and live up to their short term funding business model.³¹⁶

Venture capitalists get this ability to determine their exit from their control over the board of directors in the company they invest in by having their exit rights explicitly stated in the contracts and/or by ceasing to continue offering the business further funding.³¹⁷

The exit strategy is chosen by the VCs depending on the company's prospects at the point where exit is necessary; be it through a share sell once an initial public offer (IPO) is made or by mode of an acquisition of the company by another.³¹⁸

The rights of VCs in controlling exit should not however be overstated, at the early stages of the VC relationship;³¹⁹ VCs do not have complete control of the board of directors in the portfolio company,³²⁰ that type of control is negotiated after a period of time and gained with additional funding as granted by the VC fund.

3.6 Conclusion

The point to stress is that in venture capital, the aspect of control of the business is vital. Entrepreneurs on their own volition decide to relinquish control of their SME companies to venture capitalists in exchange for capitalization. The VCs then exercise control by engaging in actions best suited for the company based on their expertise; an example being installing professional management in the outfit. These actions are geared towards attaining profitability.

Control is integral in venture capital as a specialized financial instrument because without it, the risks to be borne by the venture capitalists become too great making the entire VC industry a toxic environment for investors. The confidence in VCs' ability to

³¹⁶ Smith D G, 'The exit structure of venture capital', 316.

³¹⁷ Smith D G, 'The exit structure of venture capital', 317.

³¹⁸ Smith D G, 'The exit structure of venture capital', 317.

³¹⁹ Smith D G, 'The exit structure of venture capital', 317.

³²⁰ Smith D G, 'The exit structure of venture capital', 317.

utilize their management and technical expertise to monitor a company in their portfolio allows for the thriving of the VC industry. Entrepreneurs who are unwilling to relinquish certain aspects of control can elect to seek financing from private investors who are passive and have not developed corporate governance expertise.



CHAPTER FOUR

THE CONCEPTUALIZATION OF CONTROL BY THE COMPETITION REGULATORY FRAMEWORK IN KENYA

4.1 Introduction

This chapter undertakes to look at the competition regulation that is provided for in the Kenyan legal system. In doing so, it will focus on regulations that affect venture capital funds and their course to establish a vibrant venture capital industry in Kenya. This chapter looks at the issue of control based on the regulatory framework available in Kenya and shows how that creates ramifications for the venture capital industry.

4.2 Examining the relevant provisions of the Competition Act

The Competition Act, 2010;³²¹ is a law enshrined by the Kenyan parliament with stipulated objectives intended to elevate the welfare of the Kenyan people through the promotion and protection of efficient competition in the Kenyan markets;³²² this is achieved by preventing market conduct that would mislead the public (consumers) and/or create unfairness.³²³

These preventive mechanisms put in place hope to; ³²⁴ spur efficiency in the manufacturing, dissemination and supply of products and services,³²⁵ renew efforts in the attempt to sufficiently protect consumers from bad actors,³²⁶ create a favourable economic environment that would spur investments by both local and foreign actors into the Kenyan market,³²⁷ and promote innovation.³²⁸

³²¹ Act No. 12 of 2010, Laws of Kenya.

³²² Section 3, *The Competition Act* (Act No. 12 of 2010).

³²³ Section 3, *The Competition Act* (Act No. 12 of 2010).

³²⁴ Section 3, *The Competition Act* (Act No. 12 of 2010).

³²⁵ Section 3(a), *The Competition Act* (Act No. 12 of 2010).

³²⁶ Section 3(d), *The Competition Act* (Act No. 12 of 2010).

³²⁷ Section 3(e), *The Competition Act* (Act No. 12 of 2010).

³²⁸ Section 3(b), *The Competition Act* (Act No. 12 of 2010).

Application of the Competition Act goes beyond the bounds of Kenyan territory. The act applies to conduct outside of Kenya if it is engaged in by a citizen or a person residing in Kenya,³²⁹ a corporation duly incorporated in Kenya or simply engaging in business activities in Kenya,³³⁰ and a person outside Kenya acquiring shares or assets that results into a change of control of a business in Kenya.³³¹

The inclusion of these provisions in the law ensures that foreign investors seeking to venture with Kenyan SMEs are subject to adhere to the competition law by virtue of its extra territorial nature. Practices deemed anti- competitive by application of this Act cannot be outside its purview if committed by citizens, legal residents or bodies corporate; whether incorporated under the Companies Act,³³² 2015 or not, and foreigners acquiring a significant amount of shares or assets in a company the result being a change of control in the regular running of the business.

