Islamic Venture Capital Mi'yar

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1.0 INTRODUCTION

1.1 Islamic Venture Capital Mi'yar

Venture capital (VC) is a form of financing that investors provide to promising small businesses and startups. Most of these small businesses and startups lack the capital and sometimes, ability to grow. The investment may come in financial or non-financial ways. The investments made by investors range from providing funds to providing managerial, logistic or technical expertise. Either way, it is meant to help the investee company grow and make a profit. Through this, investors are able to make a return on their investments. In exchange for the investments, investors get a stake in the company and have a say in the company's direction.

Venture capital is not similar to obtaining financial support from Islamic Financial Institution (IFI) at an agreed selling price which include a profit margin for providing the financial backing and in return for the financial backing, the IFI seeks security.
Like conventional venture capital, there are three basic structures in an Islamic venture capital (Islamic VC). The three structures are:

a) Direct investment to investee companies.
b) Investment through a structure such as venture capital fund.
c) Fund of funds structure (where investors have access to a number of funds via one umbrella structure).

This Mi'yar will focus on the structuring of Islamic VC and the investment in Islamic VC. User is also required to refer to the latest applicable guidelines on the Registration of Venture Capital and private Equity Corporations and Management Corporation issued by Securities Commission Malaysia as per link below:

https://www.sc.com.my/wpcontent/uploads/eng/html/resources/guidelines/VC/guidelines_vcpe_150309.pdf

1.2 Objective

The objective of the guide is to enable:

1.2.1 Structuring Islamic VC fund and investment in Islamic VC Fund.
1.2.2 Structure fund to support investment in Shariah compliant private companies.
1.2.3 Ensure continuous adherence to Shariah principles in all stages, i.e.: structuring, investment and post investment.
1.2.4 To understand the Shariah guideline peculiar to Islamic VC fund which are methodologically different from the investment in public listed companies.

1.3 Intended User

The document is meant for but not limited to the following:

a. Corporation (acting / offering to act as investment manager).
b. Co-investment manager of an Islamic VC fund.
c. Corporation wishing to carry on an Islamic VC activity in Malaysia.

2.0 Islamic Venture Capital Fund Outline

2.1 Shariah and Regulatory Compliance

To comply with Shariah and regulatory requirements, Islamic VC funds are to:

A. Appoint a Shariah Advisor to provide Shariah expertise and guidance on all matters pertaining to the Islamic VC activities and ensure that all aspects of the activities are in accordance with Shariah Requirements through:

   I. Fund structuring and the development of principal terms and conditions.
   II. Legal documentation.
   III. Disbursement of the investment funds.
   IV. Shariah Compliance monitoring.
   V. Exit strategies.

