Instruments for investment protection when structuring Islamic venture capital

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Instruments for investment protection when structuring Islamic venture capital

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Abstract

Purpose – This paper aims to explore how Sharīʿah-compliant instruments can be used to protect investments and attract investors to Islamic venture capital (IVC). Equity investments in Islamic finance are trailing behind their potential value. This is partly due to the limited instruments available to protect investors, as most of the tools used in conventional venture capital (VC) are deemed Sharīʿah non-compliant.

Design/methodology/approach – The research amends and uses Wright Robbie's (1998) VC structure and how it can be used to finance small and medium-sized enterprises (SMEs). The study uses secondary data reported in the literature and the expertise of the Sharīʿah scholarship.

Findings – There are Sharīʿah-compliant instruments available for IVC that can be used to protect investments and incentivize potential investors to promote investments in SMEs. At the various stages of the IVC process, preference shares, perpetual *mudharabah*, diminishing *musharakah*, *musharakah* with *murabahah*, *musharakah* with *qard*, negligence clauses, liquidation preference, warrants and supermajority clauses can all be used with appropriate conditions to protect investors and offer incentives for them to invest in IVC.

Practical implications – The research provides a method for screening and evaluating potential deals for SMEs using an amended VC called an IVC scheme with a focus on Sharīʿah-compliant investment protection instruments. The method can promote SMEs and entrepreneurship and financial inclusion for Sharīʿah-compliant investors.

Originality/value – This study contributes new ideas to how IVC can be structured, taking into consideration Sharīʿah constraints. The paper addresses investors' protection and incentives to attract Sharīʿah-compliant investors, which have been lacking in the literature.

Keywords Islamic venture capital, Small and medium-sized enterprises (SMEs), Investment protection, Equity finance, Islamic finance

Paper type Research paper

1. Introduction

Economic development requires financial resources, and Islamic financial institutions have an essential role to play as financial intermediaries to provide needed credit to businesses. Expectations are that Islamic finance is superior to conventional finance because it is based on the real economy. As a consequence, Islamic finance promotes economic development, especially when we consider its social aspects with multidimensional, not just one-directional profit-driven objectives as in conventional finance (Nienhaus, 2014). Gümüsay (2015) posits that entrepreneurship from an Islamic perspective is manifested in the pursuit of business opportunities in a socioeconomic and ethical manner with the ultimate goal of

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pleasing Allah. Profit-making is one of the goals of an Islamic entrepreneur and awareness and pursuit of other objectives is sacrosanct as expressed in *maqasid al-Sharīʿah* (MaS) [1].

Among the reasons that limit access to finance is the exclusion of certain segments of the population either because of religious beliefs (such as *riba* prohibition) (FSA, 2000) or because of their economic vulnerability (Beck *et al.*, 2007).[AQ1]

Critics observe that, after existing for several decades, the Islamic financial sector has done little beyond providing Sharīʿah-compliant alternates to conventional financial products that address businesses and financially well-equipped individuals. This observation is confirmed by several studies, including Gan and Kwek (2010), Chong and Liu (2009) and Nienhaus (2014).

Despite their strategic role in economic development, small and medium-sized enterprises (SMEs) including start-ups in many economies are usually not supported by banks because of their perceived high risks. Beck and Demirgüc-Kunt (2006) and the IFC (2012) have demonstrated that there are many challenges impeding the growth of small enterprises, chief among them being inadequate access to formal credit.

Venture capital (VC) is one of the forms of business finance that can be used to support SMEs to grow. Some empirical results show that VC has a significantly positive correlation with enterprise performance. This indicates that the participation of VC can promote the improvement of enterprise performance and business continuity (Yang *et al.*, 2016). Anwer (2019) asserts that conventional VC can be modified to form an Islamic venture capital (IVC) system.

This paper aims to explore how *Sharīʿah*-compliant instruments can be used to protect investments and attract investors in IVC. The motivation for this study stems from the fact that on the one hand equity investments in Islamic finance are trailing behind their potential value and on the other hand most of the instruments used to protect and attract investments in a conventional VC endeavor are deemed Sharīʿah non-compliant.

This research amends and uses Wright Robbie's (1998) VC structure and how it can be used to finance SMEs. The study uses secondary data reported in the literature and the expertise of the Sharīʿah scholarship. Investors in an IVC opportunity face the risk of capital loss, as well as Sharīʿah non-compliant risks and these must be addressed when structuring IVC prospects (Anwer, 2019).

