Fundamental Requirements for Building an Islamic Venture Capital Model

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Abstract

The aim of this paper is to demonstrate the fundamental requirements for building an Islamic Venture Capital. There is an extremely high youth unemployment rate in Islamic Countries. This is due to few numbers of SME companies and inability of governmental sector to offer jobs for all youth. Also Conventional banks finance big companies with long history of operation and refuse to finance new companies. So this new companies do not have any institution to support them. Islamic banks have inability to make a lot an adequate profit and loss sharing (PLS) financing, because the nature of Islamic banks as depository institutions. There is a need for different type of institutions that can play this role and offer PLS financing on a wide scale. The Western practice of VC had some violation to *Shariah*, so we have to develop a model of venture capital that is fully compliant with the *Shariah* principles. The paper discusses Venture Capital Investments and its Compatibility with Islamic Principles of Investment. Also we discuss Similarities and difference between Islamic Banks and VC investments to confirm that Islamic bank can’t be used as a replacement of VC investment. Moreover the paper explains the current financing methods Used by VC investments and their compatibility with *Shariah* Rules. We proposed structure for an Islamic Venture Capital Model. The paper highlighted the challenges facing VC in Islamic countries and providing an approach to overcome these challenges. Finally, the paper explores the importance of governmental support to VC investments in the Islamic countries.

Keywords: Islamic Venture Capital Model, Islamic Finance, Islamic Countries, Entrepreneurs

1. Introduction

Shariah is the set of laws and principles that makes the Islamic system of law and in general refers to the totality of the Islamic way of life. Therefore, it represents a code of life that embraces all aspects of Muslims' life. The unique aspect about *Shariah* is that it strikes the balance between individuals' interests and the society as a whole. In the context of Islamic finance, for instance, *Shariah* (unlike widely conceived) acknowledges the conventional principle of profit maximization, but at the same time it sets the boundaries governing this principle in a way that ensures the benefit for the wider society. That is why gambling is prohibited because it is a zero sum game with no added value to the economy. Islamic finance basic principles are asset based financing, partnership where parties share profit and loss (SPL) (Imad-ad-Dean 2013).

Islam encourages engagement in business activities, but at the same time Islam also encourages fair trade, commerce and an entrepreneurial culture. Undertaking a business activity is part of *Ibadah* (worship and obedience of *Allah* (God)) if they are performed in accordance with the Islamic principles. This implies that an entrepreneur who performs his business operations in accordance with the commands of *Allah* will have a reward in life after. The main Islamic principles are justice and honesty. This has much practical relevance in addressing agency problems including information asymmetry, adverse selection, moral hazard and corporate governance. (Securities Commission Malaysia, 2008)

The size and depth of venture capital markets across countries remained significantly uneven. In 2009, while VC investments in the United States constituted a round 13% share of GDP, in other OECD countries such as the United Kingdom and Sweden, VC investment constituted a lower share of GDP amounting to around 5% and 7% respectively.

In the same year, Europe's investment as a share of GDP was only around 25% of that of the US (Elsiefy, 2013; National Venture Capital Association, 2011; Jeng, 2000).

Venture capital (VC) is widely considered a significant source of financing for early-stage, innovative, and high growth start-up companies. These companies usually hold significant intangible assets and spend heavily on R&D activities. Therefore, their performance is difficult to assess especially at early stages of operations. As a result, external sources of financing for these companies are costly and difficult to obtain. For many of these companies and other unproven and high-risk projects, venture capital may become the only potential source of finance (Rea, 1989). Venture capital investment for instance, have once backed many of today's giant high-tech companies including Microsoft, Cisco System, Intel, and Netscape, and a number of successful service companies such as Staples, Starbucks and eBay. However, there are also many cases where money is lost, and the companies disappeared. Thus, there is necessity to increase the knowledge about the nature of VC investment and clearly explains its return and risks. One of the methods of mitigating the risk of failure in VC is investing in a couple of projects in parallel and not putting all the money in one project. It is a sort of diversification that is required in most investments but here is mandatory since the nature of VC investment has a high probability of failure for some projects (Mutalip, and Lutfi ,2009; Romain, A. and Pottelsberghe, B ,2004 ; Romain, A. and Pottelsberghe, B ,2003)

1.1 The Problem of the Study

Venture Capital is in its early stages in the Islamic Countries. The emerging of global competiveness has put a strong pressure on the companies to improve the quality level with minimization of cost by using latest technology, and to absorb the increasing of labor force. Islamic Banks can’t replace Islamic VC. More than 70% of financing done by Islamic banks are through Murabaha. The partnership contracts are not suitable for banking business model, the partnership contracts do not fit with it. But there are a huge need to this type of contract in the region due to the reliance on government for the growth of the economy and lack of proper private sectors that can offer descent employment for youth. Moreover there is a need for diversification of economy rather than dependence on classical sources of income (Alam, 2000). Modern economic are in knowledge based economy and only way to progress in this type of economy is opening doors to private sectors. So in order to apply these contracts, we need to build institutions with business model that suitable to the nature of these contracts so we need to encourage the development of Islamic VC institutions. Moreover there are various problems can be outlined as follows:

