

# Financial Contracting in Islamic Venture Capital: The Form-Substance Dichotomy

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## *Abstract*

Based on a series of interviews in Malaysia and the United Arab Emirates, we conduct a comprehensive exploratory study of Islamic Venture Capital focusing on the distinguishing features of its financial rights and securities and the context which affect their design. We use a qualitative methodology, the Grounded Theory approach, to generate new theory.

We find that while Islamic contractual rights and securities may have formal differences with their conventional<sup>1</sup> counterparts, they are very close in economic substance. This form-substance dichotomy is a central characteristic of Islamic Venture Capital. Market demand for an Islamic brand of venture capital based on ideals of fairness and solidarity clashes with the reality of an array of agency issues and claims venture capitalists need to address. The capacity of Islamic venture capitalists to address these conflicting forces increases with their experience. Their ability is, however, constrained by their fiscal and legal environments. In form, commitment to Islamic ideals is therefore signaled through an investment policy excluding a small number of industries and through the use of Islamic financial instruments with little economic difference, if any, with their conventional counterparts. Minor economic inefficiencies can result, although overall, they are insignificant. In substance, Islamic Venture Capital is thus operationally and economically a near-equivalent to conventional venture capital.

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<sup>1</sup> In the context of this thesis, conventional finance refers to the predominant practice of finance around the world. It is the model of finance most known in Western countries. Islamic finance by contrast is a model of finance that claims to be distinctly rooted in the prescriptions of Islam. Conventional finance is still the dominant model in Muslim majority countries as well. Islamic finance however is a rapidly growing mode of finance.

Following our analysis of the interviews, we position our theoretical contribution within related literature through an extensive survey. To further support our theory of form-substance dichotomy, that is the process by which the difference in form is maintained, but not in economic substance, we demonstrate the near-equivalence of Islamic financial instruments' economic substance with their conventional counterparts' through a systematic comparison of economic payouts for the entire Islamic venture capital asset class.

This research is unique in that it is the first to our knowledge to address the topic of financial contracting in Islamic venture capital. Previous research in Islamic finance is heavily normative, and there is generally a dearth of research publications dealing with either Islamic financial contracting or Islamic venture capital.

## *Acknowledgments*

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I would also like to thank Doctor Alexandra Dawson who helped me strengthen the methodological bases for this thesis.

## *Dedication*

To my family:

My parents, Mustafa and Najet, whose unlimited support and sacrifices made this journey easier;

My sisters Chiraz, Nesrine and brother Nahiene, and their beautiful little monsters whom I love dearly;

And just as important, my supportive, non-needy, ever-understanding wife Emna who, literally on a work break out from a war zone, spent a bizarre honeymoon in Malaysia while I was conducting interviews for my thesis.

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## 1. Introduction

Islamic finance<sup>2</sup> has been one of the fastest growing sectors in recent years. It is expected to reach a global assets size of 1.8 trillion USD in 2013. Islamic financial markets are not limited to Islamic countries and cover a variety of asset classes. Investment banks such as EEIB in London, UK, the Global Iman mutual fund, headquartered in Richmond Hill, Ontario, Canada, or private equity and venture capital firms such as UIB Capital, based in Chicago, Illinois, USA, are among businesses offering Islamic financial services to Western countries. In the same spirit, virtually every major financial institution has opened an Islamic window in the Gulf and several other Muslim-majority countries.

Islamic venture capital is still a very recent phenomenon. As Islamic financial services continue to expand, the importance of Islamic venture capital is bound to increase. Investors seeking to diversify and remain fully compliant with Islamic financial requirements will need Islamic venture capital services. The body of research in Islamic finance focused mostly on Islamic financial institutions so far. We hope to contribute to the research literature by providing a study in the new field of Islamic venture capital and provide detailed insights to professionals interested in it.

Section 2 of this thesis introduces Islamic finance by presenting its modern genesis and the theoretical premises underlying it. Section 3 describes the methodology used in this research. Section 4 gives an overview of the venture capital firms we have interviewed. We have protected

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<sup>2</sup> Islamic finance is the main attempt at implementing the concepts brought by Islamic economics. Islamic economics is the set of precepts that seek to create an economy deemed compliant with Islamic laws and traditions by certain streams of Islamic thought. See also footnote 1.

the identity of our interviewees by replacing their names with codes. Section 5 contains the analysis of our data and states our theory. Section 6 positions our theory within the agency literature. Section 7 contextualizes our findings within the environment in which they occur, and positions the theory within the Islamic financial institutions governance literature. Section 8 further elaborates on our findings on financial contracting by contrasting them with those in the conventional finance literature and proving the near-equivalence between Islamic and conventional instruments by examining their respective payouts. We conclude in section 9.

## 2. A Background on Islamic Finance

Boosted by several peaks in oil price since the seventies, conservative Gulf countries have seen major increases in their investment capacity as a result of the accumulated cash reserves. Dubai in the UAE is among a few cities in the region competing to become financial hubs, with an important share of its activities falling under the scope of Islamic Finance (Wilson, 2009).

In parallel, Malaysia's pioneering efforts in Islamic finance started as early as 1962. The first Islamic institution in the country, the Pilgrims Fund Corporation, known as the *Tabung Haji*, was created as early as 1962. Muslim Malaysians resorted to various traditional means to fund their journey to Mecca, including selling their assets. This had a negative impact on their financial situation and on the rural economy of the country. As a result, the *Tabung Haji* was created to allow prospective pilgrims to invest savings to pay for their trip (Laldin, 2008). Within the context of the New Economic Policy aimed at promoting the upward mobility of the Bumiputera Muslim Malays<sup>3</sup> following the 1969 race riots<sup>4</sup>, Malaysia further promoted Islamic finance as a way to provide access to financial services to disadvantaged sectors of the population who would otherwise choose not to deal with banks. Bank Islam Malaysia Berhad and the International

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<sup>3</sup> The Bumiputera are constitutionally defined as the Muslim Malays in Peninsular Malaysia. In Sabah and Sarawak, the definition includes other indigenous groups. Usage blurs the distinction between Bumiputera and Muslim Malays. Accordingly, the terms will be used interchangeably in the context of this research.

<sup>4</sup> Descriptive statistics on the income and ownership inequalities among the different ethnic groups composing Malaysia, show the Bumiputera being, by far, the most disproportionately impoverished. See for example Rasiah and Shari (2001). Those imbalances are thought to be the root cause underlying the 1969 race riots after which the New Economic Policy was enacted.

Islamic University Malaysia were thus established. Both institutions have been pillars in the development of Islamic finance, making the country's capital Kuala Lumpur another major center of the industry (Alfattani, 2008).

Several other countries enacted policies or regulations promoting the development, or even the exclusive use as in the case of Iran, Sudan and Pakistan, of Islamic finance.

One can sometimes come across statements<sup>5</sup> about the Islamic economy and its early successes during the first centuries of Islam or the medieval era<sup>6</sup>. A distinct Islamic economy is a new construct however, as economy was never considered a culturally or religiously separate endeavor by early Muslims (Kuran, 2004).

Indeed, Islamic finance finds its roots in Islamic Economy, a socio-political vision having its origins in the writings of Abu Ala Mawdudi. Born in India in 1903 during British rule, Mawdudi received a mostly traditional primary and secondary education both at home and in traditional religious schools. Mawdudi's views were a reaction both to Western colonialism and to the impending threat of Hindu rule when independence was becoming a realistic prospective. Moreover, significant sectors among Indian Muslims were economically destitute. The perception of existential threats created the need for tightening the community's bonds. One way to achieve this is to create visible differentiating group markers (Iannaccone, 1992). Furthermore, perceptions of relative deprivation compared to their own past or to current contemporaries, lead to such coping mechanisms as group membership which reduces negative comparisons and

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<sup>5</sup> See for example Rammal and Zurbruegg (2006), Bashar (1997) and many others.

<sup>6</sup> See Siddiqui (2010) for example.



emphasizes moral superiority (Carvalho, 2009). Where Western-educated Muslim elites adopted Western-like mores, Abu Ala Mawdudi saw a weakening of the Muslim community. His response was thus to promote Islam as a holistic way of life and his focus was directed, among others, at economics, given its centrality to everyday life (Kuran, 2004).

Following the same pattern, Sayyid Qutb, a major figure of the Muslim Brotherhood, was born in the early 20<sup>th</sup> century rural Egypt. After a religious education during childhood, he went to the United States between 1948 and 1950. As a dark skinned traditional Egyptian in an America which had yet to go through its civil rights movement, he experienced cultural shock. Also, a noteworthy influence was the Middle-East's political context: Israel's creation and ensuing Arab defeats, the Cold War competition for domination by the Soviet Union and the United States in countries with very fresh memories of colonialism, and countries ruled by rent-seeking authoritarian secular elites. Qutb turned therefore to Al-Mawdudi's vision and further elaborated on it making important contributions to the themes of Islamic Economics notably in his *Social Justice in Islam* (Loboda, 2004). Another founding author of Islamic Economics, mainly on the Shia side, was Mohamed Al-Baqir Sadr. Born in 1935, he shared the aforementioned authors' background, growing up in an indigent family in Najaf, Iraq where he received a traditional education. He would later be subjected to the persecutions of the Baath party until his execution in 1980. Although he was from a different branch of Islam, he adopted the idea of it as an all-inclusive system. One of his major books was *Our Economy*, written between 1960 and 1961, still a major source to date for Islamic Banking. A common thread in these sources and perpetuated by later authors, even as the ideas gained in sophistication, is the concern for economic justice and fairness. Rejecting the constraints of socialism as too burdensome, yet perceiving capitalism as exploitative, profits are

legitimate, but only when merited (Kuran, 2004). Interest is one gain considered to be unjust, as it is understood to be made without any risk for the lender.

Thus came what is arguably the greatest central postulate of Islamic finance: the prohibition of interest. The religious explanation is found in the interpretation of the Quranic prohibition against *riba* and in restrictions imposed by classical jurisprudence on certain types of monetary exchanges of unequal nominal value. Although there is no consensus among scholars on whether *riba* actually means usury or interest, or on the equivalence between interest and usury (Farooq, 2009)<sup>7</sup>, proponents of Islamic finance usually favor claims of absolute, unequivocal, injunctions against interest. Other notable characteristics of Islamic finance include the prohibition of *gharar* and restrictions on trade in certain kinds of products, such as pork or alcohol. *Gharar* is a loose concept which could be approximated as uncertainty on the object or execution of a contract, derived from the *hadith*, the body of sayings attributed to the Prophet in later centuries.

By applying restrictions on interests and *gharar* through a set of normative assumptions portraying economic agents as trustworthy socially concerned individuals (e.g. Lewis, 2005), as opposed to the neo-classical axioms of rational individuals maximizing personal utility underlying conventional economics and finance, the stated purpose in Islamic finance discourse is to enable a better distribution of wealth through fair trade.

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<sup>7</sup> See also El-Gamal (2003) for a full text of an Alazhar fatwa asserting the permissibility of interest. Alazhar is regarded, although not without controversy, as the highest authority of Sunni Islam.

These assumptions of a sociotropic *homo islamicus* confronted with the empirically more powerful model of *homo economicus* generate opportunities for severe agency issues to arise<sup>8</sup>. Nevertheless, to the best of our knowledge, no previous empirical study has examined how agency costs are positively managed from an Islamic finance perspective. Since venture capital is both an ideal setting to research agency issues and a stated ideal form of finance for many Islamic finance theoreticians, our focus will be on Islamic Venture Capital (IVC) as a counterpart for conventional venture capital. We further focus on contracts written by Dubai and Malaysia based firms, as the highest amounts of venture capital transactions from member countries of the Organization of the Islamic Conference are recorded there in the VentureXpert database. Moreover, both countries have been actively promoting the development of Islamic finance and have formed dedicated institutions and legislation.

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<sup>8</sup> For example, the theoretical prohibition of interest would practically amount to a prohibition of debt. This is reflected in the profit-loss sharing ideals of Islamic finance. Under the assumptions of *homo economicus*, debt has disciplining effects on an agent through the threat of bankruptcy and the legal obligation of periodic payments. Under the assumptions of *homo islamicus*, the disciplining effects would come from honesty, faith in the afterlife, and social concern by the agent for the investor. Interestingly, the use of *murabaha*, a debt instrument in economic substance, dominates Islamic financial practice.

## 3. Methodology

### 3.1. Description of the Methodology

We follow the qualitative Grounded Theory (GT) methodology first developed in the 1960s by sociologists Glaser and Strauss (1967)<sup>9</sup> as applied by Ullah (2012) in the Islamic finance context<sup>10</sup>.

Like Ullah (2012), this research doesn't start with a particular theoretical hypothesis; it rather seeks to create a new theoretical framework through a holistic exploratory process. It is only after this framework is generated that we then position our findings in the existing literature.

Ullah (2012) clearly takes a Straussian approach in his analysis. Glaser and Strauss diverged from each other since their initial description of the methodology, leading particularly Strauss and Corbin to publish several follow up books describing the methodology<sup>11</sup>, with Glaser vehemently disagreeing with the approach (Glaser, 1992). A high-level description of the Straussian approach of Grounded Theory recommends proceeding through an iterative cycle that can be broken down in three steps:

1. Open Coding: The minute details of interviews and documents are analyzed and conceptualized. Each concept is systematically broken down and described with all its

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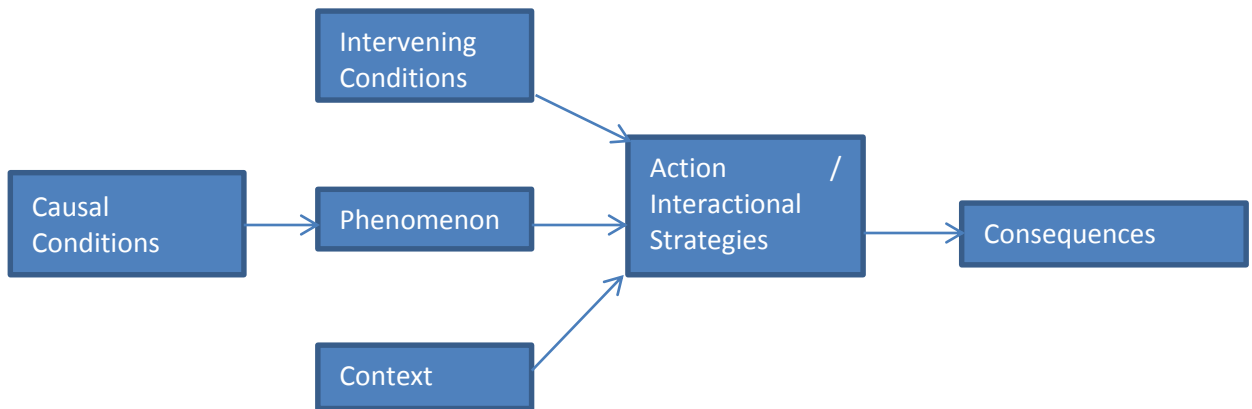
<sup>9</sup> See also Strauss and Corbin (1990); Glaser (1992); Strauss and Corbin (1994) and Corbin and Strauss (2008).

<sup>10</sup> Grounded theory is well established today and used in several studies relating to Islamic finance or Venture Capital. As an illustration, see for example Martin and Hunt-Ahmed (2011) in Islamic finance, or Fried and Hisrich (1994), Bruton and al. (2002), Mäkelä and Maula (2005) and Ahlstrom (2006) in the area of Venture Capital.

<sup>11</sup> See for example Strauss and Corbin (1990), Strauss and Corbin (1994) and Corbin and Strauss (2008).

dimensions. Constant comparison between data being analyzed and concepts already found is made to integrate with or add to the existing concepts.

2. Axial Coding: We link concepts together by examining their dimensions and identifying conceptual families. We ensure the organized concept categories will fit alongside the following paradigm:



Source: Ullah (2012), adapted from Strauss and Corbin (1990)

The causal conditions are what bring the core phenomenon into existence. Intervening conditions are not the direct causes of the core phenomenon, but they shape it by adding constraints. The context also has an influence. Although not a cause of the phenomenon, the exact mapping of the phenomenon is best understood by distinguishing its contextual factors from its causes. The interactional strategies are how the different actors deal with the issues at hand. The consequences are the overall picture resulting from the combination of all these different elements.

3. Selective Coding: This is the stage where a core theory is abstracted from the integration of the previous two steps.

Although the three steps are presented sequentially for reading convenience in this study, the research is actually conducted iteratively as mentioned above, with the three stages often executed in parallel and blending. Each iteration either resulted in new concepts or linked to old ones through constant comparison. The process was repeated until the generated set stabilized and a final theoretical framework could be articulated. The process started as soon as data collection started.

Trying to look at the specificities of Islamic venture capital, the broad question of how it was different from conventional venture capital came up. To try to understand the phenomenon, several books and articles were read, both about Islamic finance and about venture capital. Ullah (2012) was considered a valid template for this thesis. We then conducted interviews to collect data and information about the scarcely documented field of Islamic Venture Capital. Although limited by the practical amount of time and resources available to complete we did reach a moment where new data was not bringing new codes. We felt comfortable considering at that point that we reached theoretical saturation.

### **3.1.1. Data Collection**

Our data collection consisted in a set of field interviews and case studies which were conducted in both Kuala Lumpur and Dubai, further completed by follow up email exchanges and phone calls. We conducted semi-structured interviews with both conventional and Islamic venture capitalists in both cities. Interviews were transcribed and manually analyzed sentence by sentence or word by word, trying to extract concepts expressed, whether explicitly, or implicitly, by interviewees. To better understand the context in which they operate, and to obtain comparative references where relevant, we also interviewed a wide array of stakeholders, ranging from Islamic finance regulators and lawyers, to sharia and investment experts in retail and investment Islamic banks.

The guidelines established for the interviews are provided in Appendix 10. Questions from those guidelines were not necessarily all asked and were not equally treated in time allocation, as the profile of our interlocutors, the context and the flow of their ideas were important in determining relevance. The process of data collection lasted for two months and took place first in Kuala Lumpur, then Dubai. The analysis started with the first interviews, and took a total of five months. It thus was completed three months after the last interviews. Moreover, the analysis was conducted for all interviews, including those which were conducted with the actors mentioned above who are not directly working in a venture capital firm, but in a related area, such as legislators, sources of sharia authority, or other market actors. Different interviewees had varying degrees of availability. With the individuals with whom we were allotted less time, interviews were very focused on all or part of the questionnaire reproduced in section 10 Appendix: Interview Guideline. With individuals with whom we were afforded more time, with sessions sometimes lasting an entire day, interviews could be much more general, open questions were asked and we covered wider topics. These included the general history of Islamic finance in the respective countries, personal perceptions of the industry locally or internationally, theological topics, individual business questions, and much more. The interview guideline described in section 10 Appendix: Interview Guideline was contextually applied consequently. For example, technical questions about security design and agency issues management were unlikely to be of concern for Sharia scholars. Information collected was also cross-checked in some cases. As an illustration, compensation for sharia scholars quoted by interviewees was cross-checked with other studies such as Farook and Farooq (2011), noting that Glaser (1992) considers that existing literature can be used as data.