There are *Sharīʿah*-compliant instruments available for IVC that can be used to protect investments and incentivize potential investors to promote investments in SMEs. At the various stages of the IVC process, preference shares, perpetual *mudharabah*, diminishing *musharakah, musharakah* with *murabahah, musharakah* with *qard*, negligence clauses, liquidation preference, warrants and supermajority clauses can be used with appropriate conditions to protect investors and offer incentives for them to invest in IVC. The remainder of the paper is organized as follows. The next section reviews the literature on structuring, accompanied by an illustration of the structure of IVC funding as the research methodology for this study in Section 3. Section 4 analyzes the research findings and this is followed by conclusions and suggestions for further research in Section 5.

2. Structuring venture capital products for financing small and medium-sized enterprises in Islamic finance

Islamic finance forbids *riba* and advocates financing linked to the real economy, which usually comes with risks. Equity financing leads to the efficient allocation of resources as profitable businesses are financed, but this is only feasible when there is low information asymmetry as put forward by Khan (1989). Some studies have argued that the equity financing of SMEs is helpful for their growth and survival. Barry and Mihov (2015) conclude that businesses backed by reputable venture capitalists perform better.

At the broader level of Islamic finance's development, of all the various Islamic finance contracts available to Islamic financial institutions, Islamic scholars advocate for the non-debt mode of financing (Azmat *et al.*, 2015). The assertion is that equity financing is considered a blessing (Iqbal *et al.*, 1998). Additionally, profit and loss sharing in finance is believed to drive a more equitable distribution of wealth (Usmani, 2002).

Azmat *et al.* (2015) posit that, aside from the asymmetric information problem used as an explanatory cause of Islamic banks' negligible use of equity financing as argued by Khan (1989), the issue of risk aversion among bank depositors needs to be considered. Islamic bank depositors behave just like conventional banking depositors with risk-averse utility functions that prefer a stable return on their principal (Azmat *et al.*, 2015). Consequently, they would patronize Islamic banks whose financial asset side is dominated by fixed-income assets. Moreover, even when they decide to invest in an Islamic bank with a dominating equity investment, they would demand higher rewards in the form of high-risk premiums (Azmat *et al.*, 2015). The study concludes that there is a need to shift toward offering equity investments through VC and private equity (PE). This would provide investors with a more precise choice of risk and return. This will be the requisite incentive for designing products that will be motivated to attract long-term investors, particularly institutional ones, and thus have some limitations on fund withdrawals. This conclusion concurs with Asutay (2012), who asserted that based on Islamic moral economic values, Islamic finance should develop capacities and empower individuals and societies, as the majority of Muslim countries are in their development phase. In addition to this, there is a crucial need for the development of non-banking Islamic financial institutions and instruments to address the entrepreneurship and developmental needs of these societies (Marzban *et al.*, 2014).

VC in Islamic finance is not common, even though the core principles of equity investment resemble much of those underlying financing that is based on *mudharabah* and *musharakah*. From an Islamic point of view, VC equity financing (*sharikat al-inan*), falls within the framework of Islamic finance once the underlying investment is deemed permissible by *Sharīʿah*.

An IVC can be established as a company under *musharakah* or *mudharabah* and operates by attracting funds from potential investors into an IVC fund, going on to invest these funds into viable SMEs and start-ups. The most appropriate contract that an IVC can use is *musharakah* because VCs always take part in the management of investees' businesses. In a situation where the IVC invests in a venture through *musharakah*, the IVC can engage an expert to represent its interest in the venture through *wakalah*. This means that the IVC will exercise its strategic decisions through the agent. The agent may either share in the profit or be paid an agency fee for its services to the IVC.

3. Structuring of Islamic venture capital funding as the research methodology

Whichever fund structure is adopted, in IVC a contractual relationship is formed between the fund managers as *mudharib* or *wakil* (agent) and the capital contributors as *rabb al-mal*. VC contributors are typically high net worth individuals and institutional investors taking high risks and seeking long-term investments, who target capital gains to match their future liabilities. Fund management teams have to protect their investors' funds but still invest in projects with a capacity to generate the targeted rates of return. Islam allows fund managers to charge fixed fees and variable elements (tied to profits) within an overall compensation package. The well-established limited liability partnership form of legal structure could, thus, offer real benefits for the development of IVC. Resolution documents of the International Islamic Fiqh Academy of the Organization of Islamic Cooperation (OIC) assert that a *mudharib* can earn a profit based on a fixed percentage of profit but should avoid any clause that guarantees returns, as, "if such clause is implied explicitly or implicitly, the guarantee condition is voided", (OIC FA resolution number 30 (5/4), 1988).