B. Shariah Compliant in the Investment, Financing and Documentation structure:

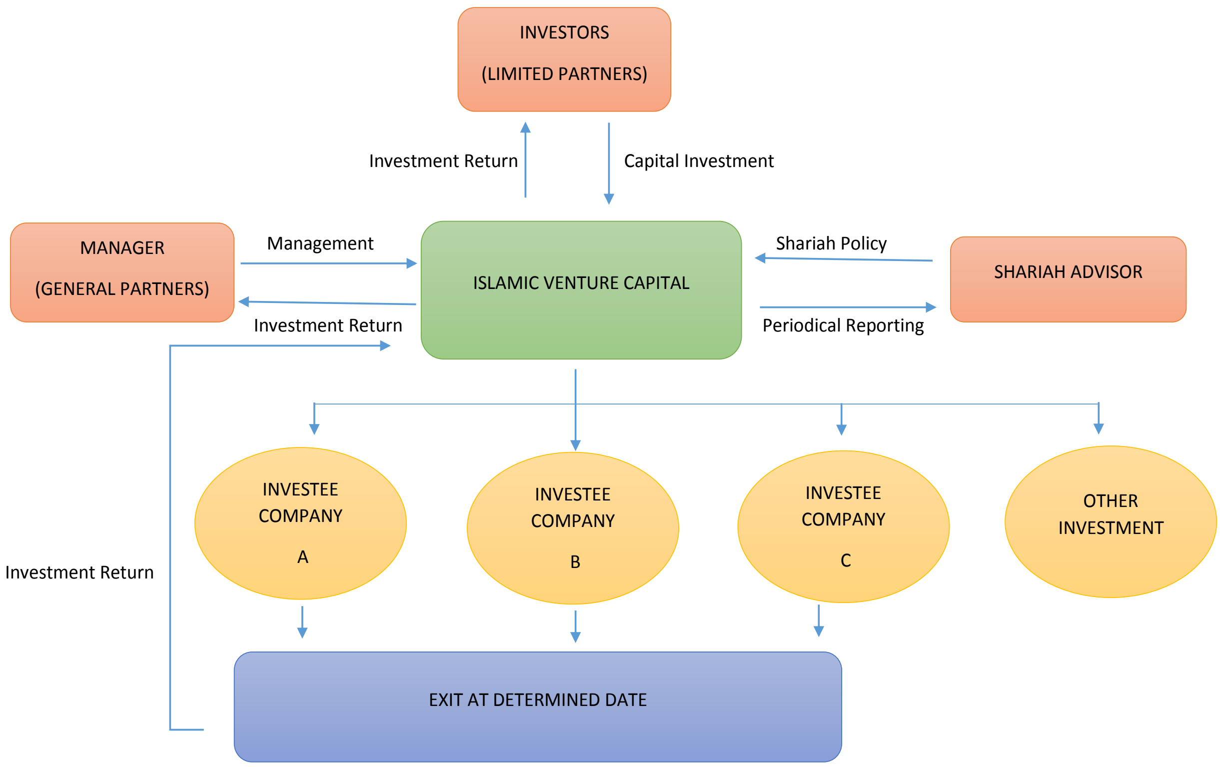
   I. The Islamic VC fund and company must stipulate in its constitution that the funds and activities are to be directed and conducted in a Shariah compliant manner, with clear prohibition on Shariah non-compliant investments and activities;
   II. The managers of the Islamic VC fund must ensure the business and core activities of the investee companies and the activities of the directors and officers of the fund be acceptable in nature and in a Shariah compliant manner.

C. In the establishment of an Islamic VC fund, the legal documentation is to specify:
   I. Shariah Advisory appointment and line of authority.
   II. Shariah Advisors are to specify the criteria of investment and to ensure only Shariah-compliant transactions.
   III. Continuous review and audit on the VC fund investment activities.

D. Islamic Venture Capital Principle and profit:
   I. Principle and profit are not to have guaranteed returns.
   II. Islamic VC shall express provision and clear understanding that any profit based on returns from the investment would be on an agreed ratio, to the parties involved.

2.2 Islamic Venture Capital Fund structure

FIGURE 1: Islamic VC Fund Structure



The general methodology of operations for the Islamic VC is as follows;

(a) The Shariah Advisors shall establish the Shariah investment and policy guidelines to conduct screening and monitoring for the Islamic VC and target investee companies.

(b) The managers of the Islamic VC Fund would raise funds for a set period of time to invest in selected target investee companies.

(c) In conformity to the Shariah investment and policy guidelines set by the Shariah Advisors, the management of the VC fund shall invest in selected profitable target investee companies and the Shariah Advisors shall endorse the investment as Shariah compliant.

(d) The Shariah Advisors and the management of the Islamic VC fund shall ensure Shariah compliance through, screening, monitoring and periodical reporting.

(e) The exit from the investee companies, Islamic VC fund and distribution of the profits and losses with the partners and investors would be in accordance to pre-determined ratios.

3.0 ISLAMIC VENTURE CAPITAL MODELS

3.1 Definition

A Shariah-compliant Venture Capital or Islamic Venture Capital fund is an investment scheme that is carried out in an accordance with the guidelines of Shariah. Both conventional and Islamic VC funds apply the risk sharing investment concept and the only difference lies in the application of Islamic principles.

3.2 Islamic VC Fund Models

There are several structures which can be used in Islamic VC funds. To illustrate how these works, example of three structures based on the profit and loss sharing (PLS) principle and these models allow the investor and Islamic VC fund to share the benefits and losses according to the structure of the applicable underlying model.