- There are a low number of establishments of new companies in the Islamic countries specially the companies that focus on new ideas and advanced technology.
- There is Lack of proper Legal infrastructure to attract venture capital investment in Islamic countries and also for attracting direct foreign investment.
- Conventional banks finance big companies with long history of operation and refuse to finance newly established companies. So this new companies do not have any institution to support them.
- There is an extremely high youth unemployment rate of 23.4% in 2010 in the Islamic countries according to International labor of organization. This is due to few numbers of SME (Small and Medium-sized Enterprise) companies and inability of governmental sector to offer jobs for all youth (Durrani and Boocock, 2006).
- The knowledge of VC is not present in the region and we are geographically distant from where VC is well practiced. (Achleitner et. al, 2010)

1.2 Questions of the Study

This study illustrates to answer the following questions:

- Why we need Islamic Venture capital institutions?
- What are the potential contributions of Islamic Venture capital to the economy of Islamic Countries?
- What are the similarities and differences between Islamic banking and Islamic Venture capital?
- Why the Islamic countries needs different VC model than the one practiced in the west?
- What is the challenges facing Islamic VC Investments in the MENA Region?
- What the governments do to encourage investors to invest in venture capital?

1.3 Motivation of the Study

Unemployment rate increases overall the world, and in Islamic countries as well. After Arab Spring the unemployment rate among youth increased to be more than 30%, the conventional banks can do nothing to solve this problem, as long as they finance big companies with long history of operation and refuse to finance new companies. Moreover, although the concept of partnership (profit and loss sharing PLS) model is the core principle in Islamic finance, its real practice in market by Islamic banks (Note 1) is minimal, so there is need to develop institution to play this role. The Primary stock market is weak in Islamic countries comparing to secondary market and there is nearly few primary public offering for new companies in Islamic Stock Exchange. There is inability for governmental sectors to offer jobs for the increasing number of youth in Islamic countries. The conventional VC is not suitable also for the Muslims' because it is not compatible with *Shariah*. There is a need to diversify the economy of the Islamic countries specially the Gulf Cooperation Council (GCC) countries (84% of their GDP from Gas and Oil only), and they have the money and youth to do this but there is lack of appropriate channel to facilitate this kind of investment (Zia Ahmed, 2011). All of these problems could be solve if we have an Islamic VC.

1.4 Aim of the Study

The aim of this paper is to demonstrate the fundamental requirements for building an Islamic Venture Capital, and to provide a best practice model for VC that is compatible with Shariah,. Moreover the paper aims to highlight the importance of VC investment in the economy of the Islamic countries and to raise awareness for investors and entrepreneurs about VC investment. Finally the paper aims to answer the study questions.

The paper has been constructed in nine sections as follows. Section 2 describes venture capital investments and its compatibility with the Islamic principles of investment. Section 3 discusses the similarities and difference between Islamic banks and VC firms. Section 4 explains the current financing methods used by VC firms and their compatibility with *Shariah* rules. Section 5 proposes a structure for an Islamic venture capital model. Section 6 presents the challenges facing Islamic VC Investments in the MENA region. Section 7 proposes an approach for the promotion of an Islamic VC in the MENA region. Section 8 proposes the potential steps that can be done by government to support the VC Finally Section 9 present the study Concludes and Recommendation.

2. Venture Capital Investments and its Compatibility with Islamic Principles of Investment

Venture capital investments have long represented an attractive method of finance, in particular, for new small companies in the conventional sense of finance. This method of investment, however, is almost uncommon in the context of Islamic finance though it principally resembles in its fundamentals much of those underlying *Mudarabha* based financing, one of the oldest practiced method of finance in the Islamic finance context.

Mudarabha is principally a form of partnership contract that has been practiced since the time of the prophet Mohamed (*pbuh*). It is defined as a capital- labor partnership contract according to which the owner of the capital (called *Rab Almal*) hands over the partnership's capital to the work provider or the trader (called *Mudarib*) to establish a profitable business agreed upon between the parties for agreed upon profit sharing ratios with the loss being borne by the capital provider. However, due to lack of proper legal system among other reasons, this type of contract has been minimally practiced in recent years.

