VENTURE CAPITAL IN MALAYSIA VIS-A-VIS ISLAMIC VENTURE CAPITAL

BY

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ABSTRACT

This study examines and analyses venture capital as a whole in an attempt to critically unveil the situation in Malaysia with special reference to Islamic modes of venture capital. It discusses the feasibility of such Islamic modes of venture capital especially in Malaysian context. It also focuses on the brief outline of the whole venture capital industry domestically, if not globally.

The method used for this study is comparative, critical and analytical. It is comparative for it compares the western mode of venture capital with an Islamic mode of equity financing. Yet, it is critical in that it studies the shortcomings in current practice in Malaysia and thus suggests the proposed reforms to give way to true Islamic modes of venture capital. On the other hand, it is analytical because it also highlights the relevant laws and practices in other countries which are relevant to it.

Venture capital is still very much at its infancy in Malaysia or even the global financial system. However, a thorough study of Islamic law of transactions (Mu'amalat) will prove that venture capital is not an alien to Islamic trade and financing. The issue remains as to its feasibility in contemporary banking and financial system. Indeed, Shari'ah, being the revelation of Allah Almighty, is relevant for all generations at all times and places. Thus, Islamic modes of venture capital are feasible, relevant, and, indeed, are better and fairer options provided that certain reforms being done to the current legislation and practices.

In view of the rapid progress of Islamic financial system both at domestic and global levels, the advent of Islamic modes of venture capital, which are contemporary and yet 'halal' (permissible), is but an exigency.

ملخص الرسالة

تهـــدف هذه الرسالة إلى بحث وتحليل "مضاربة رأس المال" بصورة إجمالية في محاولة نقدية لكشف النقاب عن الوضـــع في ماليزيا مع إشارة خاصة لأساليب هذا النوع من التمويل" في الإسلام. تناقش هذه الدراسة مدى فعالية أو جدوى العمل ب "مضاربة رأس المال" في البيئة الماليزية على وجه الخصوص. وتركز أيضاً على الإطار الموجز للتمويل لموضوع الدراسة محلياً إن لم يكن عالمياً

المـــنهج المتبع في هذه الدراسة هو منهج المقارنة والنقد والتحليل. فهو منهج مقارنة لكونه يقارن بين الأسلوب الغربي في الاستثمار المالي وبين الأسلوب الإسلامي في التمويل العادل والمنصف. وهو أيضاً منهج نقدي لكونه يُعـــنى بدراســـة أوجه النقض والتقصير من الناحية العلمية في الوقت الراهن في ماليزيا. ومن ثمّ يطرح بعض الاصـــطلاحات المقـــترحة التي تمهد الطريق للعمل بالأساليب الإسلامية للتمويل المذكور آنفاً. وهو من جهة أخـــرى منهج تحليلي لأنه يلقي الضوء على القوانين ذات الصلة بالموضوع وتطبيقاتها في دول أخرى لها علاقة بموضوع البحث.

إن مشـــاريع مضـــاربة راس المال ما زال في مهده في ماليزيا أو حتى في مؤسسات النظام المالي الدولي. إلاّ أن دراســـة متأنية لنظام المعاملات في الإسلام تثبت وتبرهن أن هذا النوع من التمويل ليس دخيلاً أو غريبا على النظام التجاري والمالي في الإسلام. ولكن تظل الإشكالية حول مدى جدوى العمل بهذا النوع من الاستثمار داخل المؤسسات البنكية والمالية العصرية. لا شك أن الشريعة الإسلامية كونها وحي إلهي صالحة لكل الأجيال في كـــل زمـــان ومكان. لذلك فإن الأساليب الإسلامية فيما يتعلق ب."تمويل رأس المال" ذات جدوى، ولها علاقـــة مباشـــرة مـــن الناحية العملية، وهي بالطبع أفضل وأعدل الخيارات المطروحة آخذين بعين الاعتبار الإصلاحات التي أدخلت في النظام التشريعي والتطبيقي الحالي.

وعـــلى ضـــوء التقدم الملحوظ في النظام المالي الإسلامي على المستويين المحلي والعالمي، فإن طرح الأساليب الإسلامية ل "التمويل.بمضاربة رأس المال" تدل على أنها أساليب عصرية ومشروعة في نفس الوقت، فهي بذلك ضرورة ملحة يقتضي العمل بها.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a thesis for the degree of Master of Comparative Laws.