### **3.1.2. Open Coding**

In conducting interviews and analyzing data, we had to be theoretically sensitive: codes were extracted from existing data without preconceived ideas. Concepts were constructed inductively from data and embodied in the open codes. During the first two months, those were also tested and refined during interviews with different interlocutors. The extracted concepts were written down, and were modified when necessary, as new information improved our understanding of the concepts. Open codes were broken down into the fine-grained dimensions found in the interviews.

### **3.1.3. Axial Coding**

At this stage, open codes are grouped into conceptual families which fit in the paradigm categories described above in 3.1. Some open codes could fit in more than one category and a judgment call had to be made to see which would be closest. Since this was an iterative process, axial coding also provided the opportunity to revisit some of the open coding and verify the relevance of the dimensions discovered.

### **3.1.4. Selective Coding**

This step is where the core phenomenon is identified and the relationships between the different codes are articulated. The concept of dichotomy between form and substance in Islamic venture capital was apparent all along, but it emerged progressively as an explicit central concept of this thesis. When the core concept was finally identified, theoretical saturation was already achieved, as new data did not bring changes to the existing codes.



### 3.2. Justification for the Methodology

This research faces similar issues to Ullah (2012)'s study in that it investigates a relatively unexplored area with little public data. Indeed, during our extensive review of the existing literature, we only came across two books<sup>12</sup> written on the area of Islamic venture capital or private equity, including one published after the first draft of this thesis was completed. Both are based on case studies, and are essentially general practitioner guides. They do not address agency issues, neither from a theoretical nor from a practical point of view. We also identified one published article with normative content on how IVC should ideally be practiced<sup>13</sup>. Additional references to venture capital in Islamic finance literature are the recurring broad statements<sup>14</sup> in normative literature about venture capital being an ideal form of Islamic finance. As a result, there is little to base on in terms of building working hypotheses in the area of agency issues in Islamic finance, and even less so with a focus on venture capital. This topic area is therefore well suited for the use of the grounded theory methodology. The use of this methodology in an under-researched field like Islamic Venture Capital can facilitate the collection of a first set of data through interviews for example, on which subsequent standardized collection and testing of hypotheses can be based (Flick et al., 2004).

Guba and Lincoln (1994) discuss the relevance of qualitative research vs. quantitative research, each having their strengths and weaknesses. They describe how, inspired from hard sciences, the focus in quantitative approaches has been on *“efforts to verify (positivism) or falsify*

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<sup>12</sup> Siddiqui (2010) and Fara (2012).

<sup>13</sup> Choudhury (2001).

<sup>14</sup> See for example Choudhury (2001), Dar and Presley (2000) and many others.

*(postpositivism) a priori hypotheses, most usefully stated as mathematical (quantitative) propositions or propositions that can easily be converted into precise mathematical formulas expressing functional relationships*<sup>15</sup>. This focus, they add, stems from its “enormous utility when the aim of science is the prediction and control of natural phenomena”<sup>16</sup>. Among the different critiques they ascribe to quantitative research, the most relevant here is that it excludes the dimension of discovery in inquiry. According to Guba and Lincoln (1994, p. 106), “conventional emphasis on the verification of specific, a priori hypotheses glosses over the source of those hypotheses, usually arrived at by what it commonly termed the discovery process. (...) The call for qualitative inputs is expected to redress this imbalance”. Moreover, while quantitative research focuses on explaining the causes of a given phenomenon, qualitative research emphasizes the understanding of the phenomenon (Firestone, 1987).

In the same line of thought, Gilson and Schizer (2003, p. 878) in their study of tax effects on the choice of securities write:

*As a matter of academic craft, our analysis suggests the difficulty of financial modeling for activities in which low-visibility, "practice"-level patterns are of first-order significance. Unless informed by institutional knowledge deep enough to reveal such patterns, models will miss a significant factor that is influencing behavior.*

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<sup>15</sup> Guba and Lincoln (1994, p. 106)

<sup>16</sup> Ibid.

Although Gilson and Schizer (2003)'s study was not based in GT, qualitative GT research can partially remedy this weakness.

Compared with other qualitative methodologies that seek to verify hypotheses established based on previous research or understand phenomena for example, Grounded Theory is particularly well suited for developing new theory (Strauss and Corbin, 1994). This new theory may of course be subject to follow up empirical validation once appropriate data becomes available. Quoting Strauss and Corbin (1990), Ullah (2012, p.47) writes:

*“GT is a scientific method” which meets the criteria of “significance, theory observation compatibility, generalizability, reproducibility, precision, rigor and verification”. These criteria make the foundation of scientific research methods and hence they classify GT methodology as scientific.*

A last note on methodology is about rigor and relevance. This study strives to reduce the trade-offs between the rigor of academic theory and the relevance to business practitioners. Through the use of a recognized qualitative methodology, we find interesting new theories that can form the basis for follow-up academic research. Additionally, one point made by Guba and Lincoln (1994) is that while the controls and other exclusionary mechanisms in research design used in quantitative methodologies add rigor to theory, they reduce transferability by limiting the applicability of the findings to specific settings that meet those particular conditions. In other words, data is stripped from its context. Qualitative research on the other hand can be more directly relevant by keeping the conceptual density given by the context. Myers (2009) also points out this gap between relevance and rigor. He explains how qualitative research has the advantage

of addressing organizational questions in all their complexity, including unquantifiable conditions, something a business practitioner could more directly identify with.

### **3.3. Limitations**

Among the specific methodological limitations of this study is that in three out of the six VC firms, only one manager was interviewed. For the three others, two managers or one manager and one entrepreneur were interviewed. In each of the three cases, one voice was definitely dominant as one of the interviewees provided most of the data. This limitation is mainly due to the time and funds available for the research. Ideally, more actors from each of the firms would have been interviewed. A mitigating factor however is that in each of these cases, the most senior members have been interviewed and most of these firms had a limited number of staff.

Another limitation is that the audit trail was informally applied. The electronic documents were re-edited as ideas were discovered and concepts evolved with new data and analyses.

## 4. Overview of Cases

To the best of our knowledge, Kuala Lumpur only has three Islamic Venture Capital (IVC) firms: We met with the Malaysian Venture Capital and Private Equity Association, which provided us with the complete directory of registered Malaysian Venture Capital firms, and we completed the list by inquiring with our interviewees. Three venture capital firms are registered with the Malaysian Securities Commission as being Islamic, although one is defunct. One of the two officially registered active IVC firms is MalaysiaBankIVC, which is the venture capital arm of a major Islamic bank in Malaysia. MalaysiaIVC is the second active IVC firm. We interviewed the managers of both these firms. We also interviewed the head of MalaysiaIslamicWindowVC's asset management unit. Although not registered as an IVC firm with the Malaysian Securities Commission, it is the venture capital and private equity arm of the Islamic window of a major regional Malaysian bank, registered at the Central Bank of Malaysia with more stringent sharia compliance requirements. In addition to these firms, we interviewed a wide range of stakeholders and related actors, including directors at MalaysiaCVC, a major conventional venture capital firm in Malaysia. We will first describe this firm as a reference point for the previously mentioned Islamic firms. We met lawyers specialized in Malaysian IVC and legislators from the Islamic Financial Services Board (IFSB)<sup>17</sup> or the Central Bank of Malaysia, as well as the heads of Sharia of several Islamic banks for the purpose of understanding the specific context of Islamic finance in Malaysia. We will limit the case descriptions to the venture capital firms as they are the ones most directly related to our research.

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<sup>17</sup> See section 7.2.1.

Dubai also has three IVC firms to the best of our knowledge. We have succeeded in obtaining an interview in one of them, DubaiIVCHolding. A Dubai conventional venture capital firm we have met and which we will describe in the following section for comparative purposes as well is DubaiCVC. In addition to these we also met with heads of Sharia departments of Islamic banks as well as investment bankers, including major private equity actors, in Dubai. As in the case of Malaysia, the objective was to frame our research in its general context of Dubai and we will only describe cases of venture capital firms.

The following table summarizes the profile of each of the venture capital firms in which we have conducted interviews:

Firm Code	Conventional (C) or Islamic (I)	Independent (I), Bank Affiliate (B) or Other (O)	Investment Focus	Sharia Oversight
MalaysiaCVC	C	O	Tech + Fund of funds	N/A
MalaysiaIslamic WindowVC	I	B	Diversified, LBOs, PE	Parent's Board
MalaysiaBankIVC	I	B	Diversified early stage	Parent's Board
MalaysiaIIVC	I	I	Tech	Independent Sharia Board
DubaiCVC	C	I	Diversified early stage	N/A
DubaiIVCHolding	I	I	Diversified, holding	Guidelines, fund managers discretion

#### 4.1. MalaysiaCVC

MalaysiaCVC is a large conventional venture capital firm created in 2001, with an investment preference for the Information and Communication Technologies (ICT) sector. It manages assets totaling over 300 million US dollars (1 billion Malaysian Ringgits). At least one of its funds has a

Bumiputera mandate requiring investments to have 51% Bumiputera ownership. Additional mandates include the creation of more venture capital talent by acting as a fund of funds with professionals with potential to succeed in the venture capital industry.

MalaysiaCVC has a tax exempt status and ensures its investees, who benefit from favorable tax laws for the ICT sector, obtain those privileges as well so tax considerations are usually not factored into their financial contracts' design.

MalaysiaCVC looks for minority equity stakes. In this context, one of MalaysiaCVC's vice presidents told us: *"I don't see the difference between what we're doing and what Islamic venture capitalists do"*. Most investments are made in the form of redeemable convertible preferred shares. Voting rights and board rights depend on risk perceptions and negotiations, but no special voting powers are sought. Like venture capital investments elsewhere, MalaysiaCVC secures reservation rights on major operational changes. Term sheets are customized in house from standard templates, although the process takes a while in order to establish a relationship first. In addition to the financial terms linked to the investee company itself, a put option is obtained personally from the investee's entrepreneurs, as a deterrent in case things go awry.

#### **4.2. MalaysiaIslamicWindowVC**

MalaysiaIslamicWindowVC is the Islamic window of a major regional bank owned in majority by non-Muslim Chinese capital. Its asset management arm includes private equity and venture capital funds, with an Asian regional focus. Projects financed by these funds at the regional level include ICT, the food industry, and major infrastructure projects with the size of individual investments ranging from one million to a hundred million dollars US. Local projects extend to all industry sectors.

In addition to the required sharia research department, six reputable Sharia scholars from diverse backgrounds sit on MalaysiansIslamicWindowVC's Sharia Committee, reflecting its international presence. Four votes out of six are needed for decisions, ensuring a qualified majority for compliance. MalaysiansIslamicWindowVC's private equity and venture capital funds leverage the sharia units of the bank. Moreover, activities are covered by investment guidelines which include sharia compliance rules. Deal sourcing, for example, according to these rules is filtered by the fund manager through two sets of criteria, one being the type of business, excluding a certain number of industries such as ones dealing with alcohol, the other criteria being the investee's financials, with restrictions notably on debt ratios among others. Term sheets are then negotiated and submitted for approval by both the Investment Committee and the Sharia Committee. Our interviewee noted a learning effect on what the sharia scholars would approve or not. More experience and learning, according to him, led to greater acceptance of conventional financial instruments as Islamic. At the portfolio management stage, fund managers monitor sharia compliance monthly and at least one quarterly report for Limited Partner (LP) consumption is issued showing that the investment is still sharia compliant. The Sharia Committee has the power to force an exit in cases of noncompliance.

Instruments used in MalaysiansIslamicWindowVC's venture capital transactions include ordinary shares, through capital increase or shares acquisition, or a combination of both. In the case of ordinary shares, shares can be of the same class as those currently outstanding or a different one, Malaysian sharia scholars accept the existence of different classes of shares, contingent upon a pro-rata distribution of profits. Although sharia scholars usually reject preferred shares, they allow certain shareholders to waive their voting rights through the shareholders' agreement, thus mimicking the economic behavior of non-cumulative preferred shares. Convertibility features are



normally included as well, based notably on the concepts of *wa'ad*<sup>18</sup>, *urbun* or *salam*<sup>19</sup> depending on tax efficiency, economic viability, IRR targets and risk factors among others.

Mezzanine financing, a type of financing conventionally based on debt with rights to equity used to supplement capital mostly in real estate and private equity transactions, has also relied on *murabaha*, whose economic behavior is equivalent to debt<sup>20</sup>. *Musharaka* and *mudaraba*, equity based instruments, have been used but they involve a legal and fiscal risk outside of Malaysia due to the uncertainty of legal interpretations around these structures. Their use has therefore been limited in cross-border transactions where the bank reverts to the safety of more familiar instruments such as *murabaha*. Equity kickers<sup>21</sup> could be used and are designed in separate financial agreements as incentives contingent on performance.

Generally, the accounting and fiscal treatments of these instruments is of particular concern in cross border transactions, where regulation and jurisprudence is different or less established than Malaysia and requires the intervention of accounting and tax specialists. Examples of jurisdiction dependent design include amortization vs. assuming upfront profit rates on *murabaha* transactions, economically equivalent to the interest rates on debt transactions in conventional

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<sup>18</sup> The *wa'ad* is a unilateral promise, binding upon certain formal conditions.

<sup>19</sup> See section 8.2.6 for a description of these.

<sup>20</sup> See section 8.2.1 on straight debt.

<sup>21</sup> Warrants are deemed legitimate by the Sharia Advisory Council of the Malaysian Securities Commission. See Securities Commissions of Malaysia, 2007, pp. 60-63.

finance. Other considerations include consumption taxes like GST or VAT for *ijara* transactions – economically equivalent to lease-back transactions – or property taxes.

Financial rights acquired are very similar to those obtained in conventional venture capital<sup>22</sup>. Differences include the absence of redemption rights or special voting rights. Like MALAYSIACVC, MalaysiaIslamicWindowVC secures put options from the entrepreneurs in venture capital deals, although they have to abide by the *wa'ad* or *urbun* principles in the put options agreements. Legal fees and expenses during the due diligence process are not covered by the investee. Break-up fees, when the investee walks out of a deal, have to be invoiced at actual tangible cost. Flat fee penalties and opportunity costs have to be excluded from break-up fees as they are perceived as unfairly benefiting from a non-deal by sharia experts<sup>23</sup>.

### 4.3. MalaysiaBankIVC

MalaysiaBankIVC is a subsidiary corporation of one of the pioneering Islamic bank of Malaysia. MalaysiaBankIVC was established in 2010 and is funded entirely by its parent bank.

Much of MalaysiaBankIVC's portfolio management processes are undocumented or informally applied, reflecting the firm's youth. Screening of potential investees is done through financial parameters with no sharia criteria. Following the Investment Committee's approval, a report is submitted to the Sharia Committee for approval. The Sharia Committee of MalaysiaBankIVC is its

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<sup>22</sup> See appendix 10.2 for a list of financial rights commonly used in venture capital deals.

<sup>23</sup> *Ta`widh* and *gharama*, or compensations and penalties are still topics of debates among sharia scholars. So far, some resolutions only have been issued rendering them permissible subject to strict conditions in case of default in a limited set of standard debt contracts or judgment debts. See Central Bank of Malaysia, 2010, pp. 129-134.

parent bank's Sharia Committee. Once approved, all other activities, from due diligence to exit, go without active sharia supervision. It is the responsibility of the fund manager to anticipate any potential sharia violation and report it to the Sharia Committee.

MalaysiaBankIVC has used straight equity in all of its deals thus far, considering preferred shares not to be legitimate from a sharia point of view. No debt was used as per its only fund's investment policy. A gentlemen's understanding between the fund and the investees is sought for the regular distribution of dividends. MalaysiaBankIVC's managers insist on creating a quality personal relationship with the entrepreneurs. The most important factor that distinguishes them as a sharia compliant firm, according to one of the managers, is the manners and trust with which they deal with their investees, whom they want to consider as equal partners. As such, no controlling stake is necessarily sought when investing. Many contractual rights common in the venture capital industry were not initially sought either, but this appears to reflect the learning curve rather than a sharia preference: attitudes are evolving in the face of some "*close calls*" as one of the managers put it. One example involves a company whose managers walked away for other jobs as soon as the investment was obtained. As a result, MalaysiaBankIVC indicates it doesn't see any issue with requiring any of the usual venture capital rights today, and have already done so for most of the rights listed in Appendix 10.2. It is also considering an individual put option requirement for financed entrepreneurs as is required by other venture capital firms we've met in Kuala Lumpur. Additionally, MalaysiaBankIVC is preparing a new fund with more sophisticated securities than straight equity, although their precise nature is yet to be determined at the time of this writing.

#### **4.4. MalaysiaIIVC**

MalaysiaIIVC is an independent sharia compliant venture capital firm in Kuala Lumpur. It was founded in 2007 by an ex-manager at one of the major Islamic banks in the country, who had

identified a new sector where Islamic financial services could be expanded, and raised then its first fund from MalaysiaCVC, focusing on technology companies. Its fund's size is 35 million Malaysian Ringgit, or about ten million dollars. MalaysialIVC is currently raising a second fund of the same size from Tabung Haji, Malaysia's pilgrims' fund.

MalaysialIVC' Sharia Committee is composed of one scholar, as per the Securities Commission of Malaysia's requirements for registered Islamic venture capital firms. After an initial screening with some basic due diligence process looking at a potential investee's business plan and financials, the Sharia Committee intervenes. It ensures the financial structure of the target company has no more than 10% of its assets in interest bearing accounts, that its term sheet, its industry and products are acceptable from a sharia standpoint. The Investment Committee only looks at deals already approved by the Sharia Committee. Each quarter, a directors meeting with the Investment Committee includes checks on sharia compliance in ongoing investments. If an exit happens through an acquisition, then the acquirer must be, at least, from an industry that is legitimate from a sharia point of view.

MalaysialIVC's fund managers are quite pragmatic about their investments. They expect agency issues to arise and try to address them proactively, although there is a learning element relative to contractual rights and financial instruments. Interestingly, most of the rights we mentioned during our interview which weren't already part of their usual terms triggered immense interest for future use, revealing that their absence was due to lack of exposure rather than sharia driven restraint. Others, like liquidation preferences or pay-to-play rights for example were seen as inconsistent with their use of Murabaha Redeemable Convertible Instruments (MRCI).

The MRCI is a security invented by MalaysiaIVC. As its name indicates, it is based on *murabaha*, or trade based debt, with an option of conversion to common shares and a redemption feature. The conversion feature has been approved by the Sharia Committee on the condition that the conversion ratio is agreed upfront. Moreover, MRCI was designed to mimic more closely the behavior of convertible redeemable preferred equity rather than debt. Although it does not contractually entitle MalaysiaIVC to dividend distributions since preferred equity is deemed illegitimate from a sharia perspective, there is an implicit understanding that MalaysiaIVC will receive a share of any dividend distribution as a gift. This expectation affects perceptions about the fairness of the relationship and many indirect contractual tools are available to ensure this implicit clause is abided by, including the possibility of discontinuing the relationship<sup>24</sup>.