Financing contracts in Islamic finance can generally be divided into two main categories. First category is exchange contracts including such contracts as *Murabaha, Ijara,* Salam and second category partnership contracts including Musharaka and Mudaraba contracts. While exchange finance contracts are heavily employed by Islamic banks in financing activities, the use of partnership contract is considered significantly minimal (Yusof, et al., 2009). Most often this is due to the lack of financial institutions that can bear the high risks implied in these contracts and here indeed where we see the role of VC institutions comes into play. In principle, venture capital is greatly compatible with the fundamental principles of Islamic finance mainly those related to risk taking and profit and loss sharing between business partners. One facet of compatibility is that the venture capital provider does share in the profit and loss incurred by the business from the early stage and therefore, is provided with no guarantees for neither the return of the capital nor any profit or interest thereof. Besides, most of these venture capital investments have been seen to have been involved in investments in companies providing real goods and services that had a positive long term influence on the economy. This already is illustrated by the tremendous effect of Venture capital-backed companies (especially in job creation) on the thriving of economic conditions of most developed countries such as the United States and many European countries. (Note 2) In addition, the private equity stake in the business presented by the venture capital in most cases is sufficient to influence the business's governance, which ultimately ensures that the business's operations are conducted in an efficient way. This latter feature of capital venture investments, which allows capital providers to establish a control over the companies they invest in, provides very important platform for venture capital to become a compatible way of finance from the Islamic perspective. This is because it allows capital provider (partners) the much needed authority they may require to ensure the compliance of business's operations with *Shariah* financing principles related to, among others, prohibition of the use of interest-based capital or engaging in impermissible business activities. Sethi, (2008) explains that the convergence of venture capital and private equity with Islamic finance is because of the attributes of the private equity financing approach that create inherent compatibilities with the principles of Islamic finance.

In particular, the structure of venture capital as an equity investment matches up really well with the Islamic financial concept of diminishing *Musharaka.* In principle, the venture capital firm provides the capital and shares in the process of decision-making, while the entrepreneur being responsible for the daily activity of the business, when both are sharing in the profit and bearing the risk of loss in case the venture loses (Kanniainen and Keuschnigg, 2005). Mutlib &Lutfi (2009) argue that the similarities between conventional VC and *Shariah* compliant VC is reflected in the fact that both are equity investment, risk-and-rewards sharing partnerships and that both are long term and value added investment. The only difference between the two is that conventional VC is applicable to all industries, while *Shariah* compliant VC is applicable only in *Shariah* compliant industries. In addition to this point we emphasize that all the methods and instruments of financing applied in the operations of the Islamic VC baked businesses should be *Shariah* compliant if venture capital investment was to be *Shariah* compliant. Al-Suwailem (1998) argues that venture capital, being based on equity financing, falls within the framework of Islamic finance as long as it invests in permissible products and in companies having no interest based financing in its structure. It therefore combines economic viability and Islamic acceptance, which makes it a promising option for Islamic financial institutions (EVCA, 2002).

Notwithstanding the above, the fact remains that the underlying principles of venture capital as a method of finance practiced in the West are not compatible with *Shariah* principles, in particular, with respect to the practices and tools used in the running of the operations of the venture capital backed companies themselves. For example, venture capital in the West usually uses convertible bonds and gets interest based financing to get capital. This principally is not admissible from *Shariah* perspective. Here, therefore, the need arises for the development of a venture capital model that is *Shariah* compliant that we further discuss in section 5 of this paper.

3. Similarities and Difference between Islamic Banks and VC Firms

This section provided to demonstrate that the Islamic Banks can be used in Islamic countries as replacement of Islamic VC. The most noteworthy similarities between Islamic banks and VC firms are at the level of funds collection and agency configuration. Investors in both Islamic banks and VC firms are sharing in the resulting profit or loss according to agreed ratios. In addition, Islamic banks and VC firms also act as agents for their investors/depositors as they both invest the collected funds in different businesses and share a percentage of the profits back with the investors. This is unlike conventional banks which do not actively participate in the businesses they lend, nor are their depositors share in the profit their banks make.

Islamic banks and VC firms both apply the same project evaluation criteria in particular when Islamic banks provide finance on profit-and-loss sharing basis. Both institutions (unlike conventional banks, which apply primarily the criteria of past performance, balance sheets ratios and entrepreneurs' credit-worthiness) look farther than the evaluation of the ability of entrepreneurs to repay but focus as well on the economic viability of proposed projects. Furthermore, Islamic banks and VC firms both apply the rules of loss bearing according to which only capital providers bear resulting loss while entrepreneurs carry the loss of their time and efforts. Mudarabah is the core of Islamic financing and the Two-Tier *Mudarabah* model is the basic theoretical Model used by Islamic banks to structure Venture Capital (Iqbal and Molyneux; 2005); the Two-Tier *Mudarabah* is an equity-based structure used to create asset and liabilities where the Islamic bank is placed between investors and depositors who provide money on one side and borrowers and beneficiaries who require money on the other side. On the liability side, the Islamic bank plays the *Mudarib* role for the suppliers of capital, while on the asset side it acts as the plays the Rabb-al-Mal investor or venture capitalist role, and the business entrepreneur (Mudarib) is responsible for all business operation.

Islamic banks may however be different from VC firms in the use of other forms of financing such as *Murabahah, Istisna* and *Salam*. Islamic banks differ from VC firms in being depository institutions whose financing activities by nature would require short term and less risky methods of financing. This is not the case for VC firms, which by definition are established to pursue higher returns for higher risks. The amount of regulations and disclosure requirements imposed on both institutions stand also to be completely different. Islamic banks being depository institutions would inherently be subject to more limitations with respect to risk taking compared to VC firms. Therefore, the criticism that Islamic banks are not investing the majority of their funds in participatory modes seems unfair. This illustrates the need for a different type of institutions that can assume the role of offering more of profit-and-loss sharing type of financing that the Islamic banks may not be able to offer on as a wide scale as might would be needed.