Figure 1 illustrates the typical VC process from the fundraising stage to the post-exit engagement by Wright Robbie's (1998). This model recognizes the dynamic nature of the VC process and by so doing contends that VC can reinvest in an entrepreneur that has exited. This model is adapted in this study in the structuring of IVC in Figure 2 with accompanying investment protection tools. After sourcing funds for VC (which may come from high net worth individuals, institutional investors and development organizations), the IVC process is set to move to the next level of deal generation. Each venture fund develops its own distinct strategy for potential sourcing of deals. The long-term investment goals might lead a fund to identify the sector, size of target projects, location and stage of investment. When deals are generated, the IVC then carries out an initial screening of the proposals received to identify the bankable ones that meet their investment criteria. The business plan is interrogated to gauge its quality with regard to the business it is seeking to undertake. The next stage is to conduct due diligence, which is carried out to minimize investment risk. This is done through the investigation of the information presented in the business plan by the entrepreneur. Particular attention is usually paid to the qualities of the entrepreneur or management team, the product and market potential and the scalability of the business. After this stage, the venture goes through valuation using various valuation models and is then moved to the structuring stage. The structuring stage is one of the critical steps in VC financing. The venture capitalist at this stage is able to approve the proposal. However, the fund manager and potential investee company still have to negotiate the deal. The venture capitalist's preoccupation is to achieve the required rate of return taking into consideration the high risk of the investment. At the same time, the entrepreneur does not want to give up too much ownership or be subject to excessive constraints in the running of the firm. The fundamental objective is to ensure that all parties are "comfortable with their positions"

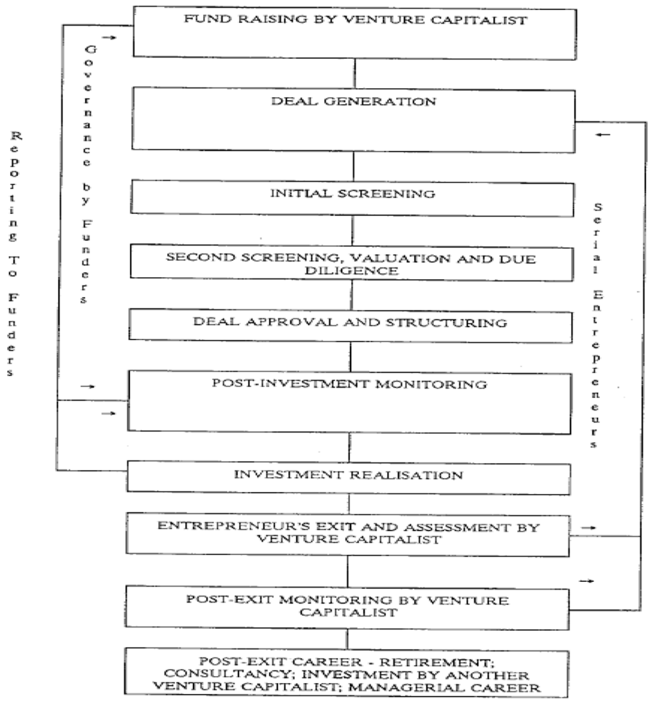
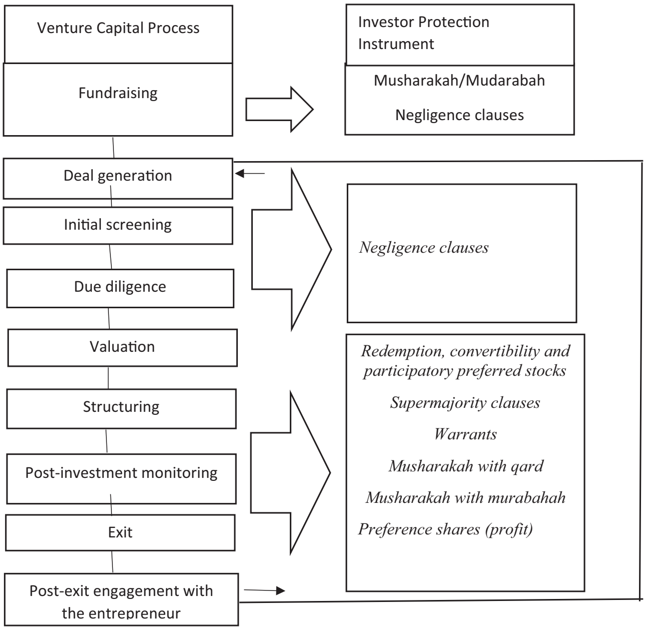