Like in much of the Islamic finance industry, investments in intangible assets are considered illicit by MalaysiaIVC' Sharia Committee. The prohibition includes investments in research and development. A target company interested in such an investment works around the prohibition by an economically similar operation of raising Islamic venture capital to be placed in real estate assets, then requesting an overdraft from a third party bank collateralized by those. Although no case of default happened so far, MalaysiaIVC assumes that such a third party bank would be likely to gain seniority of claims on the assets in such circumstances.

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<sup>24</sup> Although in states of the world where the relationship between MalaysiaIVC and the investee is fine, the MRCI is indeed an economic equivalent to convertible redeemable preferred, it reverts to being an economic equivalent to convertible redeemable debt in those states where the investee can afford bearing the cost, if any, of degrading that relationship by not sharing dividends.

Other tools used by MalaysiaIIVC similar to other Islamic as well conventional firms include for example securing an individual put option from the entrepreneurs at investment time as a deterrent against misbehavior. Also, like other Islamic firms, MalaysiaIIVC ensures continuous sharia compliance of its portfolio firms in terms of industry through its reservation rights. Unlike MalaysiaIslamicWindowVC, legal fees and expenses are born by the investee firm if the deal is closed. If the deal is called off by MalaysiaIIVC, the Sharia Committee requires that it bears the costs. If the deal is called off by the target firm, the Sharia Committee limits MalaysiaIIVC' right to reimbursement to third party costs, although this could evolve and include time spent.

Finally, and unlike some other Islamic financial firms or institutions we've met, valuation was not considered within the scope of sharia scrutiny. Where others would claim that valuation has to go through some fairness test, MalaysiaIIVC' approach is one of contractual freedom.

#### **4.5. DubaiCVC**

DubaiCVC is a conventional venture capital firm based in Dubai. Like many firms in the region, it has an international scope for its investments, including Sub-Saharan Africa, the MENA region, South-East Asia, or CIS countries. Unlike many in the region where the preference strongly goes to real estate<sup>25</sup>, the industry focus of DubaiCVC is on the media and technology sectors.

The region is awash with challenges. A lack of reliable accounting information and information on companies, most often family owned, is one of the challenges one could meet. Moreover, limited partners may have broad or shifting investment objectives in mind, with attitudes deeply based on individual preferences unrelated to financial criteria. As personal relationships are essential to

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<sup>25</sup> According to our interviewees, there is a "huge stigma against investing in the tech sector".

raising money with the exception of a handful of international high profile exceptions, funds are usually created around a set of well identified companies. DubaiCVC follows this line, and sometimes even initiates the creation of its portfolio companies after the identification of specific niches followed by the identification of related patent holders willing to become entrepreneurs. Most decisions made are closely watched by the limited partners as well. Our interviewees felt that LP demands could be quite stiff compared to the US, and as money is more concentrated in the Middle-East, LP bargaining power tends to be higher. Other local LP idiosyncrasies include the attachment to yielding instruments, to the point where they would be willing to pay a premium to receive a regular yield over an otherwise financially equivalent investment.

Term sheets are based on standard templates, used for all geographical areas. Any customization would be firm specific as opposed to area specific. However, compared to typical US equivalents, term sheets tend to be even less favorable to entrepreneurs. As our interviewees put it: *“Doomsday scenarios are built-in here in the Middle-East. Entrepreneurs are on a much shorter leash than in the US”*. Unlike what was invariably seen in Malaysia and closer to US practice, DubaiCVC does not demand an individual put option from its entrepreneurs.

DubaiCVC structures its investments as convertible preferred equity. It includes all rights usually found in typical US term sheets. Contracts with the target companies are managed through holding structures registered in the Caymans and similar business-friendly countries. Accordingly, it is the law of these jurisdictions which is applied. This choice not only reflects the favorable legal framework for holding companies in those countries, they also provide a safer choice than local Dubai laws where investors feel their protection is too weak.

#### 4.6. DubaiIVCHolding

DubaiIVCHolding is an investment holding company founded in 2009 with offices in London and Dubai. Its geographical scope is international with a preference on major Muslim markets. During our interviews with DubaiIVCHolding, two sets of issues related to the Islamic character of the firm were separated: the contractual and the spiritual. Contractual behavior was described as “*not too dissimilar from conventional finance*”.

DubaiIVCHolding uses most of the rights listed in Appendix 10.2. It focuses on mature, preferably yielding, companies and further relies on the institutionalization of the organization to mitigate many of the agency issues typical of earlier stage investments. As such, like our conventional case from Dubai, it doesn't use the individual put option on entrepreneurs typical of Malaysian venture capital. Securities issued are tailored on a case by case basis, being mostly equity based. Conventional debt is of course off-limits. Fixed return securities could be issued as long as they are sharia compliant, but our interviewees disliked them out of concerns that they violate the Islamic finance ideal of sharing risks and take pride in making the entrepreneurs feel they are treated fairly.

DubaiIVCHolding's in-house sharia advisory is composed of three scholars. They are consulted on an *ad hoc* basis if any concern is identified by one of DubaiIVCHolding's managers. All sharia compliance is driven by internal guidelines established at the DubaiIVCHolding's creation and updated as new issues rose afterwards. Their practical application is left to the discretion of its managers. Continuous sharia compliance is guaranteed over the lifecycle of an investment through its reservation rights on material changes to the business plan.



What DubaiVCHolding feels really distinguishes it as an Islamic company is the more “*spiritual*” side of its activities. Not only does it avoid potentially contentious industries such as hotels and media or ensures the conventional debt of its target companies is converted to Islamic instruments, it relies heavily on personal compatibility between the DubaiVCHolding’s managers and the target entrepreneurs. It also relies on the belief, among others, that their faith will drive to a higher standard of integrity. Investing in institutionalized, mature, companies, DubaiVCHolding also finds it easier to give more flexibility to target entrepreneurs. This flexibility is perceived to be a sign of trust, further reflecting its Islamic spirit as well.

DubaiVCHolding, like DubaiCVC, relies on SPVs based in such jurisdictions as the Caymans. There has been no case of litigation although there are at least two situations where this could have happened. DubaiVCHolding each time favored a more conciliatory approach: “*we sit down and talk*”. The holding company sees this as part of its Islamic spirit, though the surrounding Gulf relationship driven culture generally frowns upon court litigation and favors reliance on personal networks and mediation as a means to resolve conflicts.

## 5. Analysis

### 5.1. Open Coding

In the following sections, the details which appear in the minutes of the interviews are broken down into concepts. Comparison throughout the analysis ensures cohesion between new concepts and the ones already found.

#### 5.1.1. Islamic vs. Conventional Perceptions

Open Code	Properties	Dimension
Islamic vs. Conventional Perceptions	Outside Perception of Difference	high/low
	Underlying Economics	different/similar
	Internal Perception of Difference	high/low
	Perception of link to Real Assets	high/low
	Deal Initiation Difference	high/low
	Operational Difference	big/small

In many of our interviews, our interlocutors lamented the fact that many outsiders of the industry would not understand the difference between Islamic finance and conventional finance. One regulator expressed her frustration: *“if I can’t even convince my husband [a finance professional] of the difference, who am I going to convince?”*. Several justifications are given to explain the distinguishing features of Islamic finance compared to conventional finance. One is the presumed link of Islamic transactions to real assets, as opposed to conventional transactions which are perceived to be based on virtual or imaginary assets, hence somewhat fraudulent. Another difference stressed by insiders of the industry is how deal initiation and operational aspects are much more based on trust and like mindedness than in conventional finance. The underlying

economics of Islamic transactions are usually perceived to be very similar if not equivalent to conventional ones.

### 5.1.2. IFI Robustness

Open Code	Properties	Dimension
IFI Robustness	Survival Rate	high/low
	Government Role	high/low
	Role of Asian Crisis	high/low

The Role of the Asian Crisis in the late 90s was determinant in the official promotion of Islamic finance in Malaysia, as the survival rate of Islamic institutions was higher than their conventional counterparts and contributed to the perception of robustness of the industry. Malaysia's government then undertook to build Islamic financial institutions in a prudent manner by channeling skills from conventional finance and taking time to observe the industry's behavior.

### 5.1.3. Islamic Institutional Credibility

Open Code	Properties	Dimension
Islamic Institutional Credibility	Checks & Balances between Government and Market Players	many/few
	Importance of Institutional Credibility	high/low
	Industry Self-Organization	high/low

As a faith based industry, trust in the ethical standards and religious expertise of institutions surrounding the Islamic finance industry is essential. As such, while Malaysia's government leaves space for innovation and initiative by market players, it also acts as a certifying authority for their

trustworthiness, by issuing regulations, unifying sharia resolutions, or approving sharia scholars. The industry is also acting in this direction by creating a professional body that aims among others at promoting continuous education and professional certifications among its adherents.

#### 5.1.4. Islamic Identity

Open Code	Properties	Dimension
Islamic Identity	Government's Duty to Public	high/low
	Consensus Seeking	high/low
	Clarity in Policy Making	high/low
	Market Validation	high/low
	Market willingness to Deal with Non Islamic Instruments	high/low
	Role of Constituency in Policy Making	high/low

A pragmatic attitude among policy makers has been to promote Islamic finance as a way to fulfill its social duty of granting access to funds to a conservative Bumiputera constituency who would otherwise not deal with financial institutions without that Islamic label. Consistent with a cultural inclination of seeking consensus and with principles of clarity in regulations, the emphasis on the limited economic difference between Islamic finance and its conventional counterpart is considered risky and unnecessary. Success is measured by the degree by which the market validates these institutions.

### 5.1.5. Peer Validation

Open Code	Properties	Dimension
Peer Validation	Pressure to Support	high/low
	Antagonism	high/low

The question was raised occasionally about critics of the Islamic financial industry’s practices in terms of its similarities with conventional finance. While some of those criticisms were perceived as valid, particularly when implying the industry should make more efforts to differentiate itself in terms of substance, others which may question the necessity of the industry were seen as destructive. As a result, it is understood that professionals working in the Islamic finance industry should be supportive of it.

### 5.1.6. Malaysia vs. Gulf

Open Code	Properties	Dimension
Malaysia vs. Gulf	Idealization of Gulf Islamic Finance Framework	high/low
	Recognition of Different Classes of Shares	different/similar
	Influence of Gulf Sharia Standards	high/low
	Stringency of Standards	high/low

A recurring theme during our interviews was how Islamic finance would diverge between Malaysia and the Gulf. As the historical birthplace of Islam, some of our interlocutors idealized the Gulf’s Islamic financial practices as the standard that should ideally be followed. More often though, comparisons were made to illustrate how the less stringent sharia standards in Malaysia gave more flexibility in terms of financial contracting. Examples were also given on how additional

workarounds had to be created to satisfy Gulf sharia scholars in order to proceed with investments approved by Malaysian scholars. One such example concerned an investment in a hotel with several buildings. While approved by the Malaysian scholars, Kuwaiti scholars vetoed the deal due to the existence of a gender mixed swimming pool. Several attempts to reach a consensus by slightly modifying the project failed. The eventual solution was to finance the buildings which didn't contain the contentious swimming pool at a higher proportion, and assist in finding a third party willing to complete the comparatively small funding necessary for the problematic part.

It is noteworthy to mention that there is an active effort in Malaysia to converge its sharia jurisprudence with the Gulf. While this is not expected to change the substance of the industry's practices, it is aimed at attracting more Middle-Eastern capital.

#### 5.1.7. Geographic Preference

Open Code	Properties	Dimension
Geographic Preference	Investee Regional Growth Strategy	high/low
	Preference for Exits at Local Stock Exchange	high/low
	Preference for Courts at Investee Location	high/low
	Local Investment Focus	high/low
	Regional or International Investment Focus	high/low

We asked our interviewees what their geographical preferences were. In particular, we inquired about their regional perspectives, their preferences in terms of stock exchange location for exits, courts location in case of litigation, and their area of focus for investments. We also asked them for each of these factors whether the choice of financial instruments and rights used in their

contract was affected by these preferences, and compared the answers across cases. We do find a relationship between geographic preference and choice of instruments and rights. However, this apparent relationship hides a deeper one we will discuss below: this relationship with IVC instruments and rights is primarily driven by the tax impact of these geographical preferences.

### 5.1.8. Supply of Capital

Open Code	Properties	Dimension
Supply of Capital	Competition between Islamic and Conventional Suppliers of Capital	high/low
	Pool of Islamic Finance Investors	high/low

When asked about the cost of capital in Islamic investments, and how this cost compared to conventional counterparts, replies on whether Islamic capital was cheaper or more expensive varied among our interlocutors. Two factors however stood out as the main determinants of this cost, suggesting it was more dependent on overall market conditions than industry specific. The first factor is the competition between conventional investors and Islamic investors. Because conventional investors have no objections in investing in Islamic instruments, demand is higher *ceteris paribus* for Islamic instruments than for conventional ones, bringing their cost down. At the same time, the pool size of Islamic finance investors could be much smaller, therefore inducing the reverse effect.

### 5.1.9. Supply of Skills

Open Code	Properties	Dimension
Supply of Skills	Islamic Finance Lawyers	high/low
	Finance Professionals	high/low

Another market based determinant of the costs associated with Islamic finance is the supply of skills. Out of 13,000 lawyers in Malaysia, only a hundred are qualified to structure Islamic deals, for a local market size of 326 billion Malaysia Ringgit, or 107 billion US dollars. The boom in the sector and active governmental intervention has been on the other side facilitating the transition of many finance professionals from the conventional sector to the Islamic sector.

### 5.1.10. Conservative Investment Style

Open Code	Properties	Dimension
Conservative Investment Style	Venture Capitalists with Banker Mentality	high/low
	Limited Partners' Risk Aversion Relative to US	high/low
	Influence of LP's Culture	high/low
	Risk Management Style	upside/downside
	Managerial Conservative Approach	high/low

A complaint found equally among both conventional and Islamic finance professionals generally, and venture capitalists specifically, is how conservative the investment culture is in both Kuala Lumpur and Dubai. While Islamic investments are often presented as more prudent, it appears from our interviews with conventional actors that this was more a general cultural trait than a specific industry characteristic. This conservatism is found at all levels of the venture capital chain,



including the managers themselves. LPs could weight even more on this conservative approach: MalaysiaBankIVCs, for example, during its investment phase has to go through the risk management process of its parent retail bank which concentrates exclusively on the downside.

#### 5.1.11. Regulator’s Objectives

Open Code	Properties	Dimension
Regulator’s Objectives	Uniformity and Harmonization	high/low
	IVC Innovation	high/low

While the economics of the different venture capitalist, Islamic or conventional, were not fundamentally different, regulatory actions could lead to more distinct forms of financial instruments between them. As seen previously, one of the tools used by the regulator to ensure clarity in the Islamic financial industry is its harmonization, so nominates<sup>26</sup> and contractual forms from other Islamic financial sectors show initial signs of trickling down to the IVC sector. At the same time, because the Malaysian government seeks to stimulate the industry’s dynamism, it tries not to overregulate in order to spur innovation. The MRCI instrument used by MalaysiaIIVC is a prime example of the effects of this policy.

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<sup>26</sup> Nominate, as used in El-Gamal (2006), designates the use of an Arabic name suggesting a distinct instrument for a common economic reality. For example, the use of *murabaha* implies that it refers to a distinct type of instrument from the classical age, whereas its actual content is usually debt.

### 5.1.12. Jurisdictional Preference

Open Code	Properties	Dimension
Jurisdictional Preference	Degree of Trust in Local Law by Locals	high/low
	Degree of Trust in Local Law by Internationals	high/low
	Preference for Jurisdiction of Investee Location	high/low
	Knowledge of Local VC Regulations	high/low
	Degree of Litigation	high/low
	Caymans	high/low
	UK	high/low
	Malaysia	high/low
	Dubai Finance International Center	high/low

Through our cases, jurisdictional preferences are determined by several factors, including the knowledge of local regulations, the degree of trust in law enforcement in the jurisdictions considered, or convenience of location. Few Dubai based investors among those we've met for example would chose a jurisdiction other than the Caymans or the UK. We have met only one instance of investment whose contracts' jurisdiction was chosen to be the Dubai Financial International Center. The Caymans are chosen due to their business-friendly legislation for financial companies. The UK is chosen by these investors because it is perceived to possess stronger law enforcement than any of the UAE's, or Middle-Eastern for that matter, jurisdictions. This preference even applies to Dubai investors in Malaysia, probably out of familiarity. Indeed, Malaysian investors in contrast are perfectly comfortable with choosing Malaysia as their jurisdiction. Whenever we've met instances of other choices for Malaysian investors, it was out of convenience in terms of proximity to their investee company in cross border transactions.

Interestingly, these preferences apply to both conventional and Islamic firms. In this sense, jurisdictional preference is not a distinguishing feature of conventional vs. IVC.

### 5.1.13. Minority Shareholders' Protection

Open Code	Properties	Dimension
Minority Shareholders' Protection	Level of Legal Protection	high/low
	Control Stake Sought	frequent/rare

Although there are few properties to this open code, it is an important element by itself as it usually affects how financial contracts are shaped. This issue came up in some of our interviews. In Dubai's culture, where litigation is frowned upon, networks and conciliation matter a lot more than the regulatory protection provided to minority shareholders, which is considered weak anyway. In Malaysia, minority shareholders' protection was considered weak as well. As a result, unless otherwise mandated by the government, as in the case of MALAYSIACVC, more experienced investors would pursue majority stakes when possible as one of the mitigating measures. We haven't come across other strategies specific to either conventional or IVC for resolving this lack of protection.

#### 5.1.14. Regulatory Environment

Open Code	Properties	Dimension
Regulatory Environment	Influence of the Securities Commission Malaysia	high/low
	Influence of the Central Bank of Malaysia	high/low
	Influence of International Standards	high/low
	Quality	high/low
	Regulation Density on Sharia Governance	high/low
	Regulation Density for IVC	high/low
	Focus of Islamic Accounting Standards	form/substance
	Degree of Acceptance	high/low
	Specific Requirements for Sharia Jurisprudence	high/low
	Reporting Requirements	many/few
	Sharia Authority Centralization	centralized/decentralized

Another factor that affects how financial contracts are shaped is, of course, the regulatory environment. Several bodies, described in section 7.2, act as standard setters for Islamic jurisprudence. Some enjoy a greater degree of acceptance than others, such as the Central Bank and the Securities Commission in Malaysia, whereas others like the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)<sup>27</sup>, although they do enjoy a high degree of respect and visibility, either have little relevance to IVC or generally have limited practical follow-

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<sup>27</sup> See section 7.2.

up due to lack of enforcement mechanisms. The centralization of sharia resolutions issuance as in the case of Malaysia also simplifies the dissemination of knowledge about Islamic finance’s rules.

What stands out in this code though is that the regulatory focus is usually on the sharia governance mechanism, or that it bases accounting treatments of Islamic transactions much less on their economic substance than the legalistic form of the contracts and financial instruments used<sup>28</sup>, except where the fiscal impact would put Islamic finance at a disadvantage<sup>29</sup>.