Mohd Daud Bakar
Supervisor

I certify that I have read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a thesis for the degree of Master of Comparative Laws.

Norhashimah Mohd Yasin
Examiner

This thesis was submitted to the Ahmad Ibrahim Kulliyyah of Laws and is accepted as partial fulfilment of the requirement for the degree of Master of Comparative Laws.

Nik Ahmad Kamal Nik Mahmod
Dean,
Ahmad Ibrahim Kulliyyah of Laws

DECLARATION

I hereby declare that this thesis is the result of my investigations, except where otherwise stated. Other sources are acknowledged by footnotes giving explicit references and a bibliography is appended.

Name : John Lee Kien How

Signature : Date : 22/7/2002

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DECLARATION OF COPYRIGHT AND AFFIRMATION OF FAIR USE OF UNPUBLISHED RESEARCH

Venture Capital in Malaysia vis-à-vis Islamic Venture Capital

Affirmed by John Lee Kien How

Signature

22/7/2002
Date

I would like to dedicate this work to the Muslim Ummah at large and those who have been, and who will be, restlessly involving in the implementation of a full-fledged Islamic economy and financial system in Malaysia. Verily, the struggle is but a never-ending contribution to the Ummah.

"Have We not Opened your breast for you? And removed from you your burden which weighed down your back? And have We not raised high your fame? Verily, along with ever hardship is relief. Verily along with every hardship is relief. So when you have finished, devote yourself for Allah's worship. And to your Lord turn all intentions and hopes."

Surah ash-Sharh (The Opening Forth), 94:1-8

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As much as my wish to render my small contribution to the implementation of Islamic financial system, this work would not be possible without extreme guidance of my respectful yet beloved supervisor, Assoc. Prof. Dr. Mohd Daud Bakar. Despite his busy schedule and commitment, he has generously agreed to supervise and assist me in whatever ways he could. Verily, it is his persistence to have a piece of literature on venture capital that makes this work a completion. May Allah reward him all his deeds.

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Lastly, I wish to thank my friends and family for their moral and spiritual support in my struggling for the path and light of truth. This especially goes to Tan Sri Syed Agil, Hj Mansor, Dr. Azmi, Utz Hamidon and many others.

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CHAPTER 1

INTRODUCTION

The cheque of $200,000 that George Doriot of American Research and Development (ARD) handed to Denis Robinson, President of High Voltage Engineering (HVE) on the last day of December 1946, has marked the emergence of the first United States formal venture capital fund. The money is actually the first investment of the modern venture capital industry[1]. However, it is said that venture capitalism is not new, and there are historical precedents in many Member countries of the Organisation for Economic Co-Operation and Development (OECD), such as the Hansa League, the English Merchant Venturers and in the Italian City States. These instances testify that a few very rich individuals were willing to risk a part of their wealth for the prospect of considerable financial rewards.[2]

Meanwhile, the development in the global economic at large in the recent years has witnessed a change in the mode of financing especially for the small and medium business. The old-time preferred debt financing is no more the most preferable mode of financing but rather, the trend is now to the fairer and more balance mode of equity financing. The past few decades have seen the acute development of venture capital as one of the most popular modes of equity financing especially among the young ambitious group. In United Kingdom ("U.K.") alone, in the year 1995, over £2.5 billion was invested in total in venture capital, with £2,140 million invested across

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[1] Bygrave William D., *Venture Capital Investing: A Resource Exchange Perspective*, Boston University, 1989, p.1.

1,030 U.K. companies.[3] The rapid growth, in U.K., can be seen by comparing the number of venture funds available now with those in existence more than 20 years ago. At present, there are more than 100 venture funds while in 1975 only 12 venture fund management groups were in existence.[4]

Verily, every small business needs venture capital. It permits a small business to grow and prosper.[5] Be it for the Mature Small Firms (MSFs) for the UK context or Small Medium Industries (SMIs) in Malaysian context, it has been said that a commonly cited reason for the prevention of the maintaining of their growth trajectoies, is a shortage of financial capital.[6] In such situation, debt financing is no longer a good option for higher gearing increases exposure to risk, and may create vulnerability to debt-servicing crises. Also, in practice, advancement of debt from financial institutions is always coupled with the consideration of collateral securities which is almost impossible for new and up-coming entrepreneurs and specifically, start-up companies. The best solution thus comes in the form of 'business angels' or Venture Capital investors who provides "an opportunity for 'gain through growth potential', contingent on acquiring finance to permit new investment."[7]

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[2] *Venture Capital: Context, Development and Policies*, Organisation for Economic Co-Operation and Development (OECD), Paris, 1986, p. 17.