Issues of control and their integral nature in venture capital arrangements have been discussed at length in chapter three of this thesis. From the understanding of how venture capitalists require control rights that are exerted in many ways such as the appointment of CEOs to gaining seats in the directorial board of a company and overseeing the day to day running of a company among others; friction arises when those control rights accrued by a venture capital fund qualify the contracting of venture capital agreements between the VC fund and the SME company to be mergers as per the provisions of the Competition Act. This categorization of VC arrangements as mergers comes with some serious implications that will be addressed.

Mergers

³²⁹ Section 6(a), *The Competition Act* (Act No. 12 of 2010).

³³⁰ Section 6(b), *The Competition Act* (Act No. 12 of 2010).

³³¹ Section 6(d), *The Competition Act* (Act No. 12 of 2010).

³³² *The Companies Act* (Act No. 17 of 2015).

Mergers occur when previously independent entities combine to form one firm.³³³ For purposes of competition, the combination being formal such that the two firms become one or instead, being the purchase of another firm's stock or assets makes no difference when evaluating mergers.³³⁴ Neither does it matter where after merging; the acquired firm becomes a subsidiary with legal personhood and continues to exist.³³⁵ What matters is that, separate businesses with independent motives combine their efforts to form one common ownership arrangement giving the businesses a shared profit motive.³³⁶

When stock is acquired and the result is that one firm gains effective control over another, it is treated as a merger.³³⁷ Even partial stock purchases can be deemed anticompetitive even though they do not give enough control to create a merger.³³⁸ These acquisitions of a non-controlling stake are condemned by competition regimes based on theories that they reduce competition by: giving the purchaser the ability to hold significant influence in the firm and thus can affect the target firm's competitive conduct;³³⁹ giving the acquiring firm confidential material in the target firm that could cause anticompetitive shifts in the market;³⁴⁰ or reduce/eradicate completely the financial motivation for the two firms to carry on competing with each other.³⁴¹

As defined by the Act, mergers refer to acquisition of shares, businesses, or assets of a business that is in Kenya or outside Kenya that leads to a change of control of that

³³³ Elhauge E, Geradin D, *Global Competition Law and Economics*, 913.

³³⁴ Elhauge E, Geradin D, *Global Competition Law and Economics*, 913.

³³⁵ Elhauge E, Geradin D, *Global Competition Law and Economics*, 913.

³³⁶ Elhauge E, Geradin D, *Global Competition Law and Economics*, 913.

³³⁷ Elhauge E, Geradin D, *Global Competition Law and Economics*, 913.

³³⁸ Elhauge E, Geradin D, *Global Competition Law and Economics*, 913.

³³⁹ Elhauge E, Geradin D, *Global Competition Law and Economics*, 913.

³⁴⁰ Elhauge E, Geradin D, *Global Competition Law and Economics*, 913.

³⁴¹ Elhauge E, Geradin D, *Global Competition Law and Economics*, 913.

business, a part of that business or an asset of the business.³⁴² Takeovers are also included under the definition of mergers.³⁴³

Competition regulatory provisions in relation to venture capital

The Competition Act extensively addresses the topic of mergers under part IV of the Act. The legislation further points out that a merger happens when an undertaking directly or indirectly acquires or establishes direct or indirect control over an entire business or part of the business of another undertaking.³⁴⁴ From this characterization, it becomes clear that by default the engagement of venture capital with a business which involves a transfer of the company's shares to a venture capitalist together with the allocation of significant control rights in exchange for capital from the VC fund by an entrepreneur amounts to a merger.

Features of a venture capital contract with a business meet the mandate required to be classified as a merger according to the Competition Act. The first mandate is met when the VC contract requires that the company's shares be transferred into the possession of the VCs who at that point become members of the company holding a keen interest in the affairs of the company to secure their investment.³⁴⁵ The second mandate is met because VC investors as opposed to private equity investors do not take a back seat but actively monitor and exercise control by making decisions that in their expert analysis (a valued distinguishing advantage that venture capital transactions offer) would be beneficial to the company even though the company can be operated independently

³⁴² Section 2, *The Competition Act* (Act No. 12 of 2010).