3.2.1 Musharakah VC Model

Musharakah refers to a partnership between two parties or more to finance a business venture whereby all parties to the Musharakah contribute capital. In the Musharakah Venture Capital model, every partner has a right to take part in the management of the fund. However, the partners may agree upon a condition that the management shall be carried out by any of the partners, and no other partner shall work for the Musharakah. In such event, the managing partner may be entitled to an agreed remuneration for services as manager and in addition to the share in profit sharing as a partner.

The ratio of profit for each partner must be determined in proportion to the actual profit accrued to the business, not in proportion to the capital invested. It is also not permissible to fix a lump sum amount for any one of the partners, or any rate of profit tied up to the investment. However, if a partner has put an express condition in the agreement that he will never work for the Musharakah and will remain a sleeping partner throughout the term of Musharakah, then this share of profit cannot be more than the ratio of investment.

Loss caused by mismanagement due to negligence or misconduct shall hold the managing partner as liable and the loss to the partners shall be limited to the capital contribution of each partner. If the liabilities of the business exceed its assets and the business goes into liquidation, the exceeding liabilities shall be borne pro rata by all partners based on the ratio of investment.

FIGURE 2: Musharakah VC Model

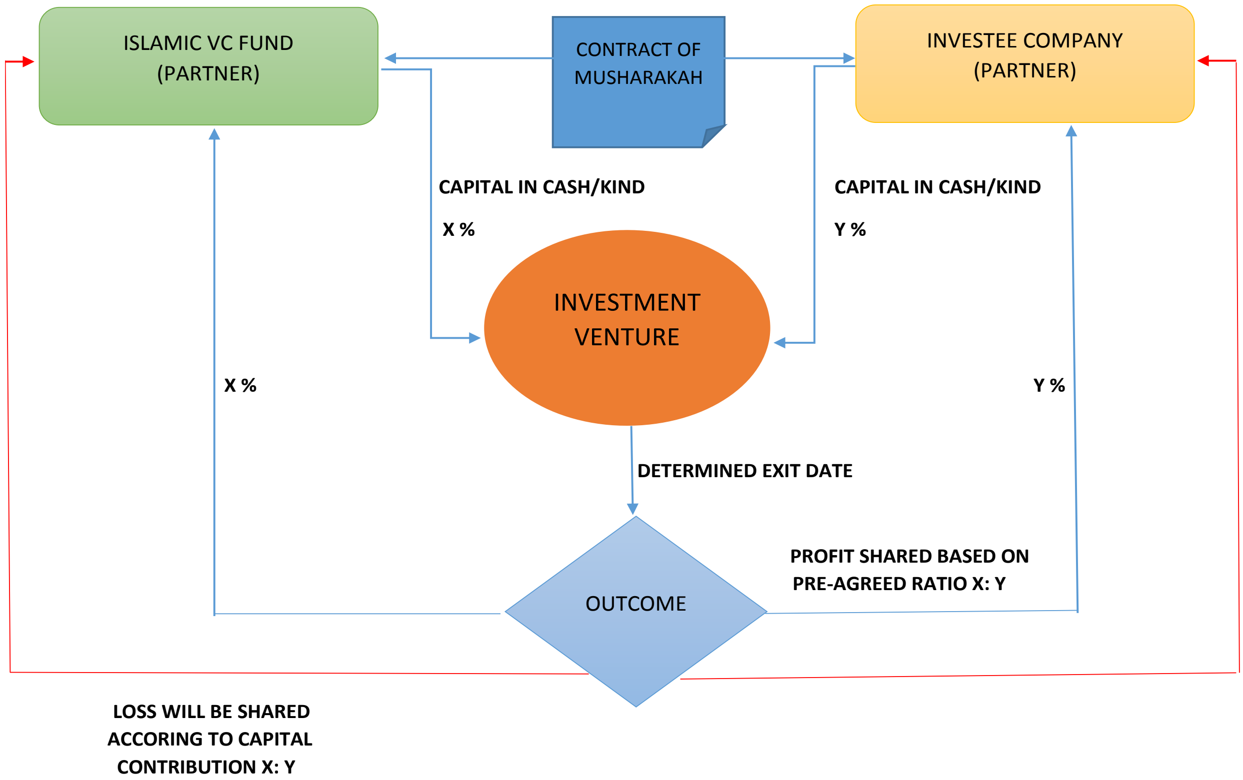


Illustration:

I. All partners must jointly contribute funding either in cash or in kind and are actively participated in the management of the venture.
II. Any outcome (profit) derived from the venture can be shared on an agreed ratio.
III. Any losses must be shared according to the capital contribution by each party.
IV. The management can be undertaken by either or both parties, or it can be sourced to a third party.

