ISLAMIC VENTURE CAPITAL AND PRIVATE EQUITY: LEGAL ISSUES AND CHALLENGES

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Quick Introduction of Azmi & Associates.

Established on 1 September 2000 with 11 lawyers.

The firm’s focus has been on matters relating to M&As, corporate & commercial, Islamic banking, financial services, capital & debt market, venture capital, projects, project finance, real estates, cross border transactions, corporate litigation, arbitration. The Firm is also actively involved in developing new Islamic products for some banks and financial institutions.

The Firm now has forty one (41) lawyers comprising eight (8) partners and thirty three (33) solicitors and further has fifteen (15) trainee solicitors.
The Firm is the sole Malaysian member of TerraLex, an international worldwide network of law firms with its HQ in Florida.

Via Terralex, the Firm has access to over 16,000 lawyers in various disciplines practicing in 160 firms in nearly 100 countries around the world.

The Firm’s Global Financial Services Practice Group’s experience includes undertaking numerous transactions and exercises.

The recent one include advising RHB Investment Bank Berhad and RHB Islamic Bank Berhad on the issuance of up to RM745 Million comprising RM330 Million Sukuk Ijarah and RM415 Million Sukuk Mudharabah by Malaysian highway concessionaire Projek Lintasan Shah Alam Sdn. Bhd., which garnered the Islamic Finance News’ Deal of the Year 2008 award for its innovativeness.
Overview and History of Islamic Venture Capital

- Historically, Venture Capital ("VC") started from the Islamic concept of "mudharabah", a form of partnership used even before Islam by Arab traders.
- Later on, this concept was formalised and embodied in Islamic law by the Muslim jurists, which is now better known as fiqh muamalat (Islamic transaction).
- As Islamic culture spread across the world, the mudharabah concept also developed and continued to be used by Islamic businessman until the 19th century.
- In the 10th century, the concept of mudharabah was taken up by the Italian and spread through Europe.
• Even though this kind of mudharabah partnership form in the Muslim world remained undeveloped, in Europe there were increasing numbers of entrepreneurs who were financed using this method, resulting in organisations becoming larger and larger.

• About three decades ago, a kind of quantum leap happened and the concept of the modern Islamic bank (mudharabah in the form of the bank managing the funds from the depositors) emerged from these roots.

• In Islam, money is not a commodity and cannot be traded for profits. It is just a medium of exchange and value storer.
• Money therefore must be invested in projects and ventures for the generation of activities for the benefits of mankind and in the process, for profits.

• This is precisely why Islamic finance praises and encourages the application of finance in the financing of real economic activities.

• The returns should be earned by active involvement and participation in the business risks in the investment (and not returns on lending)
• Islamic banks would apply the same criteria in evaluating projects to invest in, viz, the entrepreneur’s ability and the profit potential of the project.
• This is the reason why Murabahah (cost plus financing) as an Islamic transaction is considered less risky compared to Mudharabah and Musharakah.
• Truer form of Islamic financing or investment structure should have that element of sharing of profit and loss.
(a) Mudharabah

- Mudharabah is one of the typical forms of Islamic PE/VC
- It is basically a contract made between two parties to finance a business venture. The parties are a *rabb al-mal* (investor) who solely provides the capital and *mudharib* (entrepreneur) who solely manages the project.
- This is akin to a conventional PE/VC, where there exists a relationship between the capital provider and the manager.
- If the venture is profitable, the profit will be distributed based on a pre-agreed ratio.
- In the event of a business loss, it should be borne solely by the capital provider, to the extent of the capital contribution.
- The key to a Mudharabah structure is the fact that the manager cannot be placed at risk to bear losses, unless proven negligent.
Plain Mudharabah Fund Structure

Investor/ rabb al-mal

Private Equity Fund Company (Manager/Mudharib)
Size of capital: 50m

Co. A 5m
Co. B 7.5m
Co. C 7.5m
Others
(b) Musharakah

- Musharakah is a partnership between two parties or more to finance a business venture whereby all parties contribute capital either in the form of cash or in kind.