³⁴³ Section 2, *The Competition Act* (Act No. 12 of 2010).

³⁴⁴ Section 41(1), *The Competition Act* (Act No. 12 of 2010).

Note that, the Competition Act uses the term 'undertaking' all through its discourse. The word 'undertaking' as envisaged by Section 2 of the Act means a business intended to be operated for the purpose of profit making by a person, partners, or a trust having the aim of producing, supplying or distributing goods and or providing services. The act also views trade associations as undertakings.

³⁴⁵ Section 41(2) (a), *The Competition Act* (Act No. 12 of 2010).

without 'interference' from the investors as is usually the case in private equity investments.³⁴⁶

The Act then sets out the parameters of control in an effort to sum up what is viewed by the law as achieving control. Of key relevance to this thesis are the provisions asserting that control is achieved if a person has a majority of the votes or can control the way a majority of those votes can be cast,³⁴⁷ and the other being that a person has control if they have the ability to appoint or veto the appointment made by a majority of directors in the company.³⁴⁸

On the issue of votes, VCs contractually bargain to have the ability to choose the majority of a company's directors even when they have a shareholding in the company that is in the minority,³⁴⁹ it follows that in lieu of having such influence over the company's board of directors, the VCs can determine how votes will be cast and the resolutions/decisions that those votes will lead to.

Based on the fact that they hold effective control over the board means that venture capitalists can by majority vote choose to make appointments to the board or quash any appointments to the board as have been proposed by the other members.³⁵⁰

The Competition Authority (the Authority) is established by the Act as an independent and impartial institution.³⁵¹ The main function of the Authority is to ensure that compliance with the provisions of the Act is enforced.³⁵² In this regard, the Authority provided guidelines to assist in determining how the Authority made their assessment

³⁴⁶ Section 41(2) (a), *The Competition Act* (Act No. 12 of 2010).

³⁴⁷ Section 41(3) (b), *The Competition Act* (Act No. 12 of 2010).

³⁴⁸ Section 41(3) (c), *The Competition Act* (Act No. 12 of 2010).

³⁴⁹ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 465.

³⁵⁰ Haksoo K, Shin Y H, 'Venture Capital in Korea- Special Law to Promote Venture Capital Companies', 465.

³⁵¹ Section 7(2), *The Competition Act* (Act No. 12 of 2010).

³⁵² Section 9(1) (a), *The Competition Act* (Act No. 12 of 2010).

on merger issues and to inform the users on the Authority's jurisdiction in exercising their functions concerning review of merger transactions.³⁵³

Merger guidelines

The guidelines termed as 'Consolidated Guidelines on the Substantive Assessment of Mergers under the Competition Act' are merely regulatory principles applied by the Authority to achieve regulatory best practice, they do not have behind them the force of law.³⁵⁴ The guidelines are not intended to substitute the legal provisions in the Act dealing with mergers.³⁵⁵ The guidelines are to be understood through the lenses of the Act.³⁵⁶ These guidelines were created with the intention of equipping its users both businesses and their legal representation with information pertaining to how the authority carries out its review and analysis on proposed merger transactions in determining approval,³⁵⁷ declination,³⁵⁸ and approval subject to conditions of said mergers.³⁵⁹

The guidelines give light to Section 41(1) of the Act by giving explanation to what is meant when the Act mentions 'direct control', and 'indirect control'.³⁶⁰ Under Section 41(3) some parameters are provided that will lead one to presume that control has been established.³⁶¹ The Authority in creating the guidelines sought to look at other aspects which prove control when making the decision when there is uncertainty from

³⁵³ Njonjo W, Ondimu L, 'Kenya' in *Getting the Deal Through-Merger Control 2018*, Law Business Research, 2017, 246.

³⁵⁴ Competition Authority of Kenya, *Consolidated Guidelines on the Substantive Assessment of Mergers under the Competition Act*, 2018.

³⁵⁵ Competition Authority of Kenya, *Consolidated Guidelines on the Substantive Assessment of Mergers under the Competition Act*, 2018, 2.