Figure 1.
VC process according to Wright Robbie (1998)



Source: Structure adapted from Wright and Robbie (1998)

Figure 2. IVC process and investor protection instruments

(Gibson and Blake, 1992). This stage of the investment cycle involves the consideration of three broad areas:

(1) The types of financial instruments used (equity, preferred stock or debt);

(2) The specific covenants included in the subscription agreement; and

(3) The release of funds in stages to limit the downside risk of any investment.

Post-investment monitoring and exit are also critical VC processes as they ensure that the investee company generates the targeted value, minimizes any moral hazards and realizes its desired return at exit.

Exits represent the point at which exposure to an investee company is partially or fully reduced, giving way to the realization of value created in the investee company by the fund manager and investors (Povaly, 2006). Exits provide an opportunity for capital providers to assess the fund management skills of the VC manager and the profitability of the investee business relative to other investments (Gompers, 1996). Typically, a VC fund has an investment holding period of 7 to 10 years (Xu, 2004). One can infer that the existence of an exit route for the VC is considered to be an essential factor in deciding whether to invest in a firm or not. Successful exits are critical to ensuring attractive returns for investors and, in turn, to raise additional capital. Black and Gilson (1998) and Cumming and MacIntosh (2003) report five principal VC exit vehicles, including initial public offerings, acquisitions, secondary sales, buy-backs and write-offs.

In most developing countries, including Muslim countries, VC exits remain a challenge because of the limited availability of options. This can be attributed to the undeveloped nature of the capital markets in these countries. This may require government support without which investment exits may face serious difficulties. For instance, in Qatar, the Qatar Development Bank supports start-ups to become listed on the Qatar Stock Exchange to achieve economic diversification and establish a vibrant private sector in the Qatari economy (Shoeb, 2017).

Serial entrepreneurs who have exited a VC-backed business successfully may attract another round of funding from VC in the post-exit engagement.

The various VC processes give rise to risks associated with potential capital loss and the need to incentivize investors to take these risks. Islamic finance contracts and tools can be used to protect investors against exposure to risks. Negligence clauses are applied alongside *musharakah* and *mudharabah* to protect investors from the risk of capital loss due to a *mudharib's* negligence, as well as to minimize moral hazards on the part of the entrepreneur. Figure 2 shows the various *Sharī'ah*-compliant instruments that can be used to protect investors and to offer incentives for them. Redemption, convertibility and participatory preferred stocks, supermajority clauses, warrants, *musharakah* with qard, *musharakah* with *murabahah* and preference shares (profit shares) are used as shown in Figure 2.

4. Sharī'ah-compliant investor protection instruments

According to the International Monetary Fund (IMF), *Sharī'ah* principles, on which Islamic finance is founded, have inherent features that potentially promote the protection of consumers and investors. In particular, Islam prohibits transactions based on *gharar* (uncertainty in transactions), gambling (i.e. any acquisition of wealth by chance instead of exchange/effort) and *riba*. These principles are beneficial for financial stability and consumer protection [2]. The IMF has further observed that features alone cannot ensure consumer protection. Islamic financial products are provided within the same moral, regulatory and economic paradigm as conventional products and not all providers of Islamic financial products are motivated by religious or ethical precepts.

Traditional VC uses a variety of financial instruments to structure a transaction to protect capital and incentivize investors. These instruments are driven by the need to limit the risks that entrepreneurial actions may expose the investment to and avail of some tax benefits that may be available in the country. These include different classes of preferred stocks, debt, warrants, blends of common stock and other instruments (Al-Rifai and Khan, 2000). These instruments allow investors to allocate risk, establish ownership rights, control management and provide them with incentives. Some of the structures used in VC were initially developed for tax efficiencies (Gompers, 1996).