### 5.1.15. Decision Making Power

Open Code	Properties	Dimension
Supervisory Power	Board of Directors	strong/weak
	Investment Committee	strong/weak
	Sharia Board	strong/weak
	Margin of Freedom for Fund Managers	wide/narrow

Who holds power of supervision over IVC fund managers determines what type of objective has priority. While we found no evidence throughout our IVC cases that sharia scholars were complacent in terms of sharia compliance, their interventions were limited and investment committees’ active involvement and supervisory power was much stronger. This necessarily tilts

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<sup>28</sup> See section 8.2 for a full illustration on how Islamic instruments are re-engineered to mimic conventional instruments’ behavior.

<sup>29</sup> This is the case for example for *murabaha*, which recreates the economics of debt through the fiction of a sale, see section 8.2.1. This however creates double stamp issues in many jurisdictions, which has often been eliminated by specific legislation stressing the economic reality of the transaction.

the balance in favor of the investment committees' business objectives and creates further incentives for fund managers to comply with Islamic finance's stated sharia objectives in form only.

#### 5.1.16. Industry Sophistication

Open Code	Properties	Dimension
Industry Sophistication	Sophistication Relative to US	high/low
	Age of the Industry	old/new
	Years of experience of VC Professionals	many/few
	Existence of local LPs	many/few
	Number of Entrepreneurs Relative to US	more/less
	Exposure of Entrepreneurs and Venture Capitalists to Each Other	high/low
	Financial Knowledge of Entrepreneurs	high/low
	Fund Managers' Exposure to Technology	high/low
	Sharia Acceptance of Intangibles	high/low
	Universe of Investment Opportunities	big/small
	Industry Maturity	high/low
	Industry Development Speed	high/low
	Cooperation between Islamic and Conventional Institutions	high/low
	Prudential Rules in Portfolio vs. Individual Assets	portfolio/individual

There is a learning and sophistication effect on financial contracts used in IVC. The breadth of instruments and rights used is clearly associated with the age and experience of both the firm and its managers. Younger firms and less experienced managers are less sensitized to agency issues

and consequently tend to face them *ex post*. As a result, they realize the need for more sophisticated instruments and rights typical of conventional venture capital *ex ante* and see no sharia objection in using them. This is the case for MalaysiaBankIVCs, the youngest firm in our cases. It is also the case of the relatively more experienced MalaysiaIIVC as well. DubaiIVCHolding, whose managers have a solid pedigree in the industry, and the older MalaysiaIslamicWindowVC use all the financial tools typical of any well-established firm in the US. Obstacles to learning are external to IVC firms. They include, in Malaysia which has a more local mandate of investment than Dubai's firms, the number of entrepreneurs available and exposed to venture capital, or fund managers' ability to evaluate complex projects, especially in the technology sector. Interestingly, these constraints are mentioned by MALAYSIACVC as well, albeit to a lesser degree. Although IVC in Malaysia may show a slight lag in terms of maturity compared to its conventional counterpart, it is catching up quickly.

Other indicators of this sophistication come on the LP side and the prudential rules, though these tend to be external factors to each firm. Indeed, a greater number of LPs contribute to the development of a more experienced venture capital skills pool. In Malaysia, this number is relatively small, and interest in IVC specifically is even more limited to a number of major actors such as Islamic banks or public funds. In Dubai, the pool of LPs is essentially limited to wealthy families. Additionally, rules such as the US Prudent Investor Rule do not exist in either Malaysia or Dubai, thereby limiting the capital flows that could go into venture capital in general, and IVC in particular, from institutional investors.

### 5.1.17. Exits

Open Code	Properties	Dimension
Exits	Preference for Acquisitions	high/low
	Preference for IPOs	high/low
	Cash Preference	high/low
	Negotiation Preference	high/low
	Ability to Influence Exit Outcome at Investment Time	high/low
	Ability to Influence Exit Outcome at Portfolio Management	high/low
	Favorable Local Stock Exchange for IPOs	high/low
	Geographical Preference for Local Stock Exchange	high/low
	Preference for Portfolio Company Location Stock Exchange	high/low
	Determined Exit Routes at Investment Time	high/low
	Regulatory IPO Simplicity	high/low
	Documented Exit Processes	high/low
	Importance of Networks	high/low
	Sharia Oversight	high/low
	Non Sharia Compliance	high/low
Sharia Process Formalization	high/low	

We examined how exits were planned as these may affect the way financial contracts are designed at inception. Of the IVC firms we have met, only MalaysiaIslamicWindowVC went through actual exits, the others were too young to have gone through a complete investment lifecycle yet.



As in conventional venture capital, the preferred exit routes are IPOs and acquisitions. Buybacks come as a third option. There is both a geographical and network bias in the way exits are foreseen. These preferences, in both our conventional and IVC cases alike, however, were not embodied in the contracts. In most cases they were considered too remote and unpredictable to be worth the attention at contract inception.

Interestingly, sharia compliance is usually not formalized as part of the exit process, aside from very obvious violations<sup>30</sup>. Sharia is considered irrelevant to IPOs, considered inherently legitimate from an Islamic finance point of view. Whereas a sale to company that is egregiously non sharia compliant is unlikely, it was seen as an improbable theoretical case by most of our interlocutors.

#### 5.1.18. Deal Initiation

Open Code	Properties	Dimension
Deal Initiation	Firm Initiative	high/low
	Entrepreneurs Initiative	high/low
	Importance of Networks in Sourcing	high/low
	Screening Sharia Criteria	high/low
	Screening Financial Parameters	high/low

Theoretically, this could be considered the biggest distinguishing criteria of Islamic finance from an economic point of view. When screening companies for investing, IVC fund managers exclude a small number of industries, such as the ones dealing with pork, pornography, gambling, alcohol

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<sup>30</sup> It would for example be unlikely that a soda company be sold to an alcoholic beverage company.

or arms for example. Although all exclude companies leveraged beyond a certain conventional debt to equity ratio, usually one third, infrastructure projects excepted, there is no such restriction on economically equivalent sharia compliant debt. Most IVC fund managers dismiss this difference as trivial however, as they see it as no different from a conventional VC fund with an industry focus.

As is the case for conventional VC firms we have met, most deals are sourced through IVC firms' networks by the managers' initiative. As a result, entrepreneurs are quite indifferent generally to the Islamic form of the funds they receive, they tend to focus more on the economic aspects of their relationship.

#### 5.1.19. Influence of Tax

Open Code	Properties	Dimension
Influence of Tax	Tax Incentives for Islamic Structures	many/few
	Tax Exemptions	many/few
	Cross-Border Transactions	many/few

We looked at how taxes could affect the design of Islamic financial contracts. In the cases we've been through, taxes were only relevant for cross-border transactions, where uncertainty could accompany the treatment of otherwise established securities as explained in the case of MalaysialslamicWindowVC. In all other cases, conventional and Islamic alike, taxes were not a factor as the firms were either operating in a tax friendly environment such as the Caymans or Dubai, or were benefiting from tax exemptions and the even playing fields created by the Malaysian government. Islamic debt issues for example, although structured to look like equity in form, are treated like conventional debt from a tax perspective in Malaysia and benefited from a

number of exemptions. Moreover, industries which are typical targets of venture capital funding such as ICT benefit from many tax exemptions.

### 5.1.20. Islamic Financial Instruments

Open Code	Properties	Dimension
Islamic Financial Instruments	Use of Straight Equity	always/often/seldom/never
	Use of Debt	always/often/seldom/never
	Use of Personal Entrepreneur Put Option	always/often/seldom/never
	Use of Convertible Preferred	always/often/seldom/never
	Tax Incentives for Islamic Instruments	always/often/seldom/never
	Sharia Attitude towards Different Classes of Shares	acceptance/hostility
	Sharia Attitude towards Preferred Shares	acceptance/hostility
	Conversion Price	fixed/variable
	Tolerance to Conventional Debt	acceptance/hostility
	Tolerance to Sharia Compliant Debt	acceptance/hostility
Complexity	high/low	

During our interviews, we haven't seen a conventional venture capital instrument which wasn't also used in IVC, either in form or in substance. Where Islamic finance's sharia adopts a hostile attitude, for example such as with debt or preferred equity, different governance mechanisms and contractual forms are used to reproduce the same cash flows. This ability to circumvent formal restrictions increases with the experience of fund managers. Conversion price when a convertibility option exists has to be fixed at contract inception according to Islamic finance's rules, but this isn't different from conventional practice.

### 5.1.21. Valuation Fairness

Open Code	Properties	Dimension
Valuation	Relevance to Sharia	high/low
Fairness	Criteria for Fairness	defined/intuitive

We came across some variation within our IVC cases in terms of attitude towards how criteria could be judged from an Islamic perspective. While some assert “*valuation has nothing to do with sharia*”, others indicate an imperative of fairness in the process. Moreover, how fairness is defined depends on the interlocutor. While some posit valuation should be led by market value in order to be fair, others do not define it and leave it to intuition on a case by case basis.

### 5.1.22. Seniority of Claims

Open Code	Properties	Dimension
Seniority of Claims	Sharia Acceptance	high/low

In Islamic finance, sharia formally does not recognize seniority of claims in the spirit of full profit and loss sharing. This applies to IVC as well. However, in practice, financial rights and instruments which automatically affect the order of attribution of cash flow claims, such as redemption rights or Islamic debt for example, behave like their conventional counterparts.

### 5.1.23. Control Rights

Open Code	Properties	Dimension
Control Rights	Board Seats	control/minority
	Use of Redemption Rights	always/often/seldom/never
	Use of Reservation Rights	always/often/seldom/never
	Use of Pay-to-Play Clause	always/often/seldom/never
	Use of Legal Fees and Expenses Clause	always/often/seldom/never
	Use of Special Voting Rights	always/often/seldom/never
	Influence of Negotiation Outcomes	high/low
	Influence of Risk Perception	high/low

Most rights typical of conventional venture capital are used without restriction in IVC when relevant. Exceptions are reported here. Redemption rights are not accepted by all firms, Pay-to-Play rights are limited by the Islamic finance prohibition on preferred equity. Special voting rights, that is shares with a greater voting weight, are considered illegitimate, and breakup clauses imposing the reimbursement of charges incurred are subject to varying limitations. As with Islamic securities though, it is possible to circumvent most of those restrictions in substance. Redemption rights, where forbidden by the sharia board can be synthesized from convertible Islamic debt and options. Pay-to-play rights can be obtained by structuring the underlying preferred shares as dividend yielding Islamic debt as well. Special voting rights can either be obtained through changing the numerical ratios of shares where possible, or mitigated through reservation rights, which are perfectly accepted. No workaround is sought for the fact that legal fees and expenses are partially born by the Islamic venture capitalists in case of breakup during negotiation. There

is insufficient data to evaluate whether the difference between the conventional practice of a flat fee and the IVC practice of third party cost or half of it, born by the entrepreneurs is material.

As in conventional venture capital, which clause appears and which doesn't in each term sheet and contract is a matter of negotiation and risk perception in Islamic finance.

#### 5.1.24. Alternative Use of Rights

Open Code	Properties	Dimension
Alternative Use of Rights	Implicit Obligations	many/few
	Use of Staging to Enforce Obligations	always/often/seldom/never
	Use of Reserve Matters to Monitor Sharia Compliance	always/often/seldom/never

Where Islamic finance renders formally illicit certain instruments such as fixed income securities or preferred equity, some workarounds exist. Reuse of typical but licit governance mechanisms such as staged financing are used to obtain informally what would otherwise be a formal requirement. This is especially true for cash flow claims, where gifts can replace required dividend distributions for example. Likewise, continuous sharia compliance over initial industry restrictions or conventional leverage ratios does not require specific clauses. Typical conventional rights such as reserve matters, giving the fund managers veto rights on material changes of business plan are understood to include sharia matters.

### 5.1.25. Term Sheets

Open Code	Properties	Dimension
Term	Standardization	high/low
Sheets	Complexity	high/low
	Use	always/often/seldom/never

We found some variation in term sheets across our cases. Conventional firms used them systematically, starting from an internal standard template and customizing them for each deal. These templates contain all typical tools of a venture capitalist, and in the case of DubaiCVC, which does cross-border deals, is the same for Europe as well as emerging markets. IVC firms' use of term sheets is more dependent on experience. Whereas MalaysiaIslamicWindowVC and DubaiIVCHolding proceed in the same way as conventional firms, MalaysiaIIVC' term sheets are simpler, although growing in complexity with time, and MalaysiaBankIVCs has yet to use them. Revealing of IVC's similarities with conventional venture capital, the term sheet templates for many IVC deals are the same as the ones written for conventional deals.

### 5.1.26. Firm Characteristics

Open Code	Properties	Dimension
Firm Characteristics	Type of VC firm	government/bank/independent
	Industry focus	diversified/tech
	Competitive Positioning	leader/small player
	Regulatory Tax Advantages	high/low
	Age	old/new
	Legal Structure	corporation/LP

We have inquired about firm characteristics to understand how this could affect the design of financial contracts. First, we found that differences in economics between our conventional venture capital cases and our IVC firms were related to experience, as denoted by the age of the firm. Other properties above didn't affect IVC contracts in a way that was specifically Islamic.

### 5.1.27. Fund Manager Characteristics

Open Code	Properties	Dimension
Fund Manager Characteristics	Years of Experience in VC	senior/intermediate/junior
	Commitment to Business Objectives	high/low
	Commitment to Sharia Objectives	high/low
	Spiritual Sharia Compliance Level	idealistic/pragmatic
	Spiritual Ease with Choosing Reference Sharia Framework	comfortable/uneasy

We looked at fund managers' characteristics and how they could affect Islamic financial contracts. We found that more experienced managers, while still as committed in spirit to the ideals of



fairness and brotherly partnerships with their investees, were more focused on the economics of their deals than junior managers. In this sense, experienced IVC fund managers are no different from their conventional counterparts when it comes to attention to the bottom line and managing agency issues. Among the instruments at their disposal to circumvent sharia restrictions that may be incompatible with their business mandate is the choice of level of compliance. For example, while Islamic finance ideals discourage the use of debt, managers could choose to use an economically equivalent sharia compliant debt to achieve their business objectives although some may feel spiritually more comfortable using equity. This spiritual constraint is also influenced by the multiplicity of sharia frameworks, for example some frameworks recognize multiple classes of shares while others do not.

#### 5.1.28. Limited Partners Characteristics

Open Code	Properties	Dimension
Limited Partners Characteristics	Type	private/public/bank
	Nationality	Gulf/Malaysia/International
	Multiplicity	high/low
	Outsiders	many/few

During our interviews, we examined several characteristics which may affect the way an IVC firm designs its financial contracts. While the type of limited partners on board doesn't have a direct impact on Islamic issues, their nationality had an important effect. Nationality of the LPs may indeed affect the stringency of the sharia standards to be applied, such as with the more conservative Gulf, thereby increasing the distance between the formal abidance by sharia principles in IVC contracts and the economic reality of the corresponding deals. When, in addition

to the founders of the IVC firm, multiple LPs and other outsiders invest, a tighter focus on the bottom line occurs, potentially further increasing the gap between contract form and economic reality.

### 5.1.29. Social Mandate

Open Code	Properties	Dimension
Social Mandate	Training of Future VCs	high/low
	Mobilize Private Investors	high/low
	Muslim Assistance Agenda	high/low
	Entrepreneurial Development	high/low

As sharia ideals often express a social role, we have looked at whether the firms we've met had social specificities. Only two firms had an explicit social mandate, one conventional, the other Islamic. Out of the four properties, described above, indicating each of the social mandates we observed, three were part of MalaysiaCVC's mandate, the conventional government backed firm. The fourth one is a duty the independent IVC assigned itself and is slightly more general than many similar Bumiputera policies: "*do something for the Umma* [i.e. the global Muslim community] *by favoring Muslim employment*". This impacts the size of their universe of potential investments as they will only invest in companies that have at least 50% Muslim employment. This only affects the IVC lifecycle at the screening stage though, so contracts and management style are otherwise unrelated to the firm's social mandate.

### 5.1.30. Entrepreneurial Attitude

Open Code	Properties	Dimension
Entrepreneurial Attitude	Commitment to IVC	high/low
	Deal Shopping	high/low
	Indifference to Sharia	high/low

As all deals we've seen in IVC were sourced by the venture capitalists rather the entrepreneurs, there was no specific personal commitment from the latter on sharia matters. Those entrepreneurs who approach IVC firms generally have strong financials and are shopping for deals. This makes them less interesting to the IVC managers we've met who have a preference for exclusive deals, as they, otherwise, have little protection against costs of non-closed deals. This lack of commitment to Islamic financial ideals creates a type of agency issue, though non pecuniary, as entrepreneurs may decide to deviate from sharia restrictions.

Moreover, where IVC managers actually believed in a selfless partnership between themselves and their entrepreneurs, investments nearly resulted in complete losses. Indeed, in these cases entrepreneurs chose to disregard many of the obligations deliberately left out of contracts due to an overly idealistic interpretation of sharia.

### 5.1.31. VC-Entrepreneur Relationship

Open Code	Properties	Dimension
VC- Entrepreneur Relationship	Trust	high/low
	Value Adding Portfolio Management	high/low
	Consensual Management	high/low
	Decision Freedom Granted to Investee	high/low
	Time to Build Relationship	high/low
	Manners and Like-Mindedness	high/low
	Comradeship	high/low
	Risk Perception	high/low

IVC and conventional venture capital firms differ when it comes to relationships with their investees primarily in the emphasis on trust, like-mindedness and comradeship apparent in the interviews. In practice however, both conventional and Islamic firms take time to build relationships with their potential investees. Conventional firms say this is a risk mitigating tool.

Other claims of benefits brought to investees, such as value adding portfolio management, and the amount of autonomy given to entrepreneurial decision-making are part of each firm's investment style and not exclusive to either conventional or Islamic firms.

### 5.1.32. Investee Monitoring

Open Code	Properties	Dimension
Investee Monitoring	Amount	high/low
	Perception of Partnership	high/low

How monitoring is done is at least partially reflected in the covenants accompanying issued securities and in the rights specified in the financial contracts. The amount of monitoring by IVC firms is a matter of investment style. Across our cases, we have seen variation. This variation is not specific to Islamic firms however. Although the Islamic finance ideal is that true partnership amounts to fewer agency issues, and therefore requires less monitoring, *ceteris paribus*, in IVC firms like in conventional firms we've met, less monitoring means shifting investment style to later stage targets where institutionalization plays a role in mitigating agency issues.

### 5.1.33. Sharia Macro-Parameters

Open Code	Properties	Dimension
Sharia Macro- Parameters	Margin of Interpretation around Compliance Criteria	wide/narrow

Sharia Macro-Parameters are the first criteria used to select a potential target company. They can be summarized as an examination of the industry of the target company. It is based on the exclusion of some industries, such as those dealing in pork, gambling, pornography, or arms, with some variations across firms. This is one of the main distinguishing features of the investment mandate of IVC compared to the broader venture capital sector.