³⁵⁶ Competition Authority of Kenya, *Consolidated Guidelines on the Substantive Assessment of Mergers under the Competition Act*, 2018, 2.

³⁵⁷ Section 46(1) (a), *The Competition Act* (Act No. 12 of 2010).

³⁵⁸ Section 46(1) (b), *The Competition Act* (Act No. 12 of 2010).

³⁵⁹ Section 46(1) (c), *The Competition Act* (Act No. 12 of 2010).

³⁶⁰ Competition Authority of Kenya, *Consolidated Guidelines on the Substantive Assessment of Mergers under the Competition Act*, 2018, 7.

³⁶¹ Competition Authority of Kenya, *Consolidated Guidelines on the Substantive Assessment of Mergers under the Competition Act*, 2018, 7.

considering the share ownership in a proposed transaction having share transfers worth more than or less than 50%.³⁶²

Guidelines on direct control

To start with, acquisition of direct control is explained by the guidelines. It is viewed by the Authority that when a transaction can result to a scenario where one party to the proposed merger gains full control over a whole business or a part of it, to an extent that they can exercise complete influence over the undertakings and decision making of the acquired business, such a situation constitutes an acquirer having direct control.³⁶³

The Authority reviews the evidence of the proposed transactions in the form of business documents such as share purchase agreements among other contractual agreements. In reviewing the evidentiary material, the Authority focuses its interest in assessing whether the agreements lead to a situation where one party can exercise control and decisive influence over the running of the business.³⁶⁴

It is specified in the Act under Section 41(3) that control is held if one owns more than 50% of the share capital of the business. The authority goes further in extent of application of this rule by providing that an acquirer of less than 50% of the share capital of a business is presumed to have direct control if that share ownership has attached to it voting rights and decision-making capabilities.³⁶⁵

If evidence that an acquirer of shares has veto rights attached to the share ownership acquired which can allow the acquirer the possibility of vetoing board decisions, directorial appointments to the board and the ability to decide senior management/staff appointments, strategic policies a business has in place, budget or

³⁶² Competition Authority of Kenya, *Consolidated Guidelines on the Substantive Assessment of Mergers under the Competition Act*, 2018, 7.

³⁶³ Competition Authority of Kenya, *Consolidated Guidelines on the Substantive Assessment of Mergers under the Competition Act*, 2018, 7.

³⁶⁴ Competition Authority of Kenya, *Consolidated Guidelines on the Substantive Assessment of Mergers under the Competition Act*, 2018, 7.

³⁶⁵ Competition Authority of Kenya, *Consolidated Guidelines on the Substantive Assessment of Mergers under the Competition Act*, 2018, 7-8.

business plan; then, the Authority will consider such control as exercise of decisive influence.³⁶⁶

Guidelines on indirect control

As to the second aspect; acquisition of indirect control, the Authority under this categorization considers that a transaction proposed might have an acquirer who has diminished control over the target business but still can achieve material influence over the business' affairs thus creating an indirect control, then, the proposed transaction is deemed to constitute an acquisition of indirect control.³⁶⁷

Similarly, commercial agreements are assessed by the Authority to determine if an acquisition qualifies as having the element of indirect control. When the contracts reached by the parties give an acquiring party the ability to exercise material influence over key business decisions of an undertaking, the Authority takes note.³⁶⁸

In doing so, lending contracts as an example of commercial agreements are examined by the Authority. A lending contract which gives the lender the powers to veto strategic business decisions of the acquired business, transfer managerial control to the acquirer, or an agreement that demands that an acquiring business becomes an advisor to the acquired business will face scrutiny from the Authority because it achieves indirect control.³⁶⁹

A minority acquisition; an acquisition of below 20% of the voting shares which are held as passive investment in an undertaking minus any possibility of exercising influence over the affairs of an undertaking shall not be deemed to be acquisitions of indirect

³⁶⁶ Competition Authority of Kenya, *Consolidated Guidelines on the Substantive Assessment of Mergers under the Competition Act*, 2018, 8.

³⁶⁷ Competition Authority of Kenya, *Consolidated Guidelines on the Substantive Assessment of Mergers under the Competition Act*, 2018, 8.