The standards for modern corporations of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) allow for the mixing of conventional and Islamic investors in IVC but they prohibit commonly used preferred share structures. The AAOIFI's *Sharī'ah* Standard number 12 covers types of *musharakah* arrangements that IVCs can use in traditional limited partnerships. Protecting investors and incentivizing entrepreneurs to perform poses a challenge for IVC. This may lead to the attraction to conventional VC over IVC arrangements when incentives primarily drive investors.

All financial contracting confronts three fundamental problems, namely, uncertainty, information asymmetries and agency costs (Gilson and Schizer, 2003). The guiding principle in structuring IVC arrangements is *Sharī'ah* permissibility such that any instrument or structure used should not directly or indirectly lead to guaranteeing capital or returns. According to Thompson Reuters (2016):

> The main issues relate to guaranteeing capital or returns, and preference for certain parties in case of a loss. As long as these issues are not being circumvented, most of other VC norms can be adopted in a *Sharīʿah*-compliant manner [3].

There are several issues and requirements that need to be considered in IVC when it comes to *Sharīʿah* compliance and screening. This includes the concept of preference in equity, financial leverage constraints and the necessary purification processes for VC funds and their intended portfolio companies (Derigs and Marzban, 2008).

VC funds depend hugely on preferred shares to protect investors against expropriation and to finance the many stages of financing for their portfolio companies. Redeemable, convertible and participative preferred shares, which usually provide investors with a liquidation preference, are often used.

From a *Sharīʿah* perspective, preferred shares are considered non-compliant as defined by AAOIFI Standard Number 21, Article 2/6 which reads that:

> It is not permitted to issue preference shares that have special financial features leading to granting priority to these shares at the time of liquidation or preference in distribution of profits. It is permitted to grant certain shares features related to procedural or managerial matters like voting rights, in addition to the rights attached to ordinary shares.

Similarly, in 1992, the Islamic Fiqh Council of the OIC ruled against a preferred stock.

Redemption preference in stocks – Redeemable preferred stock does not have any right of convertibility into equity. Its value is its face value plus any dividend rights (Gompers and Lerner, 1999). Redeemable preferred stocks act more like subordinated debt than equity. The stock carries a negotiated term specifying when the investor redeems it, most likely the sooner of a sale or public offering or after a given number of years. It is used in PE transactions in conjunction with common stocks or warrants.

Convertibility preference in stocks – According to Al-Rifai and Khan (2000), convertible preferred stock is a stock that can be converted at the shareholder's option into common stock. In this situation, the shareholder must choose between the redemption of their preferred shares at face value or convert them into common stocks. If the value of the stock is worth more than the face value of the preferred shares, the shareholder will convert to common stock and realize a gain in value.

Participating convertible preferred stocks – Participating convertible preferred stock is the same as convertible preferred stock with an additional feature. In the event of a sale or liquidation of the company, the shareholder has the right to receive the face value and the equity participation as if the stocks were already converted (Al-Rifai and Khan, 2000). Thus, the shareholder does not have to decide between redeeming or converting since any increase in value over the face amount would be given to the investor in the form of common stock or a cash equivalent. This means that the stockholders own the stocks from day one.

Looking at these from the perspective of *Sharīʿah* compliance, redemption, convertibility and participating convertibility do not pose any infringements on the rulings of both the AAOIFI and the OIC Fiqh Academy as these are procedural preferences and not any direct financial preferences.

Preference shares – Preference shares, depending on how they are used, can be instrumental in structuring IVC investments. Redeemable preferred stock, as explained earlier, sets the period when the stockholder can redeem it. This class of preference shares is permissible provided the dividend distribution follows best accounting practices (i.e. not set at a given value). This is because if profit/loss are rightly distributed every year, the amount of principal remains the same and, of course, the loss is either charged to previously retained profit or paid-up by new funds from investors. The preference stock then amounts to the temporary stock based on temporary *mudharabah/musharakah*. Similarly, the convertible preferred stock provides the opportunity for converting preferred stock to common stock. Indeed, if the stock is converted to common stock, there is no problem of *Sharīʿah* impermissibility as far as it is agreed upon between partners. With participating convertible preferred stock, the shareholder does not have to decide between redeeming or converting the stock since any increase in value over the face amount would be given to the investor in the form of a price increase of common stock or its cash equivalent. This means that the stockholders own the stocks from day one, and hence they are *Sharīʿah*-compliant.