[3] Daryl J Cooke, *Venture Capital: Law and Practice*, F T Law & Tax, London, 1996, p.1

[4] *Ibid.*

[5] David Gladstone, *Venture Capital Handbook*, Prentice Hall Englewood Cliffs, New Jersey, 1988, p.1.

[6] See Mason C.M. and Harrison R.T., The Small Firm Equity Gap Since Bolton. Ins. *Bolton Twenty Years On: The Small Firm in the 1990s*, Paul Chapman, London, 1991.

[7] Reid, G.C., Background. Ins. Reid, G.C. (edit.). *Venture Capital Investment: An Agency Analysis of Practice*, Routledge, London and New York, 1998, p. 6.

Venture capital has been seen as a crucial ingredient in the economic development of high technology industries or new economics such as computers, semiconductors, electronics, and genetic engineering.[8] As commented by Jiro Tokuyama, Dean of the Noruma School of Advanced Management in Japan and a highly influential economist: "The entrepreneurial firms and the venture capital are the great advantages you [American] have."[9] Indeed, over one-third of the United States' largest venture capital companies have an office located in or near ' Silicon Valley' which is said to be the prime centre of venture capital activity in the nation.[10] It is said that venture capital goes hand-in-hand with entrepreneurship and one cannot understand a hi-tech centre like 'Silicon Valley' without understanding how venture capitalists operate.[11]

In the United Kingdom, a further reason for the growth in the venture capital market is said because of the emergence of management buy-outs (MBOs), which prior to a change of legislation in the United Kingdom's Companies Act 1981 had been difficult to structure in a commercially acceptable way. The Companies Act allows banks and institutions, for the first time, to take security on an acquired company's assets to facilitate the purchase of the company. Clearly, for a lender to inject significant sums of debt into a transaction security is of paramount importance. However, before 1981, the only security which could be offered was for a lender to

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[8] Bygrave William D., *Venture Capital Investing: A Resource Exchange Perspective*, p.4.

[9] Gevirtz Don., *The New Entrepreneurs: Innovation in American Business*, Penguin Books, New York, 1985.

[10] Chia, R. & Wong, K.C. , *Venture Capital in the Asia Pacific Region: with Special Reference to Singapore*, Toppan Co. (S) Pte Ltd, Singapore, 1989, p.1.

[11] *ibid*

take a charge on the assets of the target company. This would have been prevented by the financial assistance provisions contained in the Companies Acts.[12]

The MBO market fuelled a whole new wealth creating opportunity for senior employees to become owner-managers. In the enterprise culture of the 1980s, the venture capital funds quickly realised that by locking into safe and established businesses, significant returns could be made on realisation of investments, on trade sale or flotation, some 5 to 7 years further down the line. In many ways, the MBO marketplace provided to be the catalyst for venture capital funds breaking out into a number of wide ranging products from early phase investments through to providing development capital for established businesses. As a bi-product of the MBO, the management buy-in (MBI) was born, which enabled talented entrepreneurs to find suitable target companies and to then purchase those businesses assisted by venture capital backing.[13] As will be discussed later (Chapter 2), this draws a doubt whether the concentration on these two products amounting to the actual development of venture capital.

Meanwhile, the Malaysian government has launched Multimedia Super Corridor ("MSC") which is said to be a better alternative to the US's Sillicon Valley for it provides the opportunity to penetrate Asian market vide leading-edge multimedia technologies and applications and thus, providing a low cost, central and influential

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[12] Daryl J Cooke, *Venture Capital: Law and Practice*, p.4

[13] *Ibid.*

base in Asia.[14] The MSC actually offers a perfect environment for companies wanting to create, distribute, and employ multimedia products and services.[15] In line with that, a venture capital fund, the MSC Venture One fund, was established in June 1999 to provide venture capital financing to innovative and emerging information technology and multimedia companies at the start-up, growth and pre-IPO stages.[16] As of end of March 2000, the RM120 million MSC Venture One Fund has announced its first investment amounting to RM3 million and made commitments in three more companies which are expected to be announced soon.[17]

In the realization of this aim and target, it is inevitable that the country's venture capital industry, in years to come, will experience a rapid growth as experienced in the U.K., U.S., and to the least, Singapore. This dissertation will discuss in brief the conventional venture capital vis-a vis the Islamic mode of venture capital. Indeed, it is with the aim of finding new, alternative yet the best modes of venture capital which are Sharīᶜah based as well as the feasibility of them in mind that this dissertation is written.