### 5.1.34. Sharia Micro-Parameters

Open Code	Properties	Dimension
Sharia Micro-Parameters	Margin of Interpretation around Compliance Criteria	wide/narrow
	Importance of Financial Instruments in Compliance	high/low
	Undesirability of Leverage	high/low

Sharia Micro-Parameters are the financial criteria used to filter eligible companies. All IFIs use conventional leverage as the main filtering criteria. This is another one of the principal distinguishing features of the investment mandate of IVC compared to the broader VC sector. However, there is some leeway as to how those leverage ratios are interpreted. First, although Islamic and conventional debt are economically equivalent and people attracted to Islamic finance ideals aspire to have no debt, Islamic debt is not included in leverage calculations. Second, the degree of leverage of target companies tolerated varies across IVC firms and target industries. For instance, while it is accepted that infrastructure projects are not restricted in terms of conventional debt, when and for how long varies. Some sharia scholars will demand that the conventional debt of infrastructure companies which they tolerate at investment time be converted to Islamic debt within a horizon of three years. For other industries, the most widely accepted leverage ratio is one third. Depending on firms or their sharia scholars however, the tolerance level may go down to 5% or even zero in the case of some Gulf scholars.

### 5.1.35. Islamic Contract Cost

Open Code	Properties	Dimension
Islamic Contract Cost	Sharia Advisory Fees	high/low
	Sharia Cost for Each Securities Issue	high/low
	Standardization of IVC Contracts	high/low
	Customization of Transactions	high/low

The design of an Islamic contract incurs various additional costs compared to conventional equivalents. These costs include sharia advisory fees, the cost of each security issue in a sharia compliant manner, and the Islamic customization of each transaction for a sector that does not have standardized instruments yet. However, while these costs can be high in absolute terms in certain segments of Gulf Islamic finance, such as *sukuk* issues, we found no evidence that these sharia costs were material compared to overall transaction costs in IVC.

### 5.1.36. Sharia Operations

Open Code	Properties	Dimension
Sharia Operations	Formally Defined Internal Processes	high/low
	Internal Process Efficiency	high/low
	Existence of Sharia Committee	yes/no
	Intermediate Unit of Sharia	yes/no
	Guidelines for Sharia Governance	high/low
	Formal Compliance Checks at Screening Stage	yes/no
	Formal Compliance Checks at Due Diligence Stage	yes/no
	Formal Compliance Checks at Screening Stage	yes/no
	Formal Compliance Checks at Management Stage	yes/no
	Formal Compliance Checks at Exit Stage	yes/no
	Sharing Sharia Functions Across Units	yes/no

Because Islamic financial institutions are distinct in the way they operate in terms of integration of sharia components in their structure and processes, we discussed how IVC firms were structured and how this could be linked to financial contracts and influence potential agency issues. It emerged that IVC firms' operations differ little from their conventional counterparts'. Most do not have a sharia unit *per se*, interventions from sharia scholars are sporadic, often at the screening stage of the investment lifecycle, with few, if any, formal checks afterwards. Judgment on sharia compliance is mostly left to the discretion of IVC fund managers who follow guidelines, if any exist in the firm. Where IVC firms are offshoots of banks, they don't even have internal sharia units, they share the units of their parent banks.



### 5.1.37. Sharia Compliance

Open Code	Properties	Dimension
Sharia Compliance	Aspiration to Comply with Regulation	high/low
	Firm Reputation Risk	high/low
	Degree of Formalization of Compliance Criteria	high/low
	Stringency of Sharia Requirements	high/low
	External Enforcement of Sharia Compliance	high/low
	Margin of Freedom in Sharia Compliance	high/low
	Use of Benchmarks	high/low
	Duration to Compliance	long/short

There are several interpretations of what sharia is. Within each of these interpretations, the degree of sharia compliance depends on a number of parameters. Of these, there is the degree to which the various actors within the IVC firm itself actually aspire to sharia ideals. Although the degree of public scrutiny of IVC firms is much lower than that of retail IFIs, the reputational risk from doubtful compliance is real. The unclear definition of compliance leads to dramatically different requirements established in different IVC firms, for example, such as the different ratios of conventional leverage noted earlier in the thesis.

Interestingly, there is an aspect of pragmatism to the restrictions imposed, as confirmed by several of our interviewees, across the Islamic finance industry. As mentioned previously, infrastructure projects, which would normally be leveraged beyond the usual Islamic finance standards, benefit from a greater debt to equity ratio tolerance from sharia scholars than do other industries. Due to the nature of the projects financed in the regions where Islamic finance is most

active, infrastructure and real estate, requiring the standard, conservative, debt-to-equity ratios for these types of projects would reduce the universe of opportunity to the point of irrelevance. Little oversight is carried out on exits as they are assumed to be sharia compliant, although theoretical cases of violations are possible, such as exits through share swaps with non-compliant companies. Sharia scholars sometimes show flexibility by granting time to reach what they deem to be full compliance.

### 5.1.38. Sharia Variations

Open Code	Properties	Dimension
Sharia Variations	Differences among Different Schools of Jurisprudence	high/low
	Relative Stringency of Gulf vs. Malaysia Requirements	high/low
	Applicability of External Sharia Frameworks	high/low
	Influence of International Sharia Frameworks	high/low
	Interactions with Academia	high/low
	Consensual Decision Making Among Scholars	high/low

In addition to the possible levels of compliance within one understanding of sharia, there are varying definitions of what sharia itself is. In other words, Islamic financial jurisprudence is not uniform. Some factors act as a converging force between these interpretations, while others do the opposite. First, several major schools of classical jurisprudence exist, four of them Sunni. In the Gulf, the dominant school is Hanbali while the Shafii School is dominant in Malaysia. Within each of these schools, individual scholars interpret according to their own worldview of what Islamic principles uphold. There are disagreements on how much each school can practically borrow from the other, some scholars claiming, for example, that different social contexts such

as Malaysian multiculturalism makes it impossible to borrow the most stringent features of Gulf interpretations, whereas other scholars reject anything short of international consensus. Sharia resolutions being adopted by way of voting are another source of variation, as minority scholars can influence other institutions they work with. Academia, on the other hand, acts as a homogenizing factor as scholars exchange opinions and train future professionals.

These variations in sharia interpretations are a source of opportunity for IVC managers as they can choose the sharia compliant contractual forms with the least constraints thereby reducing the necessity to compromise on the substance of their dealings.

### 5.1.39. Sharia Staff

Open Code	Properties	Dimension
Sharia Staff	Conflict of Interest	high/low
	Reputation Risk	high/low
	Experience	high/low
	Relevant Academic Background	high/low
	Reports to BOD	high/low
	Business Awareness	high/low
	Compensation Level	high/low
	Density of Presence Across Different Sharia Boards	high/low
	Time Dedication	high/low
	Existence of Professional Bodies	high/low
	Sophistication of the Recruitment Process	high/low
	Importance of Networks	high/low
	Pragmatic Considerations	high/low
	Level of Screening at Licensing and Recruitment	high/low
	Gap Between Aspirations and Reality	high/low
	Level of Compromise	high/low
	Conditions and Corrective Measures on Compromise	high/low
	Exposure to Intangible Assets	high/low
	Power on Business Decisions	high/low
Margin of Freedom in Issuing Sharia Resolutions	high/low	

The Sharia staff is a fundamental element in how contractual sharia compliance is shaped in IVC. Their attitude towards different details of Islamic finance contracts is determined by many properties, including their experience, their academic background, and their exposure and understanding of finance among others. IVC managers told us during interviews that, for example, sharia staff with more finance background, acquired through either education or professional exposure, was more lenient in terms of accepting conventional financial instruments as legitimate. One of the consistent prohibitions we've encountered, on which "*scholars need to be educated*" according to one of the IVC managers we've met, is their acceptance of financing intangible assets.

We found no evidence that business incentives or hierarchical structure were driving sharia staff to willfully disregard the economic reality of the transactions they were approving. In Malaysia, the compensation levels we observed were fixed and within white-collar ranges<sup>31</sup>. There is no dismissal mechanism but the sharia staff was pressured to dedicate the necessary time to their sharia compliance work and to educating themselves to be able to renew the licenses that the Securities Commission or the Central Bank of Malaysia granted them<sup>32</sup>. In the Gulf, on the other

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<sup>31</sup> In our interviews in Malaysia, total compensation packages we observed amounted to anywhere between 20 to 50 thousand Malaysian Ringgit annually. In comparison, a software engineer in Kuala Lumpur makes an average of 47,568 Malaysian Ringgit annually (source: <http://www.payscale.com/research/MY/Location=Kuala-Lumpur/Salary>, retrieved Jan. 2, 2013).

<sup>32</sup> In Malaysia, sharia scholars sitting on sharia boards have to be approved and licensed by the Central Bank of Malaysia, or, in the case of Islamic Venture Capital funds, by the Securities Commission of Malaysia. This licensing requirement does not apply to employed sharia staff.

hand, we have heard rumors that many of the high profile scholars sitting on sharia boards were receiving stellar compensations in exchange for approving otherwise illegitimate products<sup>33</sup>. This was not the case for the staff working in any the IVC firms we met in the Gulf.

In the IVC firms covered by this study, sharia staff has the power to force an exit or veto a deal if they deem it non-compliant. There is a theoretical possibility that uncompromising scholars would not be hired again. Our interlocutors indicate this is unheard of though. The reputational foundation on which the Islamic finance business model is based largely precludes that possibility in practice. In fact, Sharia staff recruitment is largely based on networks which certify their reputation of integrity. Another side-effect of this reputational element is that it creates a professional risk for sharia staff resulting in a structural incentive to be more conservative against conventional tools.

#### **5.1.40. Sharia Monitoring**

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<sup>33</sup> Comments from interviewees working in Gulf IFIs, sometimes virulently sarcastic, were in line with the Ünal (2011) study. For the approval of a sukuk issue for example, high profile scholars could receive a fee of several hundred thousands of dollars (Ünal, 2011). According to our interviewees, some of the approved products were later recalled for lack of sharia compliance.

Open Code	Properties	Dimension
Sharia Monitoring	Intuitive Process	high/low
	Frequency	high/low
	Influence of the Accounting and Auditing Processes	high/low
	Use of an Audit Plan	always/often/seldom/never
	Use of Validity Criteria	always/often/seldom/never

Sharia monitoring is explored to find out the impact of this additional governance mechanism in comparison with conventional venture capital. During our interviews, we found that sharia monitoring is an intuitive process for less experienced and independent firms. Fund managers carry out the monitoring on an ad-hoc basis. More mature and bank backed firms have more established processes as their sharia boards are involved at defined decision. Guidelines do define rules for periodic sharia audits in the more experienced firms. Sharia monitoring basically ensures the sharia macro and micro parameters are still within valid range. There is very little intrusion, if any, in what is operationally equivalent to conventional venture capital processes.

#### 5.1.41. Multiculturalism

Open Code	Properties	Dimension
Multiculturalism	Non-Muslim Participation	high/low
	Chinese Participation	high/low
	Impact of Multiculturality on Sharia Framework Requirements	high/low

Ethnicity plays an important role in this distinction between Islamic finance and conventional finance. In a multicultural environment where many of the IVC industry participants are non-Muslim, or Chinese as is often the case in Malaysia, sharia rules tend to be relaxed. This translates into financial contracts that more readily use conventional denominations for their financial instruments. As one fund manager put it: *“I don’t use sexy names if I don’t need to”*.

#### 5.1.42. Islamic Windows

Open Code	Properties	Dimension
Islamic Windows	Workaround Sharia Restrictions	more/fewer

There have been frequent claims that the Islamic windows of conventional banks were more lax in their sharia compliance, being driven by market demand rather than belief in Islamic ideals. We have seen no evidence that. Of the four IVC firms we have met, only MalaysiansIslamicWindowVC is the offshoot of a non-Islamic bank. We found that MalaysiansIslamicWindowVC bases the design of its contract on the same set of rules issued by local and international bodies as the others. The discrepancy between formal compliance with Islamic finance’s jurisprudence and the economic reality of the financial rights and instruments used in their transactions is general to all IFIs we came across, IVC firms included.



### 5.1.43. IVC Innovation

Open Code	Properties	Dimension
IVC Innovation	Market-Driven	high/low
	Imitation-Driven	high/low

IVC innovation is spurred by the need to circumvent Islamic finance’s restrictions and to respond to the economic needs of conventional venture capital as it serves the same function.

## 5.2. Axial Coding

Axial Coding is the stage where previous concepts are further abstracted along the Grounded Theory paradigm in order to establish links between them. They will serve to undertake selective coding, ordering the set of concepts found throughout these interviews into a theory of financial contracting in IVC.

### 5.2.1. Muslim Socio-Economic Empowerment

Axial Code	Open Codes
Muslim Socio- Economic Empowerment	Islamic vs. Conventional Perceptions
	Islamic Identity
	Social Mandate

The perception that the Islamic identity is associated with superior moral values which practically translate into superior products and services is at the core of the existence of Islamic finance in general. Islamic finance, and Islamic venture capital in particular, is not meant to stand on its own, it is to be constantly compared with conventional finance to prove its advantage.

The notion of an Islamic identity plays an even stronger role in a situation like Malaysia where latent ethnic tensions between the Muslim Malays and the Chinese minority are high, and have strong undertones of competition over the country’s resources. As a result, many Muslim Malays clearly favor dealing with institutions which they perceive as belonging to their community. It also translates into explicit mandates aimed at redistributing wealth in favor of Muslims.

### 5.2.2. Industry Credibility

Axial Code	Open Codes
Industry Credibility	IFI Robustness
	Regulator’s Objectives
	Islamic Institutional Credibility
	Peer Validation

Because much of the Islamic finance industry viability rests on its image of higher integrity and robustness, it is important that this reputation is maintained. Perception of a higher survival rates combined with active government and industry intervention contribute to perpetuate it. Peer pressure diminishes the risk of detractors staining that reputation.

Although public exposure of IVC is lower than for the rest of the Islamic finance industry, the reputational risks associated with it could extend beyond its limits. As a result, Malaysia’s government has been active in regulating it as well, although with lighter requirements than traditional IFIs.

### 5.2.3. Conservatism

Axial Code	Open Codes
Conservatism	Conservative Investment Style

The “Conservative Investment Style” stands on its own as a description of how conservative the general investment culture is in both Kuala Lumpur and Dubai. With a “*banker mentality*” as one of our interlocutors put it among Malaysian venture capitalists, and with LPs in Dubai who culturally still feel more comfortable with tangible yielding assets, conservatism is not an exclusive trait of IVC.

### 5.2.4. Market Conditions and Sharia Cost

Axial Code	Open Codes
Market Conditions and Sharia Cost	Supply of Capital
	Supply of Skills
	Islamic Finance Innovation
	Islamic Contract Cost

The concept represented by this axial code is the relationship between market conditions and sharia costs. It sums up the set of concepts we observed during our interviews which were found to be determinants of the cost of sharia compliance. While we did find evidence that there are transaction costs associated with sharia compliance, who bears them is dependent on those market conditions. In some cases it could be the venture capitalist or the entrepreneur, in other cases it could be the investor if the demand for Islamic investments involves a high number of conventional investors comparatively to the number of Islamic investors. The amounts involved

depend on the relative supply of skills in the different specialties involved in enforcing the sharia framework.

Islamic finance innovation is also related to market conditions. Whether initiated by imitation of conventional instruments or by an individual need whose solution already exists in the conventional sector, the created instruments or the cost of managing the investment have to be competitive with the conventional sector. This in turn creates a downward pressure on sharia costs.

These variations notwithstanding, we found no clear indication of how material this cost of sharia compliance was overall.

#### 5.2.5. Emerging Markets Legal Conditions

Axial Code	Open Codes
Emerging Markets	Jurisdictional Preference
Legal Conditions	Minority Shareholders' Protection
	Regulatory Environment

Three of the open codes explain some of the characteristics we observed in the financial contracting preferences of our interlocutors. There are clear characteristics of weak law enforcement typical of emerging markets with some of the usual associated behaviors: choice of outside jurisdictions, or trying to acquire majority stakes from entrepreneurs. Whereas some of the behavioral patterns we observe in Islamic venture capital might be thought of as specifically Islamic if compared with conventional US counterparts, we do in fact find them to be comparable to their conventional counterparts within the same legal environments.

### 5.2.6. Conventional Investment Lifecycle

Axial Code	Open Codes
Conventional Investment Lifecycle	Deal Initiation
	Exits

When discussing the different phases of the investment lifecycle in IVC, the differences with the investment lifecycle of conventional venture capital are barely noticeable. Sharia compliance is rarely, if at all, considered at exit, rather, it is used as a screening parameter based on the conventional debt ratios as well as the choice of the industry at deal initiation, and in some cases enforced through light periodic audits at the portfolio management stage. Where these audits happen, they examine the main debt financial ratios and rely on declarations from the investee company's management. Consequently, the practical differences between conventional and Islamic venture capital, once the investment has been made, appear to be trivial.

### 5.2.7. Similar Financial Contracts

Axial Code	Open Codes
Similar Financial Contracts	Islamic Financial Instruments
	Valuation Fairness
	Seniority of Claims
	Control Rights
	Alternative Use of Rights
	Term Sheets

This is where the gap between contractual form and economic substance may be widest in IVC, although it is not as striking as in other sectors of Islamic finance such as banking. Indeed, because the need to emphasize the Islamic characters of financial dealings is less acute in IVC due to lower public scrutiny, the need to depart in form from conventional contractual forms is also lower. As mentioned previously and as we will demonstrate in Appendix 8.2, where they differ, Islamic financial instruments closely approximate the economic payouts of conventional financial instruments. Conventional control rights are further used to control the behavior of issued instruments where Islamic finance introduces minor inefficiencies, such as receiving dividends on preferred equity where formal contracts do not obligate the investee to distribute them. The rest, from the pecking order of cash claims to term sheets and valuation, are essentially the same.

#### 5.2.8. Conventional Factors and IVC Contractual Design

Axial Code	Open Codes
Conventional Factors and IVC Contractual Design	Geographic Preference
	Influence of Tax

As with conventional financial contracts, Islamic securities are chosen according to their economic efficiency relative to tax regulations. In addition to this concern, the legal uncertainty specific to Islamic finance has to be taken into account: many countries still lack the regulation and jurisprudence that provide the contract designers with the assurance that their instruments and rights will be interpreted the way they were intended. As a result, IVC contract design tries to stay

as conventional as possible, or at least, choose among the few Islamic securities which have been well tested in related courts.

### 5.2.9. Maturity

Axial Code	Open Codes
Maturity	Industry Sophistication
	Firm Characteristics
	Fund Manager Characteristics
	Limited Partners Characteristics

Less mature IVC firms, LPs and fund managers try to conform to the ideals of Islamic finance in substance. However fewer control rights, minority stakes in environments of weak legal protection for minority shareholders, straight equity securities with little disciplining effects lead to magnified agency issues. Islamic venture capitalists are left at the mercy of entrepreneur hold-ups, trilateral bargaining and moral hazard issues. As a result, as Islamic venture capitalists acquire experience, they naturally respond to these agency issues by using economically similar answers to those used in conventional finance, although they maintain, in discourse, their commitment to Islamic finance's ideals.