Certain kinds of preferences can be used in IVC arrangements because there is no blanket prohibition on preferred shares. Also, a sort of financial preference is suggested by Zarqah and Suhaybani (2012). They argue that preferred stocks are prohibited because a preference for profit may result in the interruption of profit sharing and in the form of secured return because of *riba*. Additionally, preference at liquidation diverts preferred shareholders from partners to lenders. To meet the permissibility of *Sharīʿah* there has been suggested a *Sharīʿah*-compliant preferred formula based on splitting profit flows into two streams. One would be less risky than the other, thus enabling companies to attract new investors with different risk preferences or expectations. Accordingly, profit sharing can be differentiated for common stockholders and preference shareholders. They concluded that insofar as the profit share of the preference shareholders (say 5%) does not exceed the maximum profit share of the preference shares (i.e. the preference share's profit cannot be more than the total profit declared), then it is allowed. Usually, preference shares that are issued contain the equity's dividend rate and par value in the preferred stock. The dividend rate is multiplied by the par value of the share to get the dividend payment for a particular period. Concerning the proposal by Zarqah and Suhaybani (2012), let us assume that the preference shares are 500 (5%), common stock is 1,000 and profit for the period is 40. Under the normal conventional arrangement, the preference shareholders will be entitled to 25 (0.05 of 500) irrespective of the profit level of the business. However, under the new proposals, the dividends are tied to the profit declared. For instance, with US $40 profit the preference shareholder will receive US$25. In a situation where the profit reported is US$20, the preference shareholder cannot receive US$25 as dividends. There can be a condition that provides for the maximum profit share that can go to the preference shareholder (e.g. it can be capped at 65% of the declared profit).

Liquidation and sale preferences – It is a standard practice for conventional VC investors to insist on obtaining a minimum return on their invested capital before other shareholders receive any return. This structure provides an opportunity for investors to recoup their investments (Rashid, 2005). Liquidation preference is deemed as *Sharīʿah* non-compliant.

If the IVC contribution is based on *mudarabah* with no contractual value set to the contribution of the already existing investing company (the *mudharib*), it can be argued that in the case of liquidation *Sharīʿah* requires "securing the *mudharabah* principal" before any return distribution to either party (before the recognition of any rewards generated for the managing party).

Partners must share equally in all assets of the venture. It is instructive to note that when *murabahah* or *istisna'* are used as part of the transaction where the IVC investor is a financing party, then it is permissible to prioritize the principal payment at liquidation. For instance, if the IVC investor finances the purchase of equipment through *murabahah* and there happens to be a liquidation, the *murabahah* debt has to be settled first before other tangible assets are distributed to capital contributors. Additionally, investors can ask for some sort of security against negligence or breach of the terms of the contract on the part of the entrepreneur/manager. This can only be done in regard to agreed principles of business practice (Lawal, 2016) but cannot be based on the target rate of return.

Transfer restrictions – Usually, IVC investors will wish to get a guarantee that the founding shareholders and any critical partners of the venture are committed to the company for a certain period to ensure alignment of the vision of both the management and the investors of the company. It is common to provide for a prohibition on any transfer of shares by the founders or early shareholders for an agreed period to achieve this (Aggarwal, 2010). This aims to ensure that a company's viability in the early stages of its business is not circumvented. In the context of Islamic finance where any sharing (*musharakah, mudharabah or muzara'ah)* contract is used, parties have the free will to withdraw at any time and take out their capital as valued at the time of withdrawal. However, they are required to compensate for any damage caused to other partners. This principle is essential in *Sharīʿah* as it is founded on the fundamental human rights of private ownership of property and freedom of disposition. Thus, putting a condition on the contract to prevent this right to transfer and consequently, locking in investors or entrepreneurs to a specific period may seem to violate this principle as suggested by Elseify (2014).

However, a closer look at the position of the OIC Fiqh Academy regarding common stock companies is that it recognizes the consensual and contractual commitment of shareholders to non-withdrawal and accepts other consensual restrictions on personal disposition. This indicates that *Sharīʿah* accommodates self-imposed consensual limitations, especially when such limits are crucial for the decisions undertaken by other partners in sharing contracts, since personal qualifications and considerations are always an essential part of the contractual relationship (Resolution number 77 (8/8), June 1993).