Profits are shared at an pre-agreed ratio while in the event of a loss, the loss shall be shared on the basis of capital contribution.
Plain Mudharabah Fund Structure

Manager / Mudharib
1m

Investors / Rabb al-Mal
9m

Private Equity Fund Company
(10m committed capital)

1m
Co. A

2m
Co. B

1m
Co. C

Etc
(c) **Wakalah**

- Wakalah is basically a contract where a party ("the Principal") authorises the other party or parties ("the Agent") to act on his behalf, based on the agreed terms and conditions.

- Pursuant to the Wakalah contract, it confers the power and rights to the Agent to act on behalf of the Principal as long as the Principal is alive.
Plain Mudharabah Fund Structure

PE and/or its affiliate is fund manager to the funds

Investment Committee

Investment Guidelines

Conventional Fund

Investment A

Investment B

Investment C

Islamic Fund

Investment D

Investment E

Investment F

Shariah Council

Shariah Advisor

Shariah Guidelines
## Comparison between the conventional PE/VC and Shariah Compliant PE/VC

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<th>Conventional PE/VC</th>
<th>Shariah Compliant PE/VC</th>
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<td>Equity Investment</td>
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<td>Partnership – Sharing of risk &amp; rewards</td>
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<td>Applicable to all industries</td>
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Legal Framework for Islamic Venture Capital Structure

- **Section 58 (1) of Capital Markets and Services Act 2007 ("CMSA")** requires any person dealing in securities must be licensed.

- **Section 76(1) and Item 2 Part 2, Schedule 4 of the CMSA** provides that venture capital companies are “registered persons”.

- **Item 2 Part 2, Schedule 4 of the CMSA** states “Any venture capital corporation and venture capital management corporation that is registered under the Commission's Guidelines for the Registration of Venture Capital Corporations and Venture Capital Management Corporations”

- The above provisions allow Venture Capital Corporation (“VCC”) and Venture Capital Management Corporations (“VCMC”) to deal in securities and are exempted from the licensing requirement under **Section 58(1) of the CMSA**.

- However, the above exemption is still subject to the compliance and registration with the requirements in the **Guidelines for the Registration of Venture Capital Corporations And Venture Capital Management Corporations** issued by the SC.
· On 7th May 2008, the SC issued the **Guidelines and Best Practices on Islamic Venture Capital** (“the Guidelines”).

· The Guidelines stipulate the minimal requirements for the establishment of an Islamic VCC and Islamic VCMC.

· The Guidelines meant to assist VCC and VCMC in carrying out Islamic venture capital activities.

· The Guidelines also include a set of Best Practices in an effort to promote appropriate Shariah standards in the industry.

· VCC is defined and refers to a corporation that manages on its own behalf, investment in securities of venture companies in different business stages, i.e. seed, start-up, or early-stage financing.
cont’d

- VCMC refers to a corporation that manages on behalf of a VCC, investment in securities of venture companies in different business stages, i.e. seed, start-up, or early-stage financing.
- Two fundamental requirements for the establishment of the Islamic venture capital are:
  
  (i) The appointment of Shariah Advisor to provide continuous guidance in ensuring compliance with the Shariah of the investment contract and the instrument structure; and
  
  (ii) The core activities of the investing companies must be Shariah compliant.
Core Requirements for Establishing Islamic Venture Capital Corporation and Venture Capital Management Corporations

(1) A VCC or VCMC must be registered under the Guidelines for the Registration of Venture Capital Corporations and Venture Capital Management Corporations issued by Securities Commission.

(2) In addition, the following requirements must be complied with:

(a) An independent Shariah Adviser must be appointed to provide expertise and guidance on conformance to the Shariah principles.