³⁶⁸ Competition Authority of Kenya, *Consolidated Guidelines on the Substantive Assessment of Mergers under the Competition Act*, 2018, 8.

³⁶⁹ Competition Authority of Kenya, *Consolidated Guidelines on the Substantive Assessment of Mergers under the Competition Act*, 2018, 8.

control.³⁷⁰ This explanation by the Authority guidelines sets the tone clear alienating a private equity investment which does not qualify as a merger from venture capital investment.

Venture capital as an investment strategy is captured by these rules given that it has aspects that are attributable to both acquisition of direct and indirect control. Venture capital contracts by their very nature give VCs the powers to exercise control over a business in making key decisions. They have decisive influence granted to them and assented to by the business they are investing in. Naturally, as already discussed in chapter three of this thesis, VCs have veto powers to torpedo board decisions that are not in line with their investment strategy, prevent the appointment of a person to the board of directors and call for the dismissal of a CEO in the company in favour of another appointee of their choosing.

An attribute of indirect control that captures VC arrangements is the ability of VCs to be invested in the strategic decision making of the business they are partnering with. They can veto strategies that based on their expertise will not result in business growth. Their advisory role a consideration that counts as a merit for SMEs that are yet to figure out proper corporate governance and general business management, a strength that the VCs bring to the table makes venture capital transactions qualify as acquisitions of indirect control subject to merger rules under the Act.

Implications of the competition protocols

Transactions deemed to be mergers give rise to implications under the Act. The first implication is that any transaction of any size which based on the statutory standard set out in the Act and complemented by the Consolidated Guidelines has the effect of qualifying as a 'merger' is supposed to be approved of by the Authority.³⁷¹ It is

³⁷⁰ Competition Authority of Kenya, *Consolidated Guidelines on the Substantive Assessment of Mergers under the Competition Act*, 2018, 9.

³⁷¹ Njonjo W, Ondimu L, 'Kenya in Getting the Deal Through-Merger Control 2018', *Law Business Research*, 2017, 246.

stipulated that no party may put into effect a proposed merger unless that merger has been approved by the Authority,³⁷² and performed according to the conditions given upon approval of the merger by the Authority.³⁷³

Merger agreements that are entered into by parties and carried out without authorization from the Authority have no legal effect.³⁷⁴ The parties to such an agreement cannot sue and successfully enforce performance of the contract through recognized legal channels.³⁷⁵

Payment of the full price of purchase by the acquirer is seen as an implementation of the proposed merger transaction.³⁷⁶ However making a down payment; a percentage of the contractual amount does not signify implementation of a merger transaction.³⁷⁷

Contravention of the law that requires all proposed mergers be authorized by the Competition Authority before the parties proceed to implementation raises criminal implications.³⁷⁸ Upon conviction of the offence, the offender can face a jail term of not more than five years or be charged a fine worth no more than ten million shillings or face both punishments.³⁷⁹

In addition to that, the Competition Act was amended to allow the Authority the ability to impose a financial penalty on the businesses involved in the merger transaction; the penalty would make up ten percent of the prior year's gross turnover.³⁸⁰ Such penalties would apply for parties that provide misleading and incorrect information with regards

³⁷² Section 42(2) (a), *The Competition Act* (Act No. 12 of 2010).

³⁷³ Section 42(2) (b), *The Competition Act* (Act No. 12 of 2010).

³⁷⁴ Section 42(3), *The Competition Act* (Act No. 12 of 2010).

³⁷⁵ Section 42(3), *The Competition Act* (Act No. 12 of 2010).

³⁷⁶ Section 42(4), *The Competition Act* (Act No. 12 of 2010).

³⁷⁷ Section 42(4), *The Competition Act* (Act No. 12 of 2010).

³⁷⁸ Section 42(5), *The Competition Act* (Act No. 12 of 2010).

³⁷⁹ Section 42(5), *The Competition Act* (Act No. 12 of 2010).