Supermajority clauses – Supermajority clauses with more substantial voting majorities (other than the simple majority for specific business decisions) could be used to protect investors. The entrepreneur does not command a supermajority of voting rights when this instrument is used (Thompson Reuters, 2016). This means that even if the venture capitalist has a minority shareholding, it can still influence individual critical business decisions within the premise of protecting its investment.

Decision-making can also be regulated so that the entrepreneur cannot immediately try to give the company a way to another investor and benefit disproportionately from their capital contributions. Withdrawal, although available on-demand to all partners, can be consensually limited within the application of the principle of "no harm and no reprisal by counter-harm." Partners are also enjoined to give due notice to other partners. In a case of withdrawal by any partner, the obligations and actions that preceded the termination of the *sharikah* are binding on all partners (AAOIFI, 2010, p. 209, standard number 12).

Warrants – Typically, in conventional finance, a warrant is an option that allows the bondholder, during a given period, to purchase the firm's common stock at a specified price. This purchase price is typically below the expected future stock price (Reilly and Brown, 2012). In VC structuring, warrants are used as mechanisms for entrepreneurs to grant the VC investor that option without obligating the investor, under limited situations, to exercise the warrants when desirable. The conditions under which the warrants would be exercisable would have to be sufficiently narrow to avoid the VC investor using the warrants to capture more of the gain from the company's success than they were entitled to under the original agreement (Thompson Reuters, 2016). As merely a one-sided promise to sell, a warrant can be issued according to the OIC Fiqh Academy resolution but cannot be traded as it represents a right to buy stocks at an exercisable price (Resolution number 40–412/5 and 3/5).

Diminishing musharakah – A diminishing *musharakah* makes provision in the agreement for the VC capitalist to offload their stake over time to other entrepreneurs based on actual valuations. This can mainly be used to finance family businesses where entrepreneurs usually do not want to dilute ownership. This provides an instrument for investors to reduce their exposure over time.

Negligence clauses – The venture capitalist and the entrepreneur can agree to spell out potential sources of negligence that will guide the operations of the entrepreneur. The AAOIFI's *Sharī'ah* standard 12 provides that any/all partners are supposed to hold the assets of the company in trust and avoid negligence, misconduct or breaches of contract. In the event of negligence and dispute, independent experts must be involved to decide whether this is considered a normal situation or a result of negligence.

Kahf and Ibrahim (2017) assert that failure to perform its duties by an entrepreneur toward the business is more likely to be attributed to negligence. The paper argues that in an attempt to cut corners, the entrepreneur may compromise the success of the project by compromising the project's monitoring authority. It is contended that in Islamic banking practices, an IB can address this by making the client assume the liability of non-performance based on negligence. The client, thus, has to prove beyond doubt that this was caused by external factors for which the client had no responsibility whatsoever. This condition shifts the burden of proof of negligence and transgression of the contract to the client by requiring him/her to prove non-negligence. The Maliki School approach where Imam Malik differentiates between the common worker (*ajeer aam*) and the private worker (*ajeer khas*) supports this provision. The opinion is that within the remit of non-performance, the potential for negligence is high for a common worker and they, therefore, should be held responsible for negligence unless they can prove that the case is otherwise (Hassan, 2013).

Musharakah with qard – When an IVC investor deploys funds to SMEs through musharakah combined with *qard*, there is an opportunity to secure the *qard* funds as the principal is guaranteed in the case of liquidation. The IVC investor will not be able to earn a profit on the *qard* funds in this situation, and profit-motivated investors may be sceptical about deploying their capital through *qard*. To water down the demotivating tendency, the IVC investor and the entrepreneur can make the *qard* short term with conditions of renewal set against the performance of the entrepreneur. There can also be a financing arrangement that allows the *qard* to be converted to equity at the market price on the date of conversion. The IVC can set some performance targets for the start-up company that will serve as an incentive to have access to additional capital, whether as equity or as more loans. It is important to note that, when converting *qard* to equity, care must be taken not to attract *riba* in the conversion. Thus, the outstanding debt should be valued at its face value and an equal stake in the investee company made with an arm's length valuation of the business.