(b) The activities of the venture companies must be Shariah compliant. This means that the underlying assets and investments of the fund must be permissible.
Non permitted Shariah activities include- (i) financial services based on interest (riba); (ii) gaming/gambling (maisir); (iii) conventional insurance; (iv) manufacture or sale of non-halal products or related products; (v) entertainment activities that are non-permissible according to Shariah; (vi) manufacture of sale of tobacco-based products or related products; (vii) Stockbroking or share trading in Shariah non-compliant securities; and (viii) Hotels and resorts with non-Shariah compliant activities.

Note: Apart from the activities listed above, the Shariah adviser may apply ijtihad (reasoning) for other activities that may be deemed non-permissible, as a criterion in assessing the activities for Islamic venture capital.
The Guidelines also identified some of the best practices encouraged to be adopted by VCC or VCMC:

(i) The Shariah Advisor shall act with due care, skill and diligence:

(a) to ensure that all aspects of the Islamic venture capital such as portfolio management, trade practices and operational matters comply with Shariah;
(b) to provide Shariah expertise and guidance on matters relating to documentation, structuring and investment principles;
(c) to review and scrutinise compliance report prepared by Shariah compliance officer or any investment transaction report; and
(d) to provide written opinion and periodic report.

Cont’d
(ii) Annual Written Disclosure and Declaration

It is expected that the Shariah Advisor must prepare at least on annual basis written disclosure and declaration to the Board of Directors that the VCC is managed according to Shariah principles.

(iii) Compliance Officer

The VCC or VCMC is encouraged to appoint a Compliance Officer for purposes of ensuring compliance with the specific requirements of an Islamic VCC or Islamic VCMC. Compliance Officer must report any non-compliance to the Shariah Advisor and is expected to ensure written disclosure and declaration is made by the Shariah Advisor.
(iv) Portfolio Management

- Any investment decision is expected to be endorsed by the Shariah Advisor.
- A VCC or VCMC is expected to ensure that the activities of the companies remain Shariah complaint right to the point of full divestment.

*Source: Guidelines and Best Practices on Islamic Venture Capital
Issued by Securities Commission*
Shariah-Compliant Quantitative Criteria
(issued by Shariah Advisory Council, Security Commission)

(1) The conventional debt to total asset ratio must not be higher than 30%

(2) Interest income and non-halal revenue relative to the total revenue must not exceed 5%

(3) Cash plus income bearing securities relative to the total asset must not exceed 30%

(4) Cash, cash equivalent and account receivable relative to the total assets must not exceed 45%
Some specific considerations in Islamic VC/PE funds:-

1. Structure

The documentation, financing and investment structure must be Shariah compliant:

   a. Funds must be invested in the fund which has been structured in a Shariah compliant manner. Activities of the fund are based on tangible assets and are not speculative in nature (gharar)
   
   b. The constitution of the fund stipulates for a prohibition on non-Shariah compliant activities
   
   c. The activities of the directors and officers of the fund must be acceptable in nature and that their activities are conducted in a Shariah compliant manner.
2. Underlying Assets

- underlying assets and investments of the fund must be Shariah compliant
- must not invest in non-Shariah compliant counters or securities
- assets must also be of good quality and the risk and reward associated with such investment have been fully appraised
3. Islamic VC/PE Fund Documentation

(i) Appointment of Shariah Advisor
the fund documentation shall include provisions on the appointment and powers of the Shariah Advisor

(ii) Investment Powers
to incorporate in the fund documentation a provision stipulating that the fund be invested in line with criteria as specified by Shariah Advisor

(iii) A provision specifying that the fund can only enter into transactions which are in compliance with Shariah principles

(iv) Provisions for continuous audit to determine whether the assets are Shariah compliant should be stipulated
4. **Profits of fund**

Provision that any profit of the fund shall be based on returns from investment of the fund, with no guaranteed profit return and also to include provision for reinvestment of profits into the fund.

5. **Fees**

Fees for the Shariah Advisor should also be included in the documentation.

