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ISLAMIC VENTURE CAPITAL IN MALAYSIA: THE INDUSTRY'S LEGAL FRAMEWORK

The origin of the Venture Capital operation and practice are believed to have been derived from the Islamic world, using the concept of mudharabah by the Arab traders. This concept was then formalized by Muslim jurists and embodied in Islamic law, known as Islamic transactions or fiqh muamalat. The mudharabah concept then developed and spread to other parts of the world as Islam spread. This was obvious in the Ottoman State, where there were manufacturing and trading of fabrics, production of pillows and shoes that were funded in the form of venture capital (Cizacka, 1996). It then spread to Italy and other parts of Europe in the 15th century (Cizacka, 1995). The practice of Venture Capital (VC) using the concept of mudharabah had tremendously increased the number of entrepreneurs in Europe at that time.

Islamic Venture Capital (Islamic VC) is generally structured based on the concept of risk-sharing. Mudharabah and musharakah are deemed as the most common form of Islamic VC. This is because of the following reasons as listed by Cizacka (2011):

1. VC is identical to mudharabah, and the practice is part of the Prophet's sunnah.
2. Unlike a loan or a credit transaction, there is neither interest nor collateral in a venture capital transaction. Finance is simply provided in return for shares. This is equity finance.
3. Since the entire system is based upon equity finance, there are no loans and where there is no loan, there is definitely no riba. If a third-party guarantee is provided in order to encourage the public, only the principal is guaranteed by the state.
4. VC is a profit-and-loss sharing system. Profit-and-loss sharing takes place in accordance with Islamic rules. Profit in a venture capital company is shared according to mutual agreement. This mutual agreement is expressed in the amount of shares the VC company obtains from the entrepreneur. Loss goes entirely to the venture capitalist financier. This is without any doubt mudharabah.
5. A VC company is established just like a classical Islamic shirkat, that is, as a partnership for limited duration, usually ten years.
6. Risks are truly shared and the venture capitalist does not demand collateral from the entrepreneur.

There are a number of models that can be used for an Islamic VC, such as mudharabah, the different forms of contractual musharakah, and hybrid forms of these contracts, like the Two-Tier Mudharabah Model (TTMM) or musharakah mutanaqisah (diminishing partnership) (Iqbal and Molyneux, 2005). The table below presents the different models that can be used for venture capital financing and their compliance in terms of Shariah.

Table 1: Shariah View of Some Key Practices in Venture Capital Financing

Conventional Venture Capital Practice	Islamic View
Limited partnership structure	Acceptable
Long term contracts	Acceptable
Contracts can be nullified	Acceptable
Restrictions placed on the activities of fund managers	Acceptable
Equity ratchets to entrepreneurs	Acceptable
(Investments in equity, fully convertible bonds (zero coupon	Acceptable
Preferred stocks, preference shares or convertible debt	Not Acceptable
Greater control rights through restrictive covenants	Acceptable
Board seat	Acceptable
Staged financing	Acceptable
(Replacement of management (CEO	Acceptable
Liquidation rights	Acceptable
(.Provision of non-financial services (strategic advice etc	Acceptable
Application of discount rate for valuation	Acceptable

Source: Ahmed, H. (2004.)

To support business ventures through venture capital, the government of Malaysia introduced a set of guidelines governed by the Capital Market Services Act 2007 (CMSA) whereby according to section 58(1) of the CMSA states that no person shall carry on a business in any regulated activity or hold himself out as carrying on such business unless he is the holder of a Capital Market Services Licence or is a registered person. Under this Act, it further states that under section 76 (1) (a), a person is a registered person if a person is specified to be registered in Schedule 4.

Under Item 1 Part 2, Schedule 4 of the CMSA mentions that a venture capital company is one of the categories of registered persons whereby any venture capital corporation and venture capital management corporation must be registered under the Commission's Guidelines for the Registration of Venture Capital Corporations and Venture Capital Management Corporations.

The Guidelines for the Registration of Venture Capital Corporations and Venture Capital Management Corporations (Registration Guidelines) take effect on 1 August 2008. The initiation of these guidelines is in inline with the Securities Commission's efforts to ease the growth of the venture capital industry to effectively satisfy the funding needs of emerging high-growth companies in value-added industries through the preparation of risk capital, as stated in the Capital Market Master plan (CMP). To ensure an efficient implementation process, the Securities Commission has taken into consideration all the comments, opinions and recommendations made by the Malaysian Venture Capital Association (MVCA), practitioners and professionals within the field of venture capital industry.

In addition, this guideline sets criteria for registration whereby under clause 4(A) minimum financial requirements are specified for the registration of Islamic VCC and Islamic VCMC. It stipulates that the applicant shall maintain minimum shareholders' funds of RM 100, 000 and shall immediately inform the Securities Commission of any failure to comply with this requirement. Once the applicant had been registered with the Securities Commission, the applicant shall be designated as a VCC or VCMC subjects to the structure and activities of the applicant as mentions under clause 7.1 of this guideline.

Besides that, on May 2008, Securities Commission (SC) issued the Guidelines and Best Practices on Islamic Venture Capital with the objective to insert Shariah principles such as mudharabah, musharakah and wakalah in carrying out Islamic venture capital business activities. Under this guideline, there are two core requirements to be complied for the establishment of an Islamic VCC or VCMC. First requirement is an independent Shariah adviser must be appointed to provide expertise and guidance on conformance to the Shariah principles in all matters relating to Islamic VCC or VCMC. Second requirement is that all the activities of the venture companies must be Shariah compliant, the non-permiteed Sharia activities that stipulates under clause 3.0 are include (i) financial services based on riba (interest); (ii) gambling/gaming; (iii) manufacture or sale of non-halal products or related products; (iv) entertainment activities that are non-permissible according to Shariah; (v) manufacture or sale of tobacco-based products or related products; (vi) stockbroking or share trading in Shariah non-compliant securities; and lastly (vii) hotels and resorts. It is important to note that in assessing the activities for Islamic venture capital, the Shariah adviser may apply ijtihad for other activities that may be deemed non permissible.

Thus, a strong legal framework system is necessary for Islamic venture capital to play its role in improving and uplifting the economy of the Muslim nation particularly. Islamic venture capital is believed to promote equitable distribution of income and wealth, which is in accordance to the principles of Islam. An excessive gap in income and wealth in a society will lead to the degradation of those who are extremely poor (Chapra, 2008). The Quran and hadith have mentioned equal distribution of wealth amongst the societies.

مَّا أَفَاء اللَّهُ عَلَى رَسُولِهِ مِنْ أَهْلِ الْقُرَى فَلِلَّهِ وَلِلرَّسُولِ وَلِذِي الْقُرْبَى وَالْيَتَامَى وَالْمَسَاكِينِ وَابْنِ السَّبِيلِ كَيْ لَا يَكُونَ دُولَةً بَيْنَ الْأَغْنِيَاء مِنكُمْ

"Whatsoever spoils Allah gave to His Messenger from the people of the cities is for Allah and His Messenger andfor the near relation, and orphans and the needy and the wayfarer, so that it be not the wealth of your rich..."

(Al-Hasyr:7)

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