4. The Current Financing Methods Used by VC Firms and their Compatibility with *Shariah* Rules

This section underlines why Islamic Countries can't use Conventional VC as it is without modification. Conventional VC investment can take different legal forms. The way in which funding is provided to the enterprise will determine many of the rights for the parties involved and the way and the time the VC investors can obtain a return on their investments. In addition, different VC investment structures can have different legal rights and different tax treatment. All of this, of course, depends largely on the law of the country in which VC investments operate. The most common forms of VC investment are equity (shares), convertible debt (a loan that may be converted into shares) and preferred shares. Whereas the concept of common equity shares in general is compatible with the *Shariah* principles, preferred shares and loans with interest are not accepted in Islamic finance. (Jalil, 2005)

4.1 Equity finance

Equity is the simplest form of finance where the investor buys part of the company or the project for an agreed price and become partner by percentage according to his capital contribution. This straightforward structure may be modified so that the investment is made in tranches or (steps). The steps may be benchmarked against the enterprise reaching certain milestones, or may just be related to the passage of time. The subscription price may also be adjusted up or down if, for example, the milestones are not achieved or forecasts are exceeded. The number of future shares to be issued to the VC investor may be reduced, or increased. Such adjustments are commonly called ratchets. Regarding reevaluation of value of shares subscription price according to milestones should be studies further and see its computability with *Shariah* principles and ensure its fairness for all parties (Aggarwal, 2010).

4.2 Convertible debt

For more security than equity investors sometimes prefer to join the company first by convertible debt then if the business nourishes, they transfer debt into equity. The VC investor provides financing to the enterprise as a loan at an agreed interest rate, but the loan becomes convertible into equity in the enterprise (sometimes automatically, at other times upon election of the VC investor). The choice between debt and equity funding, and the election to convert (or not) reflects the choice between the relative priority and certainty of loan repayments versus the upside potential of an equity interest (Aggarwal, 2010). This method by its current practice violates *Shariah* principles in prohibition of interest. Alternatives should be studied and innovation is needed in the Islamic contract to provide another method of financing.

4.3 Preferred shares

VC investors typically require as a precondition to their investment that they receive certain protections and rights that are superior to those of the founders or early angel investors. In most jurisdictions this investment goal is achieved by the VC purchasing preferred shares which rank above to the existing common shares. Preferred shares may give exceptional rights regarding the allocation of proceeds upon a sale, protection against future dilution, guaranteed board representation and certain negative controls. All these also violate the principle of fairness and equal treatment of shareholders in Islamic finance. In Holy Qur'an, Allah say: *"O believers! Do not consume each other's wealth unjustly, but only (in lawful) business by mutual consent"* (Qur'an, 4:29). The lack of multiple classes of shares may be a concern for some VC investors as it precludes the traditional way of structuring deals, where they may require a liquidation preference or preferred return. Therefore, there should be studies addressing the concerns of VC investors and offering suitable alternatives to investors to protect their investment.

4.4 Warrants

Warrants are another issue that may require a fair amount of negotiation at the term sheet stage. Warrants are a type of security that entitles the holder to buy a proportionate amount of common stock or preferred stock at a specified (typically nominal) price for a period of years subsequent to investment. In the VC context, warrants are effectively a form of bonus for the VC investor in the event that the enterprise performs well. Warrants may be requested by early-stage VC investors and are usually issued together with a convertible loan or share investment to act as sweeteners (i.e.to enhance the appeal of investing into a company in its early stages by giving a greater right to participate in the upside, if any). Warrant holders will exercise their warrants and buy shares when the value of the company has increased beyond the exercise price (per share) specified in the warrant. This gives them a larger share in the company at what is effectively a discount price. From shariah perspective warrants are permissible if used as a one side promise provided it underlays an equity type of investment not a loan based finance. However, trading warrants is not acceptable. In Malaysia, the Islamic Instrument Study Group (IISG) at its 4th meeting on 26 July 1995, passed a resolution permitting the use of call warrants on the condition that the underlying shares of the warrants in question(Alsayyed, 2009). In addition to the shariah related issues inherent with the use of warrants there are also legal issues. The use of warrants may be problematic in many MENA jurisdictions owing to restrictions on the issuance of multiple classes of shares, or on the issuance of shares by private agreement, except with the approval of all or a specified majority of shareholders. Approval of the relevant regulatory authority may also be required for the issuance of new shares, notwithstanding prior agreement. (Aggarwal ,2010).