6. **Lawyers**

They should preferably be appointed from amongst those familiar with Islamic transaction (muamalat) principles and be free from controversies against Islamic principles.
Opportunities For Islamic PE or VC

• After September 11 event, there has been larger diversion of funds belonging to Middle Eastern countries to the Far East, including Malaysia. This access liquidity should be tapped.
• These funds, if properly structured as PE funds or VC funds, would be able to attract the attention of the Middle Eastern countries.
• The establishment of 3 Islamic banks in Malaysia by Middle Eastern countries has enhanced the level of trust and confidence of the Middle Eastern countries and liquidity into Malaysia, bringing along with them new innovative structures of financing, so far alien to Malaysian market (e.g. development of Pavilion KL). Some of these financiers provide equity financing and investment along with Islamically structured form of financing.
Recently, the new Prime Minister announced the liberalisation of the financial services sector which aims to ensure that maximum benefits will accrue to Malaysia.

This includes the issuance of two new Islamic banking licences to strong foreign and world-class players to establish new Islamic banks with paid-up capital of at least USD1 billion.

Given the growing prominence of Malaysia under the theme of MIFC, Malaysia can be the place where the demand for and the surplus of liquidity is matched in Malaysia. Recently a local Islamic bank in Malaysia struck a deal with investors from Qatar to establish funds to invest in specific sector/industry in Malaysia.
Challenges faced by Islamic PE/VC

- The establishment of legal and regulatory framework or the appropriate guidelines to regulate the industry
- The support and backing from the government in terms of incentives, tax exemptions, etc
- The creation of appropriate business structure or investment structure to make the product better understood and accepted by the market players
- Shortages of well-trained high-caliber individuals and management teams with expertise in investment strategies and at the same time understand and appreciate the Shariah requirements
- Innovations and creativity in coming dealing with new investment climate and changing circumstances without compromising the requirement of the Shariah
- The creation of conducive environment and attracting the deal flows
Typical Legal Structure for Musyarakah

- **Investor I** (Venture Capitalist)
- **Investor II** (Promoter)
  - Fund Company
    - Investee 1
    - Investee 2
    - Investee 3
1. Salient terms of Subscription Agreement

- Conditions Precedent
- Upon fulfillment, subscription by parties of Ordinary Shares (“OS”) & Redeemable Prefers Shares (“RPS”), further subscription, entry of new investors
- Rights attaching to OS – Dividends & Voting rights
- Features of RPS
  - par value & premium
  - tenure
  - no voting rights except in relation to its class meetings
  - right to information, reports
  - free from all charges, liens
  - in the event of liquidation, RPS shall rank in priority to OS in relation to preferential dividend & repayment of Capital
• Investors being holders of OS, by way of *tanazul*, agree to waive their right in respect of preferential treatment above.

• Redemption of RPS

• Representations & Warranties

• Default

Schedule: Guidelines on Policies for Investment
2. Salient terms of Shareholders Agreement

• Conditions Precedent similar to Subscription Agreement
• Fund Structure
• Board of Directors
• Appointment of Investment Committee – Scope, quorum, voting & decisions
• Shariah Advisor & Shariah Governance – Scope of work, express provision on business not consistent with Shariah principles e.g. alcoholic, tobacco related products, gambling, pork products riba – based financial services, non-halal related products, conventional insurance, stock broking or share trading in Shariah non-compliant securities.
• General meetings
• Transfer of Shares
• Termination Clause
3. Salient terms of Investment Management Agreement between Fund Co. & Investment Manager

- Appoint Investment Manager ins by way of wakalah
- Term of Agreement
- Investment Guidelines & Operating Manual
- Confirmation by Shariah Advisor on Structure of Musyarakah Fund, Structure and all documents do not contravene Shariah principles & Shariah Governance
- Scope of services
- Management Fee 2.5% p.a on of the Fund Size
- Performance Bonus i.e. agreed percentage of Surplus
- Termination Events.
Thank you

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