Musharakah with murabahah – *Musharakah* can also be combined with *murabahah* as a tool of IVC, mainly to finance SMEs. The IVC investor will hold an equity stake in the investee SME with all the benefits that *Sharikah* brings in terms of management and control. Aside from this, the IVC investor will also enter into a *murabahah* transaction with the investee company. This allows the IVC investor to finance the essential working capital of the business on a secured debt basis. For instance, if it is a factory, the IVC can finance the raw materials and purchase machines and even vehicles all under *murabahah*. Upon entering into a deferred sale agreement with the portfolio company, based on a promise to purchase raw material, for instance, the IVC will enter into a sale agreement with a supplier of the raw material. By such an arrangement, the portfolio company will be given a delegated authority under a *wakalah* agreement to take delivery of the raw material and the amount paid, either in instalments or as a one-off reimbursement. This arrangement allows the IVC investor to secure part of its investments in a situation of distress; the *murabahah* liability of the investee company will rank higher in terms of settlement than capital share. This allows a balance of equity and debt in a *Sharī'ah*-compliant manner.

Perpetual mudharabah – To avoid a situation where an entrepreneur can arbitrarily decide to pull out from a venture, perpetual *mudharabah* can be used to structure the IVC arrangement as some *Sharīʿah* scholars allow this. The parties can agree to stipulate that the entrepreneur cannot exist until the agreed level of return is realized (Ishaq, 2016; Thompson Reuters, 2016). However, this does not become binding in a case of force majeure. Also, this cannot be a perpetual condition, but must be valid for a specific time frame or with other considerations. The purpose of this is to prevent negligence and can be used as extra security for investors (Ishaq, 2016; Thompson Reuters, 2016). The perpetual *mudharabah* provides an opportunity to mitigate the risk of an entrepreneur's acting whimsically and causing financial loss to the IVC investor. This financial loss must be real and not an opportunity cost as Kahf (2015) contends that opportunity costs may be positive or negative; it would be unrealistic to assume that any opportunity cost is positive. The idea is to ensure that a venture capitalist is not treated systematically unfairly in the execution of the IVC arrangement.

In modern practice, as approved by the OIC Fiqh Academy, a shareholder of a limited company is unable to withdraw their capital contribution but can sell their stake to another person (resolution number 77 (8/8)). This is because the business is seen as a separate entity from the owners and is expected to operate into the foreseeable future. For businesses that require long gestation periods and huge capital outlay, premature termination of the project is considered out of the question. It is also allowed for partners to enter into a binding promise for continuity of the partnership for a specified period (Kahf and Ibrahim, 2017).

5. Conclusion

The benefit of IVC investments on economic growth is undoubtedly enormous and will mainly be an avenue for Islamic equity financing. This will provide the vehicle for a shift away from debt financing that is currently the trend in Islamic finance. This study shows that Venture capitalism in an Islamic framework can bring about investments in SMEs and start-ups using a blend of *musharakah*, *mudharabah*, *murabahah*, *istisna* and *wakalah*. The findings of the research demonstrate that another set of *Sharīʿah*-compliant instruments, which is rarely tapped into by Islamic financial institutions, is available for IVC investors and can be used to protect investments and to incentivize potential investors into IVC opportunities. Preference shares, perpetual *mudharabah*, *musharakah* with *murabahah*, *musharakah* with *qard*, negligence clauses, diminishing *musharakah*, warrants and supermajority clauses can be used with appropriate conditions to protect investors and offer incentives for them to invest in IVC arrangements. A shift toward IVC will provide an opportunity for entrepreneurial activities and job creation, which are important for many Muslim countries and societies. Further studies are needed, especially to understand some of the instruments used for IVC to protect investors in practice and attract investments that can finance SMEs.

Notes

1. The Ghazalian definition of *maqasid*, which is commonly referenced in Islamic economics is interpreted as "human well-being" and articulated as "safeguarding their faith (dīn), their self (nafs), their intellect ('aql), their posterity (nasl) and their wealth (māl)" (Al Ghazali, 1937; as cited in Chapra, 2008, pp. 5–6).
2. See report at www.imf.org/external/pubs/ft/wp/2015/wp15107.pdf

3. Interview by Thompson Reuters accessible at www.salaamgateway.com/en/finance/story/interview_Shari_ahrelated_issues_in_venture_capital_activities_sheikh_esam_ishaq_SALAAM08122016051859

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