4.5 Liquidation & Sale Preference

VC investors often insist on obtaining a minimum return on their invested capital before other shareholders receive any return. This amount may be equal to the VC investor's investment (or a multiple thereof) and may be triggered by a variety of exit events, or it may only be triggered in a liquidation scenario. Once the investor receives the agreed return, the surplus is distributed, generally, pro rata amongst the shareholders. Liquidation preference is not shariah compliant concept, although equivalent provisions or stand alone agreements can be structured to give effect to this principle. However, these alternatives need be further studied to determine its computability with the Shariah principles. In Holy Qur'an, Allah say *"Give full measure, and be not of those who give less, [26:182] 'And weigh with a true balance, [26:183] 'And diminish not unto people their things, nor act corruptly in the earth, making mischief [26:184]"*

In Holy Qur'an, Allah say Also *"Woe unto those who give short measure; [83:2],Those who, when they take by measure from other people, take it full; [83:3],But when they give by measure to others or weigh to them, they give them less. [83:4] Do not such people know that they will be raised again [83:5]Unto a terrible day[83:6]"*

4.6 Transfer Restrictions (Lock-Up)

A VC investor will often wish to ensure that the founding shareholders and any key persons holding equity are committed to the company for a certain period to ensure their interests remain aligned with the investors of the company. Therefore, it is common for there to be a prohibition on any transfer of shares by the founders or early shareholders for an agreed period (Aggarwal, 2010). This makes common sense as it aims provision of protection for the company viability being in the early stage of business. However, in the context of Islamic finance where the contract of *Musharaka* is used, parties are allowed to withdraw at any time and take their money provided and compensate for any damage caused to other partners. Anyhow, this compensation is required to the extent of an actual damage not a potential one. This condition may be applicable for traditional business but normally not in the case of VC investment where the withdrawal of original investors may cause the collapse of the business. Thus, putting a condition on the contract to prevent this right and locking investors to a certain period of time need further be studied from *Shariah* point of view.

4.7 Non-Compete Restrictions (Confidentiality, Exclusivity, Costs (Break Fees))

VC investors will want to ensure that the founders and management enter into appropriate Non-compete arrangements, especially as in most VC scenarios the value of the company lies with the management and the founders. A VC investor will often want to ensure that it is not incurring the expense in third party advisor fees and time and effort in due diligence and other work if the company is also negotiating with other parties. Accordingly, a VC investor will often seek a period of exclusivity upon signing a Term Sheet where the company is prohibited from seeking investment elsewhere. Break Fees can be used in conjunction with exclusivity but are less common in the MENA region. These require the company to pay to the VC a break fee if it pulls out of the negotiations or obtains financing elsewhere (Aggarwal, 2010).

Non-compete restrictions should be investigated further according to principles of Islamic finance and see its compatibility to *Shariah.* If not, we need to offer solutions and alternatives to these practices because the value of the VC lies on the entrepreneur and the founders and VC investors want to be ensure that they will not compete with him.

5. Proposed Structure for an Islamic Venture Capital Model:

This section shows the fundamental requirements for the establishment of Islamic venture capital and the needed adjustments related in laws for facilitation of venture capital investments. Based on both international standards for investing in venture capital and *Shariah* requirements for investments, we suggest six fundamental requirements for building an Islamic venture capital model. They are as follows:

1- *Shariah* Advisor: whose function is to provide continuous guidance in ensuring compliance with *shariah* investment principles. This is a crucial requirement for any Islamic financial institution.

2-All activities of the company should be ***Shariah* compliant (Note 3)** including the methods of financing. There is a difference between investing in VC as major shareholders and investing in stocks. When investing in stocks, there is AAOIFI resolution which allows investing in companies that have permissible core business but have interest financing, not more than 30% of the capital of the company and also can have some percentage 5% of unlawful business. However, in VC all the business plus the methods of financing should be shariah compliant and this raises the need for innovation to develop financial methods to finance the venture capital investments that are *shariah* compliant.

3- **The financial instruments** provided in venture capital should be fully compliant with major view of Islamic financial instruments e. g., prohibition of trading of debt for at discounted rate.

4- The development of a **robust legal structure** that is complied with international standards. We need a set of laws that respect intellectual property rights and patents. This is particularly crucial because in order to practice venture capital and encourage people to invest, we need first to provide the legal ground so they can feel safe in undertaking shih a risky investment. In addition, some of the laws need to be adjusted like tax law. For instance, laws should consider treating funds used by banks to buy shares in VC firms as 'Mudaraba' financing and therefore are exempt from taxation. Cumming et al (2004) outlined that differences in laws between countries have a significant impact on the governance structure of investments in the VC industry: better laws smooth deal screening, a higher probability of syndication and a lower probability of possibly harmful co-investment, and enable board representation of the investor. Also by providing special courts according to international standards to judge in suits related to venture capital investments. For example, venture capital corporations must be registered under the guidelines for the registration of venture capital corporations issued by the securities commission.