³⁸⁰ Section 42(6), *The Competition Act* (Act No. 12 of 2010).

to a merger proposal or for parties that failed to comply with any conditions that the authority imposed in order for the merger approval to be granted.³⁸¹

The Authority demands that a notification be made of any proposed merger.³⁸² Each party to the transaction will have to notify the Authority.³⁸³ The notification has to be made in writing as per the prescribed format.³⁸⁴ After initial notification of the proposal to merge is made, the Authority may require within a period of 30 days from date of first notification that one or both parties provide them with additional information.³⁸⁵

In practice, after notification of the Authority is done, the Authority recognizes that the application has been received within three days.³⁸⁶ The authority has a time period of 60 days to consider and review the merger application.³⁸⁷ As pointed out, the Authority could require further information after receiving the merger application.³⁸⁸ Upon receipt of further information the Authority has 60 days to reach a determination.³⁸⁹ The Act grants the Authority powers to conduct a hearing,³⁹⁰ and then make a decision within 30 days after the conclusion of hearing.³⁹¹

Summed up, the process takes about 180 days for the Authority to make a decision on authorization of a merger.³⁹² This time period presents a challenge for sensitive transactions like venture capital arrangements and is undesirable for investors seeking to invest in Kenyan businesses.

This requirements would end up exerting costly, time consuming, and strenuous burden with regard to compliance on both parties in a venture capital arrangement,

³⁸¹ Njonjo W, Ondimu L, 'Kenya in Getting the Deal Through-Merger Control 2018', 249.

³⁸² Section 43(1), *The Competition Act* (Act No. 12 of 2010).

³⁸³ Section 43(1), *The Competition Act* (Act No. 12 of 2010).

³⁸⁴ Section 43(1), *The Competition Act* (Act No. 12 of 2010).

³⁸⁵ Section 43(2), *The Competition Act* (Act No. 12 of 2010).

³⁸⁶ Njonjo W, Ondimu L, 'Kenya in Getting the Deal Through-Merger Control 2018', 247.

³⁸⁷ Section 44(1) (a), *The Competition Act* (Act No. 12 of 2010).

³⁸⁸ Section 43(2), *The Competition Act* (Act No. 12 of 2010).

³⁸⁹ Section 44(1) (b), *The Competition Act* (Act No. 12 of 2010).

³⁹⁰ Section 45(1), *The Competition Act* (Act No. 12 of 2010).

³⁹¹ Section 44(1) (c), *The Competition Act* (Act No. 12 of 2010).

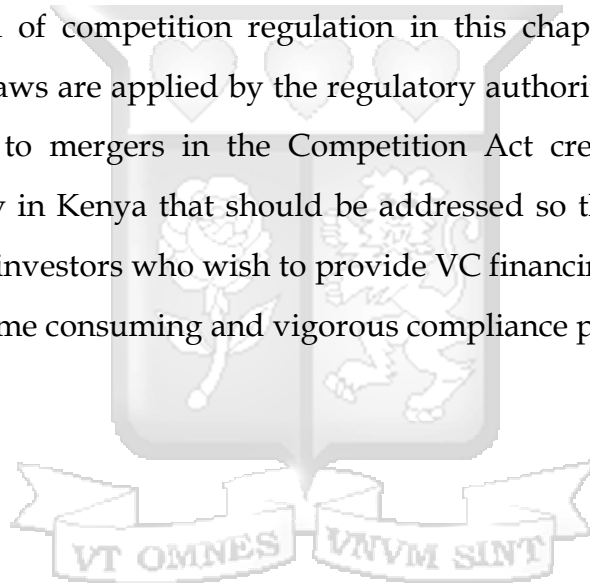
³⁹² Njonjo W, Ondimu L, "Kenya in Getting the Deal Through- Merger Control 2018', 248.

especially so for the SME seeking to gain capital from venture capital financiers, when said requirements need not apply to VC transactions.

4.3 Conclusion

The Competition Act has as one of its objectives the intent of creating an enabling environment conducive for local and foreign investment. This is stipulated under Section 3(e) of the Act. With regards to venture capital investment, it is evident that that aim has not been achieved and instead the possibility for such investment is hindered by the preceding statutory provisions.

From the examination of competition regulation in this chapter and the guidelines indicating how those laws are applied by the regulatory authority, it is evident that the provisions pertaining to mergers in the Competition Act create an impediment to venture capital activity in Kenya that should be addressed so that the Kenyan market can be encouraging to investors who wish to provide VC financing without the strain of unwarranted, costly, time consuming and vigorous compliance procedures.



CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter offers conclusions reached by the study; it also gives answers to the research questions tackled and in doing so confirms the hypothesis proposed by this thesis. Recommendations are made that could aid the development of the venture capital industry in Kenya.

5.2 Summary

This thesis hypothesized that restructuring the legal and regulatory framework governing mergers under the competition laws of Kenya and reviewing the provisions that unreasonably require notification of the regulator followed by a strenuous compliance process so as to make the regulatory landscape more responsive to the peculiarities brought about by VC financing of SMEs is a necessary step towards addressing the challenge of poor capitalization that SMEs face.

At its foundation, this thesis asked questions that were a guiding tool in understanding the hypothesis of the study. The research questions had the objective of helping to gain an understanding of the existing venture capital industry in Kenya; they also sort to give insight into how VC funds operate in financing SMEs; they asked about the legal and regulatory framework for venture capital in Kenya that proves problematic to a vibrant VC presence in the country. The final objective aimed at offering recommendations based on the research that could be implemented to stimulate the growth of the Kenyan VC industry.

The methodology adopted for this research heavily relied on the analysis of primary, secondary and tertiary sources of information. The sources of knowledge drawn from

include newspapers, reports, textbooks, philosophical treatises, journal articles and statutes.

The thesis is partitioned into five chapters. The first chapter lays the framework for the study as a whole, contextualizing the research problem.

The chapter also offers a background for the thesis; setting the parameters for the three aspects of the study: VC, SMEs, and competition; a statement of the problem, the study's hypothesis and research questions, literature review, justification of the study, a theoretical framework and the methodology used in conducting the study, limitations and assumptions in the research, and a chapter breakdown.

Chapter two purposed to give an overview of venture capital in Kenya; discussing its development and putting into context some of the challenges faced by VC funds and how the government has attempted to ameliorate said problems to attract investment into the Kenyan economy.

The third chapter drills down on the question of control in venture capital agreements between VCs and enterprises exposing the tension points that clash with Kenyan laws and regulations. The chapter briefly gives insight into the development of venture capital to further illustrate how venture capital works.

Chapter four exposes competition regulations that are antagonistic to the nature in which venture capital finances SMEs. The matter of 'control' as envisioned by Kenyan laws is expounded upon revealing tension that arises with VC involvement

5.3 Conclusion

This chapter finds that the competition laws on mergers and the regulatory frameworks that have been set up to aid in the interpretation of the Competition Act creates a less inviting environment for the development of VC in Kenya. In order to create a sustainable VC environment in Kenya, good policies and effective measures have to be adopted by regulators and legislators in their respective capacities to alleviate the

challenges that VC funds and SMEs under the current competition regulation may encounter. Alleviation of these challenges is likely to encourage growth of the VC sector and consequently the SME sector which in turn boosts the national economy.

As discussed in chapter two, Kenya has great potential to establish herself as a hub for a booming venture capital industry benefitting SMEs in the East African region. This is because the country offers the advantage of being a big economy in the region with a welcoming business environment for foreign investment.

The challenges that face the VC industry are not catastrophic to the industry prospects; they can be resolved.

The first challenge that arises is that preliminarily, there is no overarching legislative statute providing parameters for a venture capital industry. Closely linked to the first challenge is the fact that in Kenya, regulation for VC activity is dispersed and can be found under different regulatory ambits each with strenuous, repetitive and expensive compliance procedures that have to be met by VC funds and enterprises seeking VC financing.

The other challenge revolves around the crucial matter of exit for venture capital firms. The preferred exit option through the stock markets is not a viable option in Kenya as things currently stand.

The competition laws in Kenya define 'control' in a manner that raises a challenge for venture capitalists. For VCs, control is an essential aspect of their business model, as pointed out in chapter three. This control is relinquished voluntarily by entrepreneurs who receive necessary financing for their businesses. With control that can be exercised in different ways; VCs take actions that are intended to benefit the company and make it profitable by relying on their expertise and business experience.