### 5.2.10. Agency

Axial Code	Open Codes
Agency	Entrepreneurial Attitude
	VC-Entrepreneur Relationship
	Investee Monitoring

In the discourse of Islamic venture capitalists, trust and like-mindedness are an important aspect of their relationship with the entrepreneurs. These play two roles: first, they give Islamic venture capitalists a non-pecuniary benefit of moral and spiritual comfort. Second, as in conventional venture capital, keeping a close relationship is part of a venture capitalist’s role of reducing information asymmetries while monitoring their investments and actively managing them to add value.

### 5.2.11. Investment Policy

Axial Code	Open Codes
Investment Policy	Sharia Macro-Parameters
	Sharia Micro-Parameters

These are the main criteria of filtering out target companies. Given that Islamic debt is acceptable and there are routes to “Islamicizing” debt, the practical result of this policy would be to reduce the universe of potential investments by excluding some industries. Effectively, with an industry focus such as Information and Communication Technologies for the majority of the cases we interviewed, conventional and Islamic alike, these filters are irrelevant in substance.



### 5.2.12. Flexibility

Axial Code	Open Codes
Flexibility	Malaysia vs. Gulf
	Sharia Compliance
	Sharia Variations
	Islamic Windows
	Multiculturalism

Among the tools the IVC industry possesses to pragmatically circumvent the restrictions imposed by Islamic finance is the variety of interpretations of its rules, both among scholars and across borders. While the phenomenon of flexibly picking and choosing the most favorable religious opinions is limited, to a certain extent, at the individual level by the reputational risk and the actual power of the sharia scholars, it is apparent at the institutional level where business objectives dominate.

### 5.2.13. Non-Intrusiveness

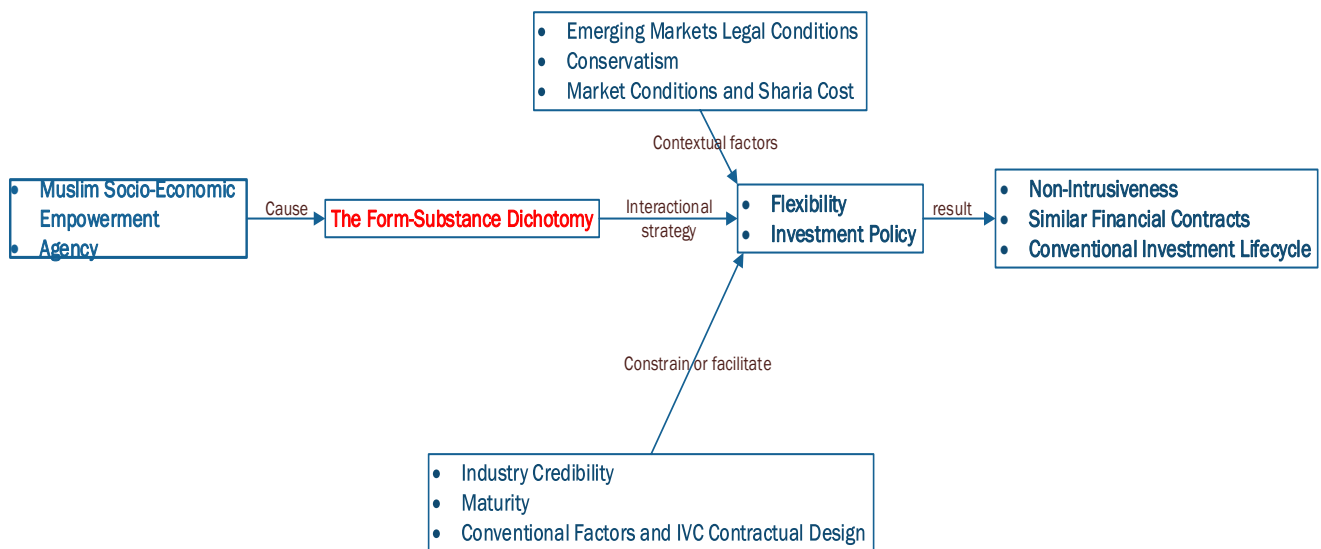
Axial Code	Open Codes
Non-Intrusiveness	Sharia Staff
	Decision Making Power
	Sharia Operations
	Sharia Monitoring

More apparent in other sectors of the Islamic finance industry, the sharia compliance process is operationally relatively unobtrusive in IVC. Aside from guidelines concerning maintaining

conventional debt ratios and industry commitment, or rudimentary regular audits conducted by some IVC firms, the actual sharia related activities in an IVC firm are virtually non-existent. Therefore, operationally, an IVC firm is barely distinguishable from a conventional firm.

### 5.3. Selective Coding

In Selective Coding, we organize the previous concepts along the paradigm described in section 3.1.



#### 5.3.1. The Core Phenomenon

The core phenomenon which appears across all the codes and topics we have seen is the constant dichotomy between the form of Islamic contracts and their substance. Islamic instruments are engineered to mimic as closely as possible the behavior of conventional instruments, and control rights are largely unchanged. Names however may change, sometimes to reflect a more Islamic identity, and the management of some rights is shifted outside the contractual realm.

### 5.3.2. Causal Conditions

Axial Codes
Muslim Socio-Economic Empowerment
Agency

Two diverging forces constitute the causal conditions leading to the constant dichotomy between form and substance in Islamic venture capital.

On the one hand, sociological factors create a market demand for a distinctly Islamic finance sector. Most actors on the demand side are not sophisticated investors and, consequently, do not fully evaluate the underlying economics of the financial contracts. The demand, however, rests on a perception of both moral and economic superiority of transactions with an Islamic label over conventional ones. Perceived advantages include fairness in dealings and reduced systematic risk. Additional perceived advantages are the group solidarity mechanisms they provide by trading mostly with Muslims, or to the benefit of Muslims. IVC is a necessary component of Islamic finance, as it fills the role conventional venture capital plays in conventional finance. For Islamic institutional investors, it constitutes the channel through which a portion of their investments is allocated to the risk/return profile of conventional venture capital, while remaining compliant with the Islamic financial rules as their market requires.

On the other hand, prescriptions in Islamic financial theory effectively increase agency issues. The problem is aggravated in IVC as private entrepreneurial investments are characterized by more pronounced agency issues than other investments. For example, the disciplining effects of debt on entrepreneurs and management would be excluded due to Islamic finance restrictions. More generally, all kinds of moral hazards are increased if pure straight equity is exclusively used as is

usually recommended in Islamic finance ideals of profit and loss sharing. Likewise, in the regions where Islamic finance is in demand, infrastructure projects, for example, are in high demand, more so than technological projects. Being highly leveraged in nature, restrictions on debt, for example, if actually implemented in substance would practically rule out investments in this industry, consequently reducing the relevance of IVC.

### 5.3.3. Intervening Conditions

Axial Codes
Industry Credibility
Maturity
Conventional Factors and IVC Contractual Design

Several factors constrain or facilitate the response of Islamic venture capitalists to the diverging forces of the demand for a distinctly Islamic venture capital and the need to efficiently manage agency issues.

The first one is the drive to maintain the credibility of the Islamic financial sector in general, and IVC in particular. This compels financial regulators to impose frameworks aiming at more stability, and at an increased convergence of interpretations of Islamic financial rules. These rules, of course, have a binding effect on, or at least influence, IVC contracting. Peer pressure also helps in protecting actual economic practice against criticism for its deviation from its stated discourse. The same peer pressure also ensures, to a certain extent, that form remains distinct from conventional practices.

The second factor is the maturity of all actors involved. Countries with a more mature Islamic finance industry offer more resources to circumvent Islamic financial restrictions in practice and less legal uncertainty around the more complex instruments Islamic venture capitalists use. Likewise, more experienced Islamic venture capitalists have a higher awareness about the different types of agency issues they are likely to face. At the same time, they are better acquainted with the different contracting rights and instruments they can use while satisfying the sharia compliance test.

Finally, Islamic venture capitalists, like their conventional counterparts, are influenced by the legal and fiscal environment in which they operate. For example, the different fiscal treatments of the same Islamic contracts can lead to efficiency trade-offs.

#### 5.3.4. Context

Axial Codes
Emerging Markets Legal Conditions
Conservatism
Market Conditions and Sharia Cost

Two broad factors were found to define the general context in which IVC operates. These factors are not directly linked to the form-substance dichotomy in IVC, but influence all the characteristics of IVC. Phenomena which could be wrongly interpreted as IVC specific first should be examined comparatively under these filters in order to be correctly understood. First, both Malaysia and the UAE exhibit emerging markets characteristics when it comes to their legal environment, though at varying degrees. An environment that provides better minority shareholder protection, for example, could reduce the gap between form and substance as pure equity would involve fewer

agency issues. Second, venture capital in both Malaysia and the UAE are structurally conservative, often compared to banking by our interlocutors. As an illustration, a shift in risk appetite may put more tension on the form-substance dichotomy as the IVC universe of investments includes more intangible assets.

The third factor, the impact of market conditions on sharia costs, is more difficult to categorize as a purely contextual factor. Indeed, the number and sophistication of IVC skills available on the market or the ability of Islamic financial engineers to provide more resources to Islamic venture capitalists may be expected to impact their interactional strategies. However, we have found no such link during our interviews. In fact, this factor appears to be more of an environmental factor reflected indirectly in financial contracts.

#### 5.3.5. Action/Interactional Strategies

Axial Codes
Flexibility
Investment Policy

The interactional strategy used to face the causal conditions that lead to the form-substance dichotomy is dual. First, the distinctive Islamic character of IVC is mostly obtained through a loose investment policy defined by few relevant restrictions on certain industries. Second, where Islamic financial restrictions have a more material impact on their management of agency issues, Islamic venture capitalists respond by taking advantage of the flexibility that different interpretations of Islamic finance jurisprudence offer. They pragmatically choose the ones that allow them to mitigate those issues as much as possible.

### 5.3.6. Consequences

Axial Codes
Non-Intrusiveness
Similar Financial Contracts
Conventional Investment Lifecycle

As a consequence of the interactional strategies adopted, the operational process of an IVC firm is very similar to a conventional one and sharia compliance processes are minimal, often reduced to mere guidelines freely implemented by the fund managers. Contracts are economically the same, although they may differ somewhat in form, with some minor inefficiencies and costs introduced if necessary to maintain that form.

## 5.4. The Theory

We represent our paradigm diagram in a more detailed conceptual diagram on page 86. Following our qualitative analysis, this helps us finally state the new theory:

The form-substance dichotomy is a central characteristic of IVC. Market demand for an Islamic brand of venture capital based on ideals of fairness and solidarity clashes with the reality of an array of agency issues and claims venture capitalists need to address. The capacity of Islamic venture capitalists to address these conflicting forces increases with their experience. Their ability is, however, constrained by their fiscal and legal environments. Commitment to Islamic ideals is therefore signaled through an investment policy excluding a small number of industries and through the use of Islamic financial instruments. The latter are different in name but have little economic difference, if any, with their conventional counterparts. Minor economic inefficiencies can result, but they

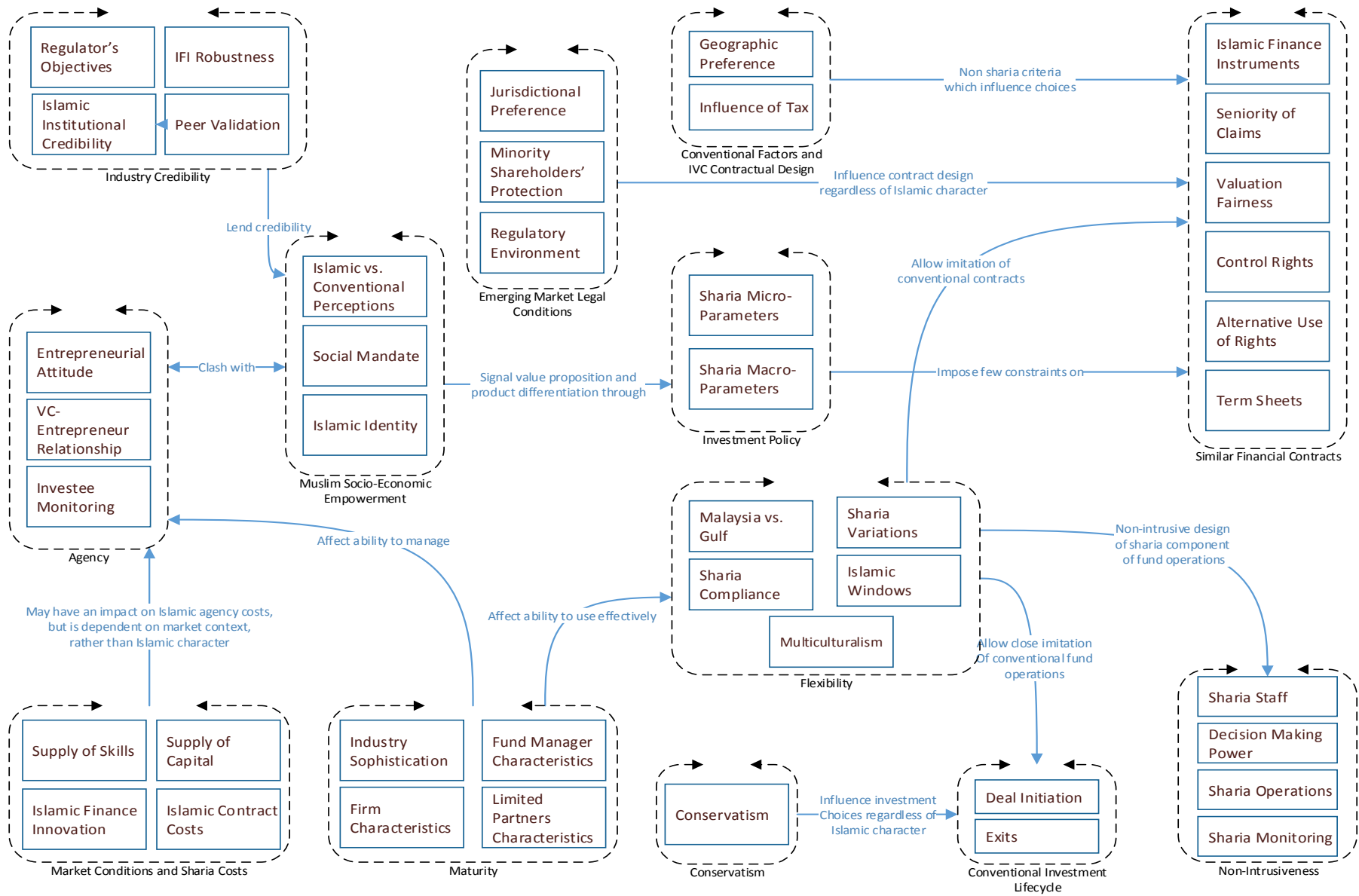
are insignificant overall. IVC is thus operationally and economically equivalent to conventional venture capital.

We can further detail and break down this theory in a set of assertions which could later be tested through follow up quantitative studies:

1. *Ceteri paribus*, investments in IVC and investments in conventional VC do not differ significantly in terms of their economic payouts.
2. Junior IVC players will incur significantly higher agency costs than senior IVC players. More experienced Islamic venture capitalists use a wider array of financial instruments and rights.
3. Malaysian contracts will display greater variety and more sophistication in their Islamic instruments than contracts from other areas.
4. Experienced Islamic venture capitalists use conventional rights to enforce implicit obligations which reproduce conventional venture capital payouts. In some states of the world however, these rights may be insufficient, leading at least theoretically to economic inefficiencies for the Islamic venture capitalist.
5. There are additional transaction costs associated with Islamic venture capital. However, they are not significant economically relative to overall IVC transaction costs.
6. Overall transaction costs do not differ significantly between IVC and conventional VC.
7. A larger pool of Islamic financial skills in the market drives specific IVC transaction costs down.
8. A larger pool of conventional investors relative to Islamic investors drives costs of IVC transaction costs down for the issuer.



9. Benefits, such as preferred dividends, which cannot be enshrined in contracts according to IVC rules are obtained informally through alternative tools. Hence, economic payouts are the same.
10. There is currently no correlation between planned exit routes and instruments used in IVC contracting.
11. The risk-return profile of IVC investments is the same as conventional venture capital investments'. *Ceteris paribus*, it is however more conservative in Malaysia or the UAE than it is in the US.
12. Tax and jurisdiction choice play a significant role in the formal choice of Islamic instruments.



## 6. Agency Issues in the Literature

Following the methodology applied by Ullah (2012), we position our theory within the literature.

As one of the main causal conditions bringing the form-substance dichotomy at the core of our theory and the concepts we have observed, we examine our findings through a short survey of the agency literature. We first see how Islamic finance literature treats agency issues, from a normative standpoint then from a positive one. Second, we comparatively discuss how financial contracting and security design in conventional finance in general, and venture capital in particular, are used to manage these agency issues. Finally, we describe some of the factors we found to influence various elements of our theory, in their relation to financial contracting and agency issues, such as experience of venture capitalists, the legal environment or taxation.

In the theoretical foundations of Islamic finance, profit loss sharing (PLS) methods of finance are preferred. Contracts finding their roots in medieval Islam such as *mudaraba*, whereby passive investors provide equity capital to entrepreneurs, and *musharaka*, a more active form of partnership, are expected to increase the ownership base of society. Both are often likened to venture capital and idealized as fair modes of finance where risk and rewards are shared by cooperative agents, unlike debt financing presumed to be risk free for the investor and, therefore, exploitative. Moreover, agency issues are understated, dismissed or simply ignored by many authors as the set of socially centric behavioral assumptions on *homo islamicus* is expected to mitigate them. Sarker (1999) for example suggests incorporating “*ignored behavioral consideration in the contract*” to “*induce the agent to behave honestly*” and “*principal-agent problem will be at a minimum magnitude*” because “*Muslims believe in the eternal concept of life, in which honesty is rewardable and dishonesty punishable*” and “*if all financial operations are*

*based on sharing (...) honest entrepreneurs will force dishonest entrepreneurs out of the market”.*

He also proposes measures typical of venture capital, such as writing contracts that link gradual vesting of ownership to performance objectives or improved personal knowledge between lenders and borrowers and exploiting geographical proximity to reduce information asymmetries and monitoring costs. Khan (1987) shows through a mathematical model the superiority of variable return schemes over fixed return schemes, conditional on the absence of informational asymmetries. He attributes these asymmetries to dishonesty, and argues that Islamization will result in their disappearance.

Other authors propose theoretical solutions to agency issues. Ahmed (2002) discusses underreporting of profits, characterized as dishonesty, as an impediment to profit-sharing modes of finance. He recommends an audit based scheme of rewards and penalties to create incentives for reporting actual profits. Dar et al. (1998) on the other hand recognize moral hazard and propose a theoretical model based on tradeoffs between transaction costs and monitoring costs. The model predicts a negative relationship between size, profitability and the use of PLS contracts. Dar and Presley (2000) suggest Islamic financial institutions should structure their organization along venture capital firms to address the problems arising from lack of control over management.