5- **Standardize Musharakah contract** in clearly defined terms as that it is accepted internationally which would insure the rights of stakeholders involved in these contracts. The *Musharakah* contract as it exists now has many technical and ethical problems that make it very difficult to raise financing through it (Choudhury, 2001). It is essential to transform *Musharaka* into truly dynamic nature of shareholding, one that could provide both active participation at the level of decision making and entrepreneurial contributions remains absent, once the powers of decision making are vested with those in authority. VC need more than finance, VC need support specially in the pre seed and seed stage, we recommend that we use Musharaka in all early stages of VC and do not use *Mudarabah* until the company is developed. (Note 4) Because Mudarabah does not give any right of management; and during the early stages of VC there is a need for a partner that can provide both finance and management support for the company.

6**- Providing easy exit from the investment**: Most of venture capital investors need an exit from the investments after a certain period of time. This can be encouraged by making rules, distinctive form stock market, for venture capital companies in which they can easily exit and enter into investments through specialized exchange. Some countries have already taken steps in this direction. Egypt for instance there is Nile exchange for SME, and in Qatar there is an intention to make stock exchange for small companies. These steps are on the right path in creating a suitable environment for VC investments.

The most important issue for any Islamic institution is that the activities of the venture company are Shariah compliant meaning that the underlying assets and investments of the fund must be permissible. Since from the contractual point of view the structure does not raise any Shariah issue, the role of the *Shariah* advisor, if any, would be of screening the investments/projects that most satisfy the *Shariah* requirements. In this process, the consideration of Maqasid al- Shariah, as a tool to sort out the projects to be selected, is crucial. (Dusuki, 2009)

Most important is the issuance of a law of Islamic VC firms, which must provide for conditions of risk, risk exposure, transparency, etc. For the kind of risk that exist in VC, we need special *Wakalah* (power of attorney) that mentions the potential risk, not the normal general Wakalah applied by Islamic banks' *Mudarabah* deposits accounts. (Note 5)

6. Challenges Facing Islamic VC Investments in the MENA Region

Venture capital is still in an early stage in the MENA region. However, there is a massive need in the region for this type of investment given the excessive dependence on the governments in the region for economic development and lack of proper private sectors that can offer decent employment for youth and contribute in process of economic diversification. Modern economies are knowledge based, and the only way to progress in this type of economies is by opening doors for the private sector and engaging financial institutions in the economic process, in particular, Islamic financial institutions. The reality reflects that more than 70% of financing done by Islamic banks are through *Murabaha* (Ali Salman Syed, 2011; Ayinde, 2012) and not through participatory contracts such as *Musharakha* and *Mudarabha* as the latter being inherently of risky nature and therefore are not suitable for the banking business model.

Therefore, the need arises for the development of other institutions to undertake this type of risky financing. One of these institutions may be Islamic VC institutions. However, before this can be envisaged taking place in reality there are various challenges that may encounter the development of such institutions, which we outline as follows:

1- Lack of transparency and uniform legal framework creates substantial obstacles for foreign ownership and representation in the target investee company. Also, the lack of the legal structure that respects the intellectual property rights and respects patents. In addition, there are no specific laws or courts to judge fast in cases of dispute between partners like in VC or traditional Islamic *Mudarbaha.* There is no clear cut between what is considered misconduct from *Mudarib* and what is not.

2- Lack of know-how and education among investors about VC investment and it is returns and risks. Moreover, there are few cases of VC in MENA region if it is compared to US. This few cases make most investors not experienced with VC investment and most of them prefer to invest in real estate or stocks. By nature people like to invest in what they know and what they saw other people are investing and profiting from it. "The lack of many established success stories in the region creates a barrier for potential entrepreneurs to 'take the plunge' and start companies". The fear of failure hinders many of the people in the region from taking actual steps in converting their ideas into reality. The most successful entrepreneurs around the world fail several times before they reached success, so the taboo of failure need to be broken by the presence of successful local examples of entrepreneur in the region (Gelderen,et al. 2006).

3- Lack of educational programs that train young people on how to develop their ideas and become entrepreneurs. Young people in the MENA region have the enthusiasm to take part in the economic development process of their countries, but the problem is the lack of suitable culture and channels that facilitate turning these ideas into real projects

4- *Shariah* issues on some transactions of VC like preferred shares or forward contracts can hinder the growth of VC if alternative *shariah* compliant tools remains underdeveloped.

5- Lack of the support and backing from the government in terms of incentives, tax exemptions etc., and 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, (Mutlib &Lutfi, 2009)

6- Weakness of the region's primary stock market comparing to the secondary market as there is nearly few primary public offerings for new companies in the region.

Although these challenges could be seen as an obstacle for developing VC, but on the other side there is enormous untapped potential for VC in the region. The MENA region is being seen developing in fast pace and has strong economic fundamentals and strategic location that can enable it to become a well-developed economic center that can attract investors from all over the world. In addition to that, the percentage of youth in the population is high compared to other countries. For all of the above, we believe would give the region a competitive advantage to be a hub for VC investment.

7. Proposed Approach for the Promotion of Islamic VC in the MENA Region

To overcome the challenges mentioned above and promote Islamic VC in the MENA region we in this section propose the following remedial action plan.