Indeed, recently, venture capital has been a demanding source of corporate financing. This is especially proven by the Cinderella stories of few successful information

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[14] Sivagurunathan, Multimedia Super Corridor, a seminar paper delivered at the *Conference on Venture Capital – An alternative Source of Funding*, Consembition Jaya Sdn. Bhd., Parkroyal Hotel, Kuala Lumpur, on 19th and 20th May, 1997, pp. 7.

[15] Sivagurunathan, Multimedia Super Coridor, p. 1.

[16] Zeti Akhtar Aziz, Deputy Govenor Bank Negara Malaysia (as she then was), Venture Capital Investment: Outlook & Trends; Venture Capital—Financing The New Economy, a seminar paper delivered at the *Venture Capital Europe-Asia 2000 Conference*, European Business Information Centre, University Technology Malaysia and International Business School, Putra World Trade Centre, Kuala Lumpur, on 28th – 30th March, 2000, p. 9.

[17] *Ibid.*

technology or dot com companies like, Amazon.Com etc. Hence, interesting queries arise as to the possibility of its permissibility under Sharīʿah and the feasibility of such Islamic version together with its limitations or even advantages comparing to the conventional way of venture capital. If such venture capital is permissible in Islam, what then will be the difficulties of the implementation of it in view of the current common law legislation as well as those of other jurisdictions? This dissertation, thus, aims to provide an insight and zooming into the fundamental Islamic banking products to seek a definite answer before answering others queries.

In brief, this dissertation will attempt to provide answers to these queries firstly by proving that not only is such funding permissible in Islam but also that, indeed, it has already in existence in the history of Islamic transactions (Mu'amalat) long before the conventional system. It will then discuss further the pillars and conditions of a few related Mu'amalat transactions. Also, this dissertation will look at the current limitations (especially related legislation, both locally and abroad) for the implementation of such Islamic venture capital financing and suggested reforms. Besides, this dissertation will also try to adopt this equity financing into other currently available Islamic banking products in Malaysia to overcome some of the controversial issues surrounding them.

This dissertation will concentrate more on the various modes of equity financing under the Sharīʿah. These include their basic definitions, pillars and conditions, the usual practices, the trend so far and related legislation. However, it will not discuss the conventional venture capital in deep although from time to time, comparative studies will be made between it and the Islamic equity financing. Nor will it discuss the problems related with the conventional Venture Capital in full. Also, it could only discuss the opinions related to the four Sunni schools. As most of the performing capital venture corporations are situated in the United States, it is unfortunate that most of the information and material on conventional capital venture will be obtained via secondary sources i.e. published materials or even Internet.

This dissertation will first discuss the conventional venture capital (Chapter 2) and then introduce various Islamic counter-part available contracts (Chapter 3). The feasibility of an Islamic venture capital would not be possible should there be any obstacle in the legislation. Hence, this writing will then look at the current legislation available for the conventional venture capital before analyzing their feasibility for Islamic venture capital and thus, the suggested reform (Chapter 4). It will then discuss briefly the future of Islamic Venture Capital (Chapter 5) before proceed with the finding(s) and conclusion(s) (Chapter 6).

As far as literature review is concerned, since this dissertation will be venturing on something which is unprecedented, there is no direct literature which will be the basis for such review. However, from time to time, reference will be made to two brief seminar papers presented by two Malaysian bankers, namely, "**Islamic Based Prospects for Future Growth in Perspective PUNB**[18]" by Mohd Noh Othman and " **A New Wave in Venture Capital: Islamic Financing Perspective**[19]" by Hamdan

[18] Paper delivered at the *Venture Capital Europe-Asia 2000 Conference*, European Business Information Centre, University Technology Malaysia and International Business School, Putra World Trade Centre, Kuala Lumpur, on 28th – 30th March, 2000.