In practice, Khalil et al. (2002) indicate that Islamic financial institutions limit their use of *mudaraba* contracts due to their inherent characteristics inducing moral hazard. Possible misrepresentation of results by the entrepreneur, uncertainty of returns, and consumption of perks are among several concerns of Islamic financial institutions. El-Hawary et al. (2004) also briefly discuss the agency issues induced by *mudaraba* and *musharaka* within the context of the prudential standards that need to be established for Islamic financial institutions. Those contracts are used notably in Islamic investment accounts, where a bank is characterized as an entrepreneur

and the account holders are characterized as the silent partners. Safieddine (2009) discusses the agency issues those investment accounts pose to account holders with limited governance recourse. Mirakhor and Zaidi (2007) recommend for concerned lenders that they resort to *ijara sukuk*, or lease-backed securities. Far from the PLS ideals, *murabaha* or sale based credit, functionally equivalent to conventional debt, as well as various types of *sukuk*, or Islamic bonds, are by far the most popular instruments among investors (Farooq, 2007; Iqbal et al., 1998; Khan, 1995). Accordingly, the actual operating mode of Islamic financial institutions is to replicate conventional finance tools (El-Gamal, 2006)<sup>34</sup>. These studies from the world of banking are relevant to this research as the contractual devices used in banking are commonly used in venture capital (Triantis, 2001).

Restrictive religious interpretations in the theoretical framework translate into the existence of a sharia board overseeing transactions and contracts as a defining feature of Islamic financial institutions. Theologians sitting on these boards certify the islamicity of their respective institutions' activities and instruments. Arab denominated contracts are designed by specialized financial engineers as alternatives to conventional securities, catering to a captive market exhibiting behavioral preferences toward an ostensibly distinct Islamic identity (Kuran, 2004). This engineering through contracts with sometimes little relation to the original circumstances of their creation creates inefficiencies, at the very least in terms of higher transaction costs (El-Gamal,

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<sup>34</sup> See also El-Gamal (2003). "In an interesting fatwa for HSBC Amana Finance in New York, two active Islamic bank jurists signed a document that stated that such language (including the terms "borrower," "interest," and "loan," etc.) was only mandated in HSBC documents by New York State, but further noted that the contract was nonetheless essentially interest-free." (footnote p. 124)

2006). Farook and Farooq (2011) suggest that the costs of sukuk issuance can be up to 60% higher than conventional bonds.

There is some debate around the incentives of sharia scholars to validate financial products for business reasons, regardless of their actual sharia compliance. Farook and Farooq (2011) discuss these incentive issues extensively. They mention the network analysis conducted by Funds@work which shows that 50 top scholars sit on 73% of all boards, or 834 positions. While this could promote the standardization of Sharia rulings, it could also compromise the quality of Sharia diligence. They indicate how at least one attempt by AAOIFI to cap the number of sharia boards on which scholars can sit, which was met with resistance by scholars. Farook and Farooq (2011) explain this using the publicly available anecdotal figures for top sharia scholar fees per sukuk issue validations range in the \$100K-\$300K interval for the Gulf region. Our own interviews reveal lower pay rates however for average sharia staff (see footnote 31).

Although *mudaraba* and *musharaka* are implicitly conceived as asset classes by being compared to venture capital, they're mostly used as specific equity based financial instruments by Islamic financial institutions. As Islamic finance is bound to face in practice the same agency issues conventional finance does (Asutay, 2007), equity financing necessary leads to agency issues between entrepreneurs and investors (Farmer and Winter, 1986), or their Islamic *alter ego*, the *mudarib* and the *rab-il-mal* respectively. Amit et al (1998) show that a central feature of venture capital is its capacity to reduce agency costs and Salhman (1990) explains the setup of venture capital funds in relation to agency costs. Whether in conventional or in Islamic finance, projects with strong information asymmetries are thus better served by the superior abilities and specific organization of venture capitalists to screen and monitor.

Cumming and Johan (2009, pp. 32-44) give an overview of agency issues. They describe moral hazard, bilateral moral hazard, multitask moral hazard, adverse selection, free riding, hold-up, trilateral bargaining, window dressing, underinvestment, asset stripping and risk shifting. There is a rich literature on which security is optimal according to circumstances, type of company, and type of agency issue. Cumming and Johan (2009, pp. 297-358) examine several securities in this context. The proposed correspondence between different agency costs and proposed securities is summed up with matching IVC instruments in section 8.1.

Security design is deeply intertwined with rights allocation in the mitigation of agency costs. Grossman and Hart (1986) describe how, because contracts are costly to establish, rights over assets can be classified in either specific rights, or residual rights. Residual rights are all those given by ownership and not necessarily mentioned in the contract. In this framework of incomplete contracts, Aghion and Bolton (1992) propose a theory of capital structure based on control rights. The contingent allocation of these based on *ex-post* observed states of the world ensures decisions are taken in ways that reduce agency costs when *ex-ante* planning is not possible. A simple illustration of this is found in debt contracts, which transfer control rights to creditors in a state of default, while serving as an *ex-ante* disciplining measure in states of non-default for entrepreneurs valuing control. Berglöf (1994) examines control rights from the perspective of exits in venture capital and the trilateral bargaining problems they can generate. The allocation of the right to sell mitigates potential collusion with a late coming buyer, the third party, which would result in extraction of value at the expense of one of the initial contracting parties. He argues that control forms an essential incentive for an entrepreneur and defines a model where convertible debt contracts are optimal to preserve that incentive in good states of nature, and

protect investors in bad states. Hellmann (1998) discusses how control rights shield investors from hold-up issues in states where a change of management is necessary.

The body of research concerning financial contracting is in fact rich and several surveys are available<sup>35</sup>. It generally deals with how capital structure, the design of securities and the state contingent allocation rights respond among others to different problems of agency, including adverse selection and information asymmetry, uncertainty as well ownership and control.

Kaplan and Strömberg (2000) empirically describe and measure these rights in light of existing financial contracting theory. They examine a sample of 213 investments in 119 portfolio companies by 14 venture capital firms. Their study confirms theoretical predictions about contingent state allocations, but also finds that financial contracting is in reality more complex. Indeed, they recognize a continuum of control rights used for contingent contracting, which they categorize as cash flow rights, board rights, voting rights, liquidations rights and other rights.

Although agency issues are the main concern behind contractual design, a comprehensive view on the venture capital contracts must also take into account a set of factors unrelated to agency. One is taxation. Gilson and Schizer (2003) demonstrate how tax practice has had a first-order importance in shaping the current prevalence of convertible preferred equity securities in US venture capital. They explain how lower investment returns taxation allow management to be compensated through a combination of common equity and lower valuations relative to the convertible preferred equity issued to venture capitalists. Cumming and Johan (2009, pp. 312-

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<sup>35</sup> See for example Harris and Raviv (1992), Allen and Winton (1995), Hart (2001), or Roberts and Sufi (2009) for surveys of the field from different angles.



346) presents further evidence in an international setting consistent with this theory, showing a negative correlation between tax rates on capital gains and the use of convertible preferred equity. Our own interviews suggest that tax matters too, but in a different way. The legal uncertainty surrounding the tax treatment of untested Islamic financial instruments favors the use of simpler structures.

Another factor is the legal environment. Two competing streams of theory prevail. The first stream purports weaker legal enforcement and shareholder protection leads to a shift towards other mechanisms of governance. This is illustrated for example by Lerner and Schoar (2005), who show that common law countries with stronger law enforcement are more likely to use convertible preferred equity, whereas countries with weaker law enforcement, French civil law or socialist countries favor a mix of straight debt and/or equity. The analysis points to the sophistication of judges and lawyers or their hostility relative to different classes of shares with different cash flow and control rights. Investors consequently try to acquire controlling blocks, which is inefficient as investors have to increase their investment size, reducing diversification, and entrepreneurs' incentives are diminished. The second stream posits that weaker legal enforcement and shareholder protection is compensated by more complex contracts.

A last factor is experience. Bengtsson and Sensoy (2011) discuss how more sophisticated venture capitalists focus less on downside protection and more on obtaining board rights. In a nascent industry like IVC, our own research suggests venture capitalist experience is a crucial parameter.

Because IVC addresses the same economic needs as conventional venture capital within an Islamic finance framework, the need for conventional-like securities and rights arises, ranging from debt

to derivatives as well as for state contingent contracts allocating differently voting, control, board and liquidation rights.

## **7. Firm and Fund Governance**

Another element of literature that is relevant to our theory is about governance, and particularly, governance of Islamic financial institutions and venture capital firms, since these are at the heart of the defining differences between conventional and Islamic firms. Moreover, the contextual factors influencing the operations of Islamic venture capital firms explain several aspects of our theory. Following the methodology used in Ullah (2012), this section therefore contrasts and contextualizes our findings through a quick survey of literature and a description of the environment in which IVC operates.

Salhman (1990) explains how venture capital firms are optimally organized to select the best entrepreneurial ventures for investments and minimize agency as well as operating costs. The typical firm is organized as a management company dealing with several funds having their own legal existence. Funds are raised by these firms with a typical lifespan of ten to twelve years. In the first years, the funds are invested in portfolio companies, with three to six years investment horizons. The proceeds from these investments are then distributed to the investors.

### **7.1. The Investment Process in an Islamic Fund**

In a convention firm, for each portfolio company, investments are staged so as to keep the option to discontinue investments. Moreover, mechanisms are kept to force managers to distribute returns. The typical investment lifecycle in an entrepreneurial venture goes as follows in a conventional venture capital fund:

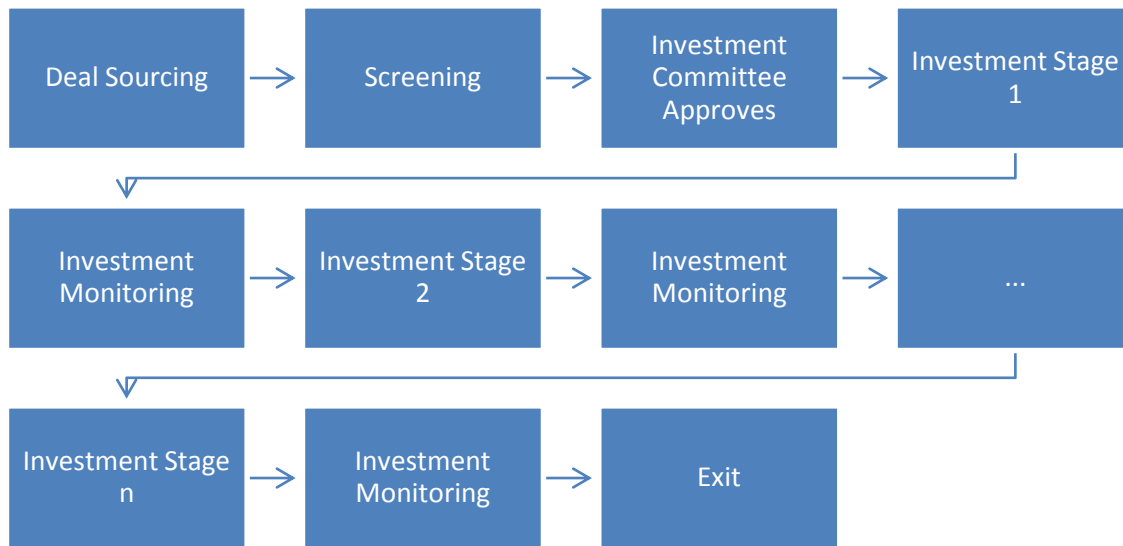


Figure 1: Typical investment lifecycle in a conventional venture capital fund

In contrast, a typical IVC firm has a sharia committee which approves deals as well before initial investments are made. The lifecycle becomes:

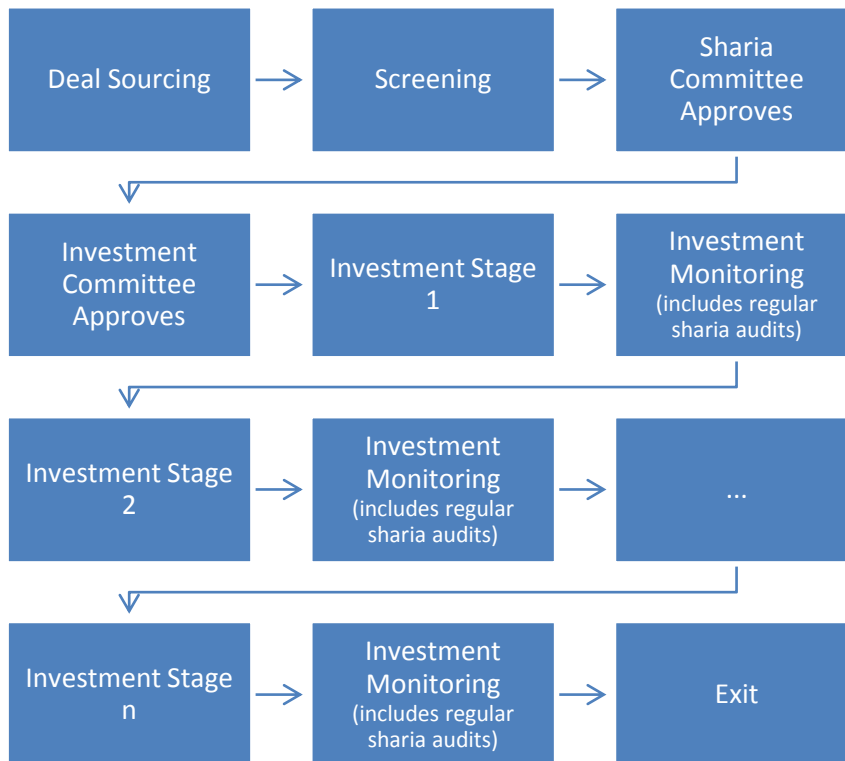


Figure 2: Typical investment lifecycle in a Islamic venture capital fund

The order in which investment and sharia committees approve investments vary between firms. Sharia audits can also be as simple as submitting a short questionnaire to the company's management or ensuring continuity in line of business and conventional debt ratios according to firm guidelines.

## 7.2. Regulatory and Environmental Characteristics

### 7.2.1. Islamic Financial Standards

A few international institutions act as standard setters for the Islamic finance industry, with overlapping roles, but two among them stand out as the major leaders.

The first one is the Bahrain based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which sets accounting, auditing, governance, sharia as well as ethical standards for Islamic financial institutions. The second one is the Kuala Lumpur based Islamic Financial Services Board (IFSB), which sets standards for the supervision of Islamic financial institutions and the promotion of their stability.

### **7.2.2. Kuala Lumpur, Malaysia**

Two institutions regulate Islamic finance generally, and IVC specifically. The first one is the Central Bank of Malaysia. Its Sharia Advisory Council acts as a central authority on sharia resolutions and issued a compilation of these (Central Bank of Malaysia, 2010). The second one is the Securities Commission, whose Sharia Advisory Council acts in the same way, and also issued a compilation of its sharia resolutions (Securities Commission of Malaysia, 2007). Both aim at creating some consistency across the industry in terms of what is considered sharia compliant and what isn't. Both have an endogenic relationship, together with the IFSB, so harmonization between them is straightforward.

Moreover, they regulate the minimal governance mechanisms in Islamic finance generally, and IVC particularly. One of the cornerstone governance rules for IVC firms is the requirement to have a board with at least one approved sharia scholar to supervise the firms' activities.

Litigation goes through federal courts, as only family law is a state matter. Therefore, federal courts play a role in applying Islamic finance jurisprudence. Key regulation includes:

- the Islamic Banking Act (1983) which regulates the licensing and operation of Islamic banks in Malaysia;

- the Takaful Act (1984) which regulates the licensing and operation of Islamic insurance in Malaysia;
- the Central Bank of Malaysia Act (2009), which mandates that the Central Bank promotes Malaysia as an international center of Islamic finance and consecrates the role of the Sharia Advisory Council in harmonizing Islamic finance sharia resolutions;
- and the Guidelines and Best Practices on Islamic Venture Capital (Securities Commission, 2008), which set the core requirements for Islamic venture capital firms.

Other details and references on the regulatory framework in Malaysia for IVC can be found in Mutalip (2009).

### **7.2.3. Dubai, UAE**

Contrary to Malaysia where Islamic finance is a federal matter, the UAE regulates Islamic finance at the emirate level. Dubai itself has several free zones with specific regulations. Among these, the Dubai International Financial Center is the most active for the financial industry and is where DubaiIVCHolding, the Dubai based IVC firm we interviewed, is located.

The Dubai Financial Services Authority is the regulating authority on financial matters in Dubai. One of the key regulations it issued is the DIFC Law No.13 (2004), which specify sharia governance requirements, prudential rules and disclosure requirements among others for Islamic financial institutions. These are further detailed in the Islamic Finance Rules (2012). Latif (2009) describes how Dubai's Islamic finance regulation focuses on the process of Sharia compliance, that is the systemic point of view, such as the existence of, and communication about, supervisory sharia board over Islamic Financial Institutions, rather than the outcome of sharia resolutions.

Dubai has no regulation specific to Islamic venture capital.

### 7.3. Sharia Governance Considerations

The choice of the individuals overseeing sharia compliance has an impact on financial contracts. In addition to the varying costs and market value of these individuals, more relevant to our study is that this choice can determine the shape of the contracts and the amount of constraints placed on the management of agency issues. Regardless of whether any given venture capitalist is actually driven by religious motives or not, as it only affects the level of sharia compliance being sought, a set of factors associated with this choice create risks and opportunities in contract formation and implementation. Those factors which we address in the following paragraphs are the margin of interpretation in Sharia, the agency configurations between investors and sharia supervisors, the limited capacity of sharia scholars in understanding complex financial transactions, and the focus on form over substance in much of Islamic financial practice.

Although institutions such as the AAOIFI or the IFSB try to create standards, there is no single unified understanding of Sharia (Ghoul, 2011b). Our own research in IVC confirms this. In addition, the processes through which sharia experts reach their religious edicts are non-transparent (Farook and Farooq, 2011). Two Islamic investment banks we interviewed illustrate the possible discrepancies. The first one, a Malaysian affiliate of a Gulf bank, described how a prospective hotel real estate project initially approved by the Sharia scholars on the Malaysian side was subsequently invalidated by the Gulf based Sharia scholars at the parent bank. The disagreement revolved around the existence of a gender mixed swimming pool described in section 5.1.6. The



other second example is the frequent occurrence in a UAE investment bank of disagreements with other syndicated banks' Sharia boards on the terms of issued *sukuks*<sup>36</sup>.