Bring about agreements between *Shariah* scholars about *fiqhi* controversial issues about business and finance and develop a common thinking platform that is based on the objectives of Shariah. Dusuki (2010) argues that the substance of the contract that has greater implications to the realization of *Maqased Al-Shariah* should be studied carefully. He further argues that some innovations in Islamic finance that try to achieve the same economic outcome like conventional instruments distort the vision of Islamic economics based on justice and equitability. Overemphasizing of the firm over the substance leads to potential abuse of *Shariah* principles in justifying certain transactions.

2- Offer educational programs on VC investments in colleges and universities and educate investors about the returns and risks characteristics of this kind of investment.

3- Develop special stock markets that facilitate easy exit for VC investors. Without clear exit roots, VC cannot be provided efficiently (Khan and BenDjilali, 2002). These specialized stock markets need to have specific rules other than traditional stock exchange to prevent speculative activities.

4- VC investments are sophisticated and risky ones that invest in ideas and not in projects. It is extremely difficult for individual investors to take the first move in embarking on VC investments especially in the MENA region because there is no past successful experience (Al-Rifai et al.2000),. Therefore, in the MENA region especially in GCC, the sovereign funds should take the first move to invest part of money in VC projects and establish the environment to set successful model in the region for potential investors. Brander, et al. (2010) analyzing international company-level data show that government VC activity has a significant and highly non-monotonic amount of GVC investment appears to be a good thing, increasing the likelihood of successful exit though they also argue that larger amounts of GVC activity appear to be counterproductive.

5- The cornerstone of establishing a new industry in any region is knowledge. The knowhow therefore is tremendously valuable and crucial. As mentioned before education is tremendously influential but it cannot alone do the job. Bringing experienced VC investors in the region and make them take the first step in the development of a VC industry in the region would certainly bring about success. The region needs to attract direct foreign investors, which would help transfer technology and knowledge into the region.

Due to the availability of excess liquidity plus tax benefits the GCC countries have an excellent opportunity to become a hub for VC investments attractions. However, GCC countries need to increase their venture capital investments through their sovereign funds, increase their investment in education and support a culture of entrepreneurship and business innovation in their economy. The development of Islamic Venture capital in the GCC would provide many benefits, such as diversification of economic activity and decrease dependence on gas and oil sector.

8. Potential steps that can be done by government to support the VC.

1- The academic research should be directed towards applicable projects that the country needs. This will increase the available jobs for Islamic nation and also help diversify the economy of Islamic countries.

2- Reduce the failure rate of small startups by providing technical advice from experts and providing education to junior investors.

3- Making nurture creative entrepreneurs program which not only provide finance but provide education and tools to develop the skills of young entrepreneurs.

4- The government needs to take the lead by supporting 3-5 big VC projects, the success of these projects would encourage investors to follow the government steps. (Cumming, 2006)

5- Government has to start Science and Technology Park everywhere in the country which can be considered as an incubator for new ideas and to provide full support by proving funds based on partnership and also experts and knowledge. (Wallsten, 2004)

9. Conclusion and Recommendation

Islamic venture capital, if practiced correctly would have substantial benefits on the economy of the Islamic countries. This will able the countries to diversify their economy, support the innovative youth and increase the wealth and prosperity of the country. GCC countries have the financial ability that can make them hub for islamic venture capital investments. The only factor that makes them lag in this area is the shortage of the healthy infrastructure that can help these investments to nourish. So we need to build the legal and economic structure to be able to make the technology in Islamic countries and transfer them from countries that consumes technology to countries that export technology. The first step to build infrastructure of Islamic VC is to regulate it through certain organizations and to make guidelines. The guidelines of Islamic Venture Capital should set out the best practices which are needed to be followed by VC investors. An independent *Shariah* adviser must be appointed to provide expertise and guidance on conformance to the *Shariah* principles, and to ensure that all the activities are compliant with all aspects of the Islamic venture capital business activities including portfolio management, trading practices, and other administrative and operational matters are in accordance with *Shariah* principles.

The failure rate of small firms is high; the main reasons for failure are the poor quality of the original business idea and management shortcomings. The founders often find it difficult to attract human capital as the firm develops. The focus of VC community is entrepreneurial firms with a desire to achieve rapid growth. The successful winners like Microsoft or Google succeeded due to a combination of factors: satisfying underserved customers by current products, adding value to the customer, offering innovative solution and dominating the market segment in which they compete. There is no single road to success, and the combination of several factors plus being dynamic and flexible to do change as the business develops and market circumstances alter. That is why firms in startup phase need VC and not just money.

VC plays a crucial rule for established firms that have the potential to achieve success yet they encounter barriers to growth due to shortage of internal finance. VC is an ideal solution for providing finance for these firms because getting external finance from conventional banks will be very costly and sometimes difficult to get. The idea of partnership is originated from Islamic finance and practiced long years ago through *Musharakah* and *Mudarabah* contract. VC can play a vital role in bringing these contracts back into practice. VC is a win-win situation, it offers entrepreneur the opportunity to put their ideas into practice and also offer investors high return on their money.