This take on the importance of control for VCs coupled with the legal provisions governing control as provided for by the Competition Act and regulatory guidelines

covered extensively in chapter four leads to the primary conclusion that to enhance development of the venture capital industry in Kenya, a precondition necessary to sustaining a flourishing SME sector, the legal provisions under the Competition Act on mergers have to be restructured and fashioned in a manner that is amenable to VC funds.

5.4 Recommendations

In planning for the future, Kenya has to maintain relevance and competitiveness in the global economy. The current legal and regulatory environment for VC funds is not conducive for a thriving investment environment. Specific policy and regulatory frameworks have to be re-examined to encourage VC investment. These recommendations could help policy makers, legislators and regulators ensure the development of the Kenyan VC sector.

It would be a step in the right direction for policy formulators and legislators to create a special law governing venture capital operations in Kenya. This law would oversee the aspects of registration, taxation and regulation of venture capital firms under a single institution/authority that would act as the main regulator. This law should be made after careful consideration and conducting a serious consultation process with key experts who have a thorough understanding of venture capital financing and its legal implications.

Having a single regulatory regime as proposed through the institution of a special VC law would cure the secondary challenge of having a dispersed regulatory regime as it currently exists leading to strenuous compliance requirements. Understandably, the process of law making is rigorous and takes time, as it should; therefore, making a special law for VCs could take a considerable amount of time. In the meantime however, the compliance process for VC firms should be streamlined and simplified at the inter-agency level.

Spearheaded by the Capital Markets Authority which holds regulatory oversight over venture capital in Kenya, the streamlining and simplification process should be embarked upon bringing to the table the various regulators involved in venture capital activity such as the offices of the registrar for income tax and companies, together with the Competition Authority of Kenya.

In doing so, these regulators can agree by signing a memorandum of understanding clearly stipulating their roles in relation to venture capital. They can limit their requirements for registration of VC firms and the compliance protocols they demand. This helps to avoid a lot of the repetition that is found in the venture capital laws offered by the different legal provisions.

Such a measure has the effect of reducing the expense involved and the time factor encountered when going through compliance procedures with more than one regulator.

Another recommendation would be on the issue of exit options for venture capital firms. This matter is of interest to this study however it deserves more nuanced discussion in a different forum. In Kenya and Africa at large, the capital market exchanges are under developed and highly illiquid. This fact creates a challenge for venture capital investors as they consider ways to recoup their investment in successful enterprises.

Building a thriving capital market is not an endeavour that could be carried out overnight even with necessary extra incentives. Capital markets all over the world have strict listing requirements that bar entry of SMEs. It is for this reason that stock exchanges have created second tier stock exchange markets with relaxed listing requirements that can offer a possible exit avenue for venture capitalists.

The United Kingdom under the London Stock Exchange has Alternative Investment Market (AIM), South Africa has a second tier capital market under the Johannesburg Stock Exchange dubbed AltX (The Johannesburg Alternative Exchange). Similarly, in Kenya, GEMS (Growth Emerging Market Segment) was instituted in 2013 to enable Kenyan SMEs access financing through the capital markets. Venture capitalists can

utilize GEMS when considering exit options if the market is strengthened and becomes liquid. Awareness campaigns informing the stakeholders of the usefulness of GEMS will aid in building its capacity and strengthening the market a goal that can be accomplished over a considerably short period of time.

Of utmost importance to this thesis, having the Competition Authority reassess their policy on the crucial issue of control would go a long way in enabling venture capital activity in Kenya. Arguably, the Authority could limit the application of the merger directives on control as stipulated by the Competition Act by issuing a temporary block exemption for venture capital and SME transactions.

Having this differentiation will recognize the fundamental distinctness between venture capital contracting to aid in SME financing and mergers as understood in common parlance; that is not the case in the current regulatory regime.

The exemption of venture capital transactions in merger control measures included in the Competition Act would have the effect of discarding the mandatory notification required from both the venture capital fund and the SME seeking to access funding. In addition, any sanctions pursuant to part IV of the Competition Act would be rendered inapplicable.

The exemption would have to be instituted as a stopgap measure pending the passing of a special VC law which would have a more refined understanding of venture capital operations and its legal connotations.

This measures if adopted will benefit SMEs and ensure that they have a viable option in venture capital financing to mitigate the issue of access to capital which has impeded them from realizing their full potential for many years.

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