3.2.2 Mudharabah VC Model

The Mudharabah VC model is where one party gives money to another for investing in a commercial enterprise. The Rabb Al-Mal is the investor while the Mudharib is the exclusive manager of the VC Fund and/or company.

The two main types of Mudharabah are the restricted and unrestricted kinds, in which the *Rabb Al-Mal* may specify the *Mudharib* to invest the funds in a certain type of business. If the *Rabb Al-Mal* decides to authorize the *Mudharib* to act in the best interest without restriction, then the *Mudharib* would invest the funds in any business venture deemed fit.

FIGURE 3: Mudharabah VC Model

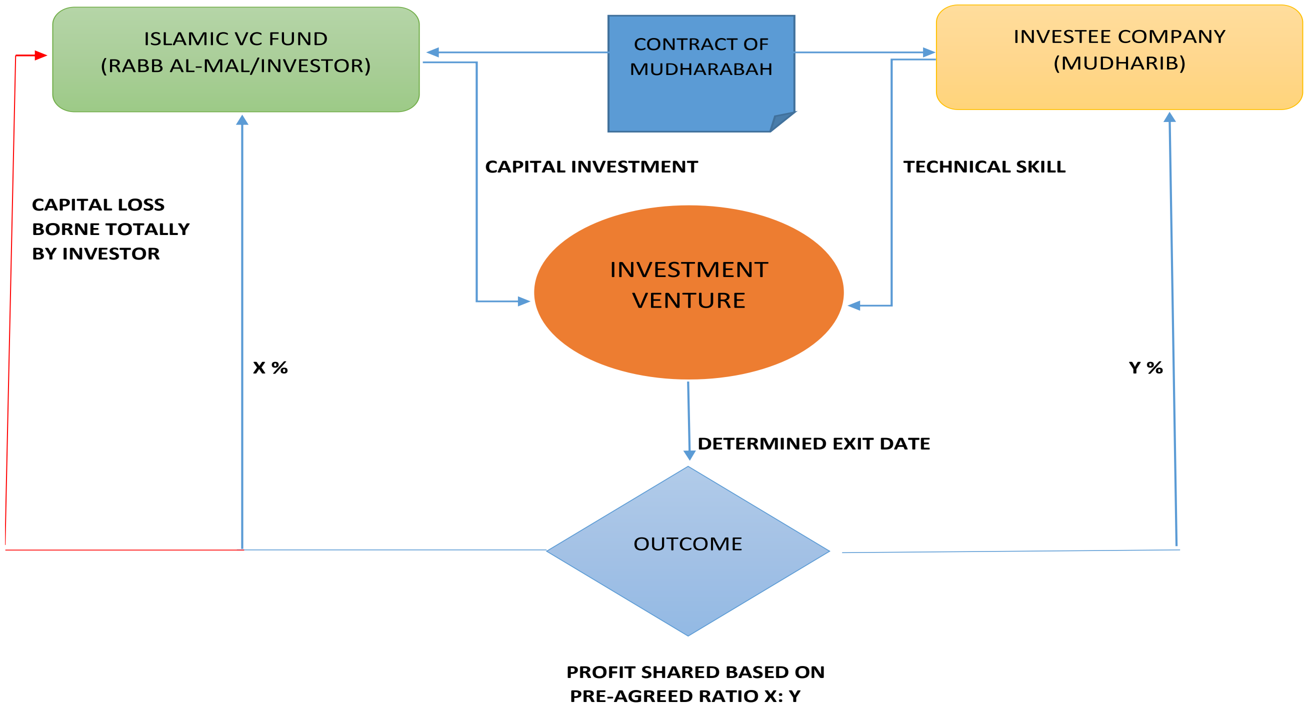


Illustration:

I. Mudharabah is a partnership between two (2) parties, namely Rabb Al-Mal (Investor or Limited Partner) and Mudharib (Entrepreneur or General Partner).
II. The Investor (Rabb Al-Mal) will provide funding/financing, whereas the Investee (Mudharib) will act as an Entrepreneur / Manager which will contribute skills and know-how to the venture.
III. Any outcome (profit) derived from the venture will be shared on an agreed ratio.
IV. Any losses will be borne solely by the Investor.
V. The Investee as the manager has all the control rights, whereas the Investor cannot participate actively to the management of the venture. However, the Investee must report the performance of the venture to the Investor on an agreed frequency, i.e.: quarterly, semi-annually, or annually basis.

3.2.3 Wakalah VC Model

Wakalah refers to a contract whereby a party (principle) authorises another party or parties (agent) to act on their behalf, based on the agreed terms and conditions for a fee consideration (Wakalah Bil Ujrah) or without any fee consideration (Wakalah Bi Ujrah).

FIGURE 4: Wakalah VC Model

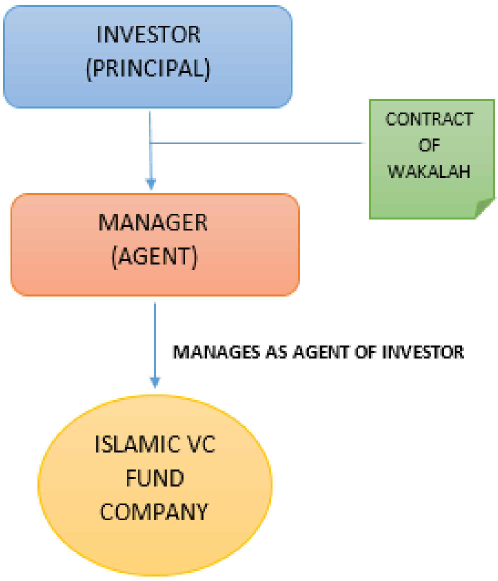


Illustration:

I. A Partner may authorize and confer the power and rights to the other partner or partners to act on its behalf, managing the venture based on agreed terms and conditions.
II. In a Wakalah model, LP can be appointed by another LP to become the GP of the fund to manage the fund based on agreed terms and conditions.

4.0 Screening and Monitoring Islamic Venture Capital

The Islamic VC fund is continuously screened and monitored for Shariah compliance during the life of the fund. The investee company which is part of an Islamic VC portfolio, must remain Shariah-compliant in all aspects for the length of the portfolio investment.

Investee(s) which conduct mixed business activities [Shariah compliant and Shariah non-compliant] screening methodology is based on a percentage benchmark.
User is required to refer to the latest applicable guidelines issued by Securities Commission Malaysia with regards to Business activity benchmarks and Financial ratio benchmark.

4.1 Islamic Venture Capital Periodical Reporting

The Islamic VC are required to conduct periodical reporting to the Shariah Advisors to comply with regulations and ensure company's activities are Shariah Compliant. Periodical reporting would also ensure that the Shariah Advisors and managers of the fund to be in line and updated with the Shariah resolutions, Shariah compliance and enables the Shariah Advisors to conduct the screening and monitoring process.

4.1.1 Reporting Semi-Annually

Every six months, a report detailing investment and business activities of the company and investee companies shall be sent to the Shariah Advisors. Upon reviewing the report, and ensuring that the underlying assets is compliant, the Shariah Advisors would issue a Shariah compliance certification to the Islamic VC.

4.1.2 Reporting Annually

On an annual basis, an audited financial report detailing investment and business activities of the Islamic VC and Investee companies shall be sent to the Shariah Advisors. Upon reviewing the report and ensuring the underlying assets is compliant, the Shariah Advisors would issue a Shariah compliance certification to the Islamic VC.

5.0 Investment Disposal

User is required to refer to the latest applicable guidelines issues by Securities Commission Malaysia with regards to disposal of Shariah non-compliant securities. The link to the purification of income is as per link below:

https://www.sc.com.my/wpcontent/uploads/eng/html/icm/Resolution_SAC_2016.pdf