Europe now is facing a financial crisis due to the expansion of some countries in sovereign debt and this will have a global impact and will affect the growth of the world's economy and will cause a raise in unemployment rate worldwide. Also the Europe crises can affect badly debt based financing like what happened in 2008 financial crises. VC can play a vital role in supporting the economy by providing finance and support for private sector and help creating more jobs (Chemmanur, et.al, 2008).

Equity based financing including VC financing can decrease the unemployment rate in Arab region and increase the wealth and prosperity in these countries. The initial step of any new idea is very difficult so these steps should be done by the government and any big investors to form the environment that is suitable for such a kind of investments (Belke, 2003).

Venture Capital is still in an early stage in the Islamic countries. There are massive needs in the region due to the large dependent on governments for development of the economy, and lack of proper private sectors that can offer decent employment for youth and also share in diversification of the economy rather than dependence on government jobs.

The Motivation of this study was developed because the VC idea was originated from Islamic finance and is considered as a support for the core idea of profit and loss sharing. There is no reason why Islamic countries should not benefit from it as much as the West has done. At same time there is an extremely high youth unemployment rate of 23.4 per cent in 2010 in Arab countries according to International labor of organization and this ratio increased to be more than 30% after Arab Spring. This is due to few numbers of SME companies and inability of governmental sector to offer jobs for all youth. There is Lack of proper Legal infrastructure to attract venture capital investment in Arab countries and also for attracting of direct foreign investment. The Study aims to offer the fundamental requirements for building an Islamic venture capital model.

In this study we clarify why we need VC investments, we proved that the Islamic bank can't play the same role, more than 70% of financing done by Islamic banks are through Murabaha. Because the nature of their deposit accounts and of supervisory regulations, Islamic banks cannot afford to have a high risk, while VC institutions are founded on the basis of bearing high risk. This point illustrates the inability of Islamic banks to do a lot of PLS financing. Because of the nature of Islamic banks as depository institutions, there is a need for different institution that can play this role and offer PLS financing on a wide scale.

The study discusses the most common conditions put in the conventional VC contract in the west, and examine its *Shariah* compatibility. such as Warrants, Liquidation & Sale Preference, Transfer Restrictions (Lock-Up) and Non-Compete Restrictions (Confidentiality, Exclusivity, Costs (Break Fees)). The study recommends six fundamental requirements for the establishment of the Islamic venture capital model in section 5.

In section 6. The study discusses the challenges facing Islamic VC, also we offer an approach to overcome these challenges and promote Islamic VC in Islamic countries in section 7. Finally the study suggests the in section 8 the Potential steps that can be done by government to support the VC.

10. Recommendation

The conventional venture capital investment as discussed in this paper is fully complying with core principles of Islamic finance. We highly recommend for future researches to build an Islamic model while avoiding all problems encountered in each and all Stages of VC Investment such as (Seed capital, Startup phase, Expansion and development and IPO), so that we rich a better *Shariah* compliant model as raised in this paper.

Moreover, in any investment we used to use CAPM model to evaluate the project in order to accept or reject; and we stressed only on its rate of return and risk regardless of other factors, however, there are other factors that are very important to look for when we evaluate Islamic VC These factors become visible after 2008 financial crises and were clearly illustrated in Islam hundreds of years ago such as effect on environment, long term effect on macroeconomics of country and effect on financial stability and what is the added value of the project offer than the already existing ones in the market, These factors should be considered as the ethics of investment in Islamic finance in our modern society. We have to consider these factors and implement new models than CAPM that can take these factors into consideration.

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Notes

Note 1. As shown in the study of Ali Salman Syed, (2011). Islamic banking in MENA Region, IDB- Islamic Research and Training institute. He shows that over 70 % of bank assets are Murabaha which is sale contract.

Note 2. For more details please refer to paper by author “Venture Capital: Survey of the Economic Impact and the Determinants - Empirical Evidence from Egypt.” Working paper, Alexandria University, Egypt.

Note 3. Non-permitted Shariah activities include: Financial services based on riba (interest) - Gambling/ gaming - Manufacture or sale of non-halal products or related products - Conventional insurance - Entertainments that are non-permissible according to Shariah - Manufacture or sale of tobacco-based products or related products - Share trading in Shariah non-compliant securities - Hotels and resorts with non-Shariah compliant activities.

Note 4. Both *mudarabah* and *musharakah* are equity -based, profit sharing structures, although there are some key differences between the two forms of funding. The main difference is that the entrepreneur offers no capital contribution in *mudarabah*, and therefore s/he is not liable to incur any financial loss apart from losing his/her effort (cost of labor) if the venture fails. Moreover, the financer is not authorized to participate in the management of a *mudarabah* project hence this form of financing carries a greater degree of risk. In a project financed by *musharakah*, the financer has right to participate in management unless it deliberately waives the right to do so.

Note 5. Ali Salman Syed, (2011). Islamic banking in MENA Region, IDB- Islamic Research and Training institute.