[19] Paper delivered at the *Venture Capital Europe-Asia 2000 Conference*, European Business Information Centre, University Technology Malaysia and International Business School, Putra World Trade Centre, Kuala Lumpur, on 28th – 30th March, 2000.

Mohd Bintang. Also, for a reflection of an American perspective, reference will also be made to "**Islamic Venture Capital: A Critical Examination**", an article published in "Proceedings of the Third Harvard University Forum on Islamic Finance[20]" written by Masudul Alam Choudhury.

In Mohd Noh's work, he submits that Islamic based venture capital instruments varies from *Mudārabah* to *Islamic convertible bond.*[21] Meanwhile, Hamdan tries "to look at the basis of venture capital activities based on the principles of Sharīᶜah or Islamic jurisprudence[22]" as well as "to highlight the significance of undertaking venture capital activities which are Shari'ah-compliant."[23] However, both of these works are too fundamental and brief while the findings are none other than reflecting general practices at present.

On the other hand, Masudul Alam's finding shows that the proper instrument for raising and mobilizing Islamic venture capital is centrally premised on a single unified or interactive principle between *Mudārabah* and *Mushārakah.*[24] This is to overcome the problems of asymmetrical ownership and income/ wealth distribution in

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[20] Masudul Alam Choundhury, Islamic Venture Capital: A Critical Examination, paper delivered at the *Proceedings of the Third Harvard University Forum on Islamic Finance*, Harvard Islamic Finance Information Program, Austin Hall, Havard University, Chambridge, Massachusetts on 1st October, 1999.

[21] Mohd Noh Othman, Islamic Based Prospects for Future Growth in Perspective PUNB, p. 7.

[22] Hamdan Mohd Bintang, *A New Wave in Venture Capital: Islamic Financing Perspective*, p. 2.

[23] *Ibid.*

[24] Masudul Alam Choudhury, Islamic Venture Capital: A Critical Examination, p. 25

both of these Sharīᶜah transactions.[25] Although, this finding of Masudul Alam might be innovative, the adaptation of it into the Malaysian context remains unclear.

This dissertation tries to examine and analyse venture capital as a whole in an attempt to critically unveil the situation in Malaysia with special reference to Islamic modes of venture capital. It discusses the feasibility of such Islamic modes of venture capital especially in the Malaysian context. It also focuses on the brief outline of the whole venture capital industry globally and domestically.

The problem with the discussion of Islamic based venture capital instruments is that many tend to look at it from the conventional venture capital's view point and try to change its uniform at the outer layer to render it Islamic. Also, with a pre-conceived perception that there is nothing unislamic about venture capital, the legal hurdle for the feasibility of such Islamic venture capital instruments is always overlooked and taken for granted.

The method used in this study is comparative, critical and analytical. It is comparative for it compares the western mode of venture capital with an Islamic mode of equity financing. Yet, it is critical in that it studies the shortcomings in current practice in Malaysia and thus suggests the proposed reforms to give way to true Islamic modes of venture capital. On the other hand, it is analytical because of it also highlights relevant laws and practices in other countries which are relevant to it.

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[25] *Ibid*, at p 17.

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CHAPTER 2

VENTURE CAPITAL: AN OVERVIEW

2.1 What is Venture Capital?

E M Rogers and J K Larsen define venture capital as "money placed in new or young high-technology companies with a high potential for growth".[26] A venture capital firm "serves as an intermediary between investors looking for high returns and entrepreneurs in need of capital".[27] According to them,

> "venture capital firms often invest money solely on the basis of an entrepreneur's promising idea, a form of collateral that conventional bankers consider worthless. Entrepreneurs trade a percentage of the ownership of the company (often 50%) in exchange for venture capital. Understandably, entrepreneurs have little love or venture capitalists, sometime referring to them as 'vulture capitalists' but venture capitalists are as essential as the entrepreneur as a bank account".[28]

A closer look at this definition would reveal the trend of the venture capital industry in the United States whereby it is more high-technology based and the element of

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[26] Rogers, M. and Larsen, J.K.E., *Silicon Valley Fever*, George Allen & Unwin, London, 1984. p.62.

[27] *Ibid.*

[28] *Ibid,* pp. 62-63.