In a topic area where the literature is scant, Ullah (2012) provides an in-depth study of the conflicts arising from the pursuit of different objectives by IFIs' management and their sharia departments or sharia supervisory boards. Thus, while the management pursues business objectives such as the maximization of shareholders' value, sharia staff pursues a different set of sharia objectives. Ullah (2012) argues that the strength of sharia compliance depends on whether shareholders of IFIs are Muslim or whether the IFI is the Islamic window of a convention financial institution. The former he says will be more concerned with the sharia compliance of their institution's dealings. Moreover, he brings up, together with other authors such as Farook and Farooq (2011) or Rammal (2006) for example, the potential conflict of interest between sharia experts' commitment to sharia compliance and the high compensations some of them receive from the institutions for which they provide their certification services and creates an opportunity for *fatwa-shopping*. However, there seems to be at the same time an agreement that this only concerns a few individuals. Our own interviews suggest this. First, sharia compliance as an institutional function is usually divided between the sharia board and one or more internal sharia departments responsible for compliance and audit. The stellar compensation packages only concern a small amount of sharia superstars sitting on sharia boards; and the income levels of most sharia experts in Malaysia disclosed during our interviews are in average white-collar ranges (see footnote 31). Moreover, the institutionalization of internal sharia departments and the

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<sup>36</sup> Some issues even had to be recalled after they were first approved by a given board, then rejected as non-compliant with sharia by other scholars.

reputational risk for rank and file employees is high enough to mitigate that phenomenon. The IVC industry is less regulated and its supervision is less institutionalized though. In Malaysia, the only requirement is to have a sharia supervisory board with one scholar (c.f. section 7.2.2). In the UAE, there is no such requirement at all. Additionally, one of the main benefits from a strict business point of view of obtaining sharia certification is the legitimacy and economic power they provide (Ullah, 2012). In the IVC industry, the incentives for this sharia certification, as well as the reputational risks associated with doubtful sharia validation are diminished, though not eliminated, due to lower public exposure. As a result, there is much more room in this industry to choose business friendly sharia experts.

Another element in these trade-offs derives from the personal constraints of sharia scholars. These constraints manifest themselves in their time availability and the nature of their training and experience, limiting their ability to understand complex financial structures (Ullah, 2012). The disproportionate concentration of a few high profile scholars at the top of the majority of IFIs limits their ability to delve into the details of what they approve (Ünal, 2011). While this phenomenon is moderated in the case of IFIs who have internal sharia departments who actually prepare the compliance day-to-day activities before hand, or in the case of Malaysia where there is a regulatory limit on the number of institutions on which a scholar can be sitting, it provides some leeway for Islamic venture capitalists given that IVC firms are less regulated in terms of sharia compliance (c.f. section 7.2.2). As is the case with the agency issues arising from the business-sharia tensions discussed above, the lower exposure to the public provides the Islamic venture capitalists with the ability to establish a relatively more business friendly sharia validation process.

An additional personal constraint is cultural. Particularly relevant to the world of IVC is the attitude of sharia scholars towards intangible assets as a basis for Islamic financial transactions for example. Currently, they are essentially prohibited. We found only two papers discussing the acceptability of intangible assets in Islamic finance. The first one reports how a telecommunication company obtained Islamic approval for using airtime as a base asset (Utting, 2007). The second paper (Ngadimon, 2008) is authored by a sharia specialist from the Malaysia Securities Commission arguing in favor of their permissibility by exposing different Sunni views on intangible assets, and goodwill in particular. Along these lines, although the majority of IVC firms we've met focus on innovative companies, their transactions are tied, at least formally, to tangible assets. Yet, venture capitalists are best at managing agency issues, which are more pronounced when investments require higher specialization, are based on intangible assets and have high growth prospects (Gompers, 1995). This attitude could be rooted in Middle-Eastern practices where trade is still traditionally based, with the concept of trading in companies not culturally ingrained yet (Bolton, 2011).

The reputational cost however of validating contracts not reaching a minimum level of sharia acceptability is perceived to be high (Ghoul, 2011a; Ullah, 2012; see also sections 0 and 0). Additional potential costs include the ability to cancel entire investments if the sharia certification is later revoked (Garas and Pierce, 2010) and hand over corresponding profits to charity<sup>37</sup>. In some of the IVC firms we interviewed, sharia supervisors have an ex-post power to force an exit if the transaction is retroactively considered non sharia compliant or the investee company have moved

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<sup>37</sup> The concept of "cleansing returns" is discussed by El-Gamal (2006, pp. 133-134) for mutual funds and public stock. The IVC managers we've met also have to go through cleansing if gains are deemed illegitimate by their sharia scholars.

outside sharia compliance parameters. That prerogative has not been exercised in any of the cases we have met though.

One more factor influencing the form of contracts is the focus of Islamic finance on form over substance. We found this to be the central theme of this research. It is in most cases possible to re-engineer conventional financial instruments through contracts from classical jurisprudence (El-Gamal, 2006). Chong and Liu (2009) find evidence that in practice, Islamic banks' dealings are not fundamentally different from their conventional equivalents. In contrast with existing practice however, which may add to legal uncertainty, Bank Negara Malaysia's official position on the "substance over form" principle is that in case of conflict between substance and form, it is ultimately substance that should prevail<sup>38</sup>. Our interviews also suggest Islamic finance is more associated with the spiritual side of engaging with people sharing the same values than material differences in the underlying economics. DubaiVCHolding's head of investments for example insisted the spiritual difference was more important than the economics of the transactions. This suggests that the conflict between business objectives and sharia objectives can be mitigated

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<sup>38</sup> Central Bank of Malaysia (2010), p. 192, in its sharia resolution issued in the context of the "substance over form" reporting principle in accounting and financial statements declares:

*The SAC, in its 57th meeting dated 30 March 2006 and 71st meeting dated 26 - 27 October 2007, has resolved that in principle, "substance" and "form" are equally important and highly taken into consideration by the Shariah. In this regard, the Shariah emphasises that "substance" and "form" must be consistent and shall not contradict one another. In the event of inconsistency between "substance" and "form" due to certain factors, the Shariah places greater importance on "substance" rather than "form".*

through a focus by Islamic venture capitalists on engineering in formally acceptable terms what in substance is a relatively straight economic equivalent to the financial instruments they need.

## 8. Financial Instruments and Security Design

### 8.1. Response to Agency Issues

Cumming and Johan (2009) enumerated typical agency issues found in conventional venture capital and suggested solutions to many of them. Likewise, Feld & Mendelson (2011) and Wilmerding (2001) listed the different control rights typical in conventional venture capital term sheets and contracts. These agency issues, and the corresponding responses, are summarized in Figure 3. The definitions for the different control rights can be found in our interview guideline, in Appendix 10.2. Since this study relies on the perspective of the venture capitalist as the principal and the entrepreneur as the agent, our descriptions are limited to this specific agency relationship.

Moral hazard happens when the returns to efforts of the entrepreneur are not fully returned to him or when the costs of private consumption by the entrepreneur are not fully borne by him, such as in the case of equity partnerships. Multitask moral hazard are a specific case, where the entrepreneur undertakes several activities, some of which will not benefit the investors. Asset stripping is another situation resulting from information asymmetries on the state of the company, when entrepreneurs reduce the value of the company through actions that, as its name indicates, strip it from its assets.

Adverse selection, first described by Akerlof (1970), refers, in our context, to how different contracts attract different entrepreneurs. *Ceteris paribus*, a debt offer will attract riskier entrepreneurs. Indeed, for the same expected return, a riskier entrepreneur has a higher probability of achieving a very successful scenario whose profits he wouldn't share by issuing debt. The higher probability of failure also makes the venture capitalist bear the losses in case of

bankruptcy. On the other hand, an equity offer will attract *ceteris paribus* entrepreneurs with lower expected returns. In their case, the expected cost of giving up equity is lower for the same risk.

A hold-up happens when the entrepreneur has the power to expropriate the venture capitalist as a result of unbalanced bargaining power. This could happen when, for example, an entrepreneur who is a vital resource to the funded project threatens to leave. Trilateral bargaining is a situation where the entrepreneur negotiates the sale of company stakes to a third party, in terms that are not in the interest of the venture capitalists. Window dressing refers to entrepreneur make their companies look better than what they actually are. Underinvestment is the situation where incentives are not sufficient for the entrepreneur to exert the necessary effort to make a project succeed. Cumming and Johan (2009) illustrate this situation in a scenario of bankruptcy, where a project can move the company from a state A to a state B, both of which are in bankruptcy, although B has better payouts to the venture capitalists than A. Risk shift is another agency issue, where entrepreneurs shift the risk profile of the company after venture capitalists have entered the business.

To manage these agencies, conventional venture capitalists use an array of securities and contractual rights. Interestingly, the personal put options acquired from entrepreneurs seem to be a Malaysian idiosyncrasy, which is why the literature may not have been interested in it yet. The reliance on a company's institutionalization, a characteristic we found in Dubai, is similar to the one found in later stage investing or private equity. The tools used in IVC are the same, with some restrictions. First, financial instruments are Islamicized. A full comparison between convention and Islamic instruments payoffs used in venture capital is given in the following section. Second, clauses like Legal Fees and Expenses which oblige the entrepreneur to bear the

costs of broken negotiations before a deal is close are limited in IVC to tangible costs, whereas in conventional venture capital, they are usually a flat penalty.



<p>VC-Entrepreneur Agency (as described by Cumming and Johan, 2009, pp. 32-44)</p>	<p>Conventional Venture Capital Response</p>	<p>Islamic Venture Capital Response</p>
<p>Moral hazard</p>	<ul style="list-style-type: none"> <li>• Personal Put option / Institutionalization</li> </ul> <p>Cumming and Johan (2009):</p> <ul style="list-style-type: none"> <li>• Effort is an increasing function of residual claim =&gt; Entrepreneur's effort is an increasing function of debt to common offered to the VC in case bankruptcy isn't expected.</li> </ul> <p>Feld &amp; Mendelson (2011) and Wilmerding (2001):</p> <ul style="list-style-type: none"> <li>• Vesting,</li> <li>• Board of directors,</li> <li>• Voting rights,</li> <li>• Restrictions on founders' activities.</li> </ul>	<ul style="list-style-type: none"> <li>• Personal Put option / Institutionalization</li> <li>• <i>Mudaraba</i> based instruments,</li> <li>• Vesting,</li> <li>• Board of directors,</li> <li>• Voting rights,</li> <li>• Restrictions on founders' activities.</li> </ul>
<p>Multitask moral hazard</p>	<ul style="list-style-type: none"> <li>• Personal Put option / Institutionalization</li> </ul>	<ul style="list-style-type: none"> <li>• Personal Put option / Institutionalization</li> </ul>

	<p>Feld &amp; Mendelson (2011) and Wilmerding (2001):</p> <ul style="list-style-type: none"> <li>Restrictions on founders' activities.</li> </ul>	<ul style="list-style-type: none"> <li>Restrictions on founders' activities.</li> </ul>
Adverse selection	<p>Cumming and Johan (2009):</p> <ul style="list-style-type: none"> <li>Syndication in first round (p. 290)</li> <li>Convertible preferred equity (pp. 314-315)</li> </ul>	<ul style="list-style-type: none"> <li>MRCI.</li> </ul>
Hold-up (by entrepreneur against investor)	<p>Personal Put option / Institutionalization</p> <p>Salhman (1990):</p> <ul style="list-style-type: none"> <li>Investment staging (option to discontinue)</li> </ul> <p>Cumming and Johan (2009):</p> <ul style="list-style-type: none"> <li>Vesting</li> </ul> <p>Feld &amp; Mendelson (2011) and Wilmerding (2001):</p> <ul style="list-style-type: none"> <li>Drag-Along</li> <li>Redemption</li> <li>Restrictions on founders' activities.</li> <li>No-Shop</li> <li>Legal Fees and Expenses Clause</li> </ul>	<ul style="list-style-type: none"> <li>Investment staging (option to discontinue)</li> <li>Vesting</li> <li>Drag-Along</li> <li>Redemption</li> <li>Restrictions on founders' activities.</li> <li>Personal Put option / Institutionalization</li> <li>No-Shop</li> <li>Legal Fees and Expenses Clause is used albeit with restrictions</li> </ul>
Trilateral bargaining	<p>Personal Put option / Institutionalization</p>	<ul style="list-style-type: none"> <li>MRCI</li> </ul>

	<p>Cumming and Johan (2009):</p> <ul style="list-style-type: none"> <li>• Convertible preferred equity</li> </ul> <p>Feld &amp; Mendelson (2011) and Wilmerding (2001):</p> <ul style="list-style-type: none"> <li>• Right of First Refusal</li> <li>• Restrictions on Sales</li> <li>• Co-Sale</li> <li>• Anti-dilution</li> </ul>	<ul style="list-style-type: none"> <li>• Personal Put option / Institutionalization</li> <li>• Right of First Refusal</li> <li>• Restrictions on Sales</li> <li>• Co-Sale</li> <li>• Anti-dilution</li> </ul>
Window dressing	<ul style="list-style-type: none"> <li>• Personal Put option / Institutionalization</li> </ul> <p>Cumming and Johan (2009):</p> <ul style="list-style-type: none"> <li>• Convertible preferred equity</li> <li>• Indemnification</li> </ul>	<ul style="list-style-type: none"> <li>• MRCI</li> <li>• Indemnification</li> <li>• Personal Put option / Institutionalization</li> </ul>
Underinvestment	<p>Cumming and Johan (2009):</p> <ul style="list-style-type: none"> <li>• Provide equity, not debt</li> </ul>	
Asset stripping	<ul style="list-style-type: none"> <li>• Personal Put option / Institutionalization</li> </ul> <p>Cumming and Johan (2009):</p> <ul style="list-style-type: none"> <li>• Provide equity</li> </ul> <p>Feld &amp; Mendelson (2011) and Wilmerding (2001):</p> <ul style="list-style-type: none"> <li>• Protective Clause</li> </ul>	<ul style="list-style-type: none"> <li>• Personal Put option / Institutionalization</li> <li>• Protective Clause</li> </ul>

Risk shifting	<ul style="list-style-type: none"> <li>• Personal Put option / Institutionalization</li> </ul> <p>Cumming and Johan (2009):</p> <ul style="list-style-type: none"> <li>• Provide equity</li> </ul> <p>Feld &amp; Mendelson (2011) and Wilmerding (2001):</p> <ul style="list-style-type: none"> <li>• Protective Clause</li> </ul>	<ul style="list-style-type: none"> <li>• Personal Put option / Institutionalization</li> <li>• Protective Clause</li> </ul>
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Figure 3: VC-Entrepreneur Agency and Typical Response

## 8.2. Comparison between Conventional and IVC Instruments

### 8.2.1. Straight Debt

There are several types of contracts for debt in Islamic finance. The two we have met in the context of IVC are *murabaha* and *sukuk*. The former is a trade based loan, the latter is a bond.

Regular *murabaha* consists in a lender buying a property from a seller and reselling it to the buyer. The buyer then repays the lender according to a regular amortization calendar. Sharia scholars accept this transaction as valid since it is considered a sale with differed payment, not an interest based loan. Like most Islamic finance contractual forms, there is variation in the way *murabaha* is implemented. For example, not all *murabaha* transactions are secured. We have seen, in the case of Malaysia IVC, how the object of sale is used as collateral to obtain a regular bank credit, giving the bank priority of claims and making it effectively unsecured. In some jurisdictions, the double sale involved in *murabaha* implies double taxation, making transaction costs higher. Ignoring transaction costs, the payouts are otherwise the same for regular loans and *murabaha*, both secured and unsecured.

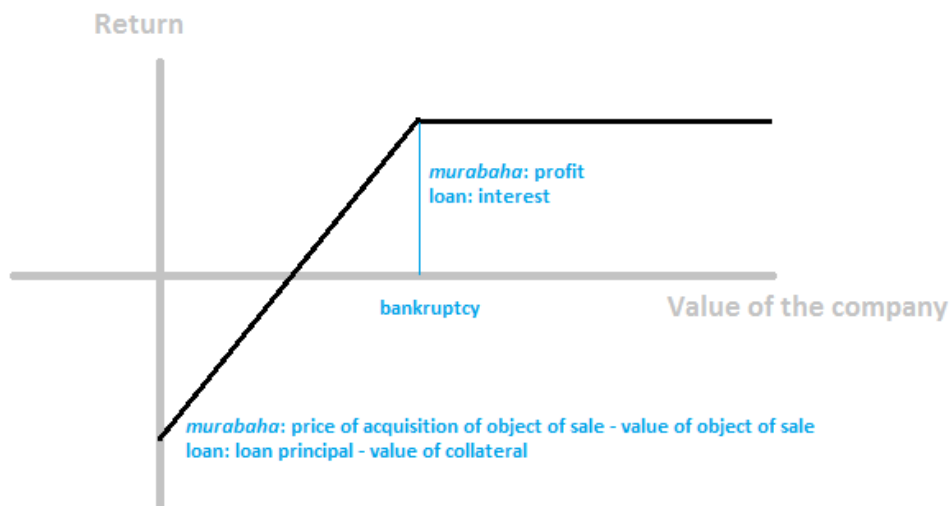


Figure 4: payouts: secured loan vs. regular *murabaha*

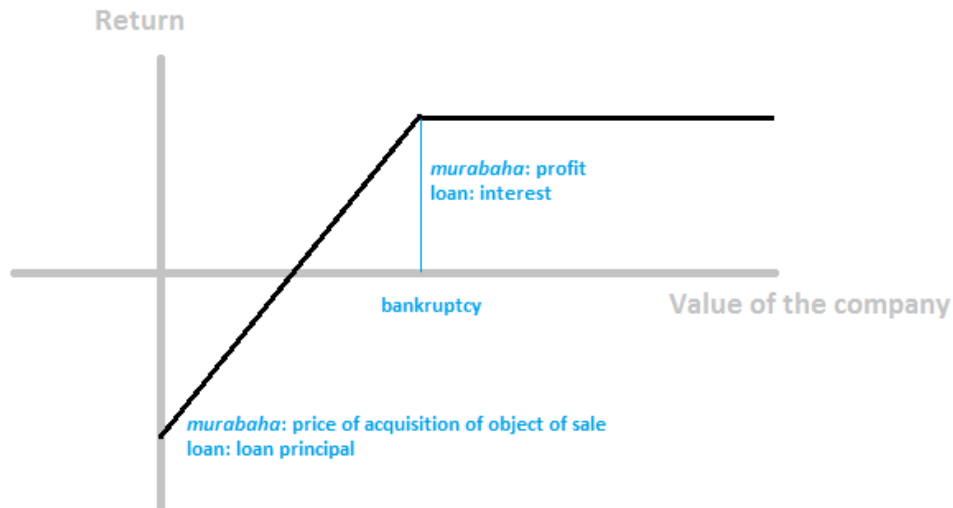


Figure 5: payouts: unsecured loan vs. unsecured *murabaha*

*Sukuk*, as debt instruments, have the same economic payouts as above. They are structured to behave like bonds. As with *murabaha*, *sukuk* are theoretically based on underlying transactions on real assets. For example, the most common *sukuk* structure, *sukuk ijara*, is based on a sale-and-leaseback transaction. Like *murabaha*, it can be unsecured by unlinking explicitly the underlying asset from the cash flows. It can be stated explicitly for example that the lending is unsecured and the agreed upon payments must be made regardless of the existence of the asset, such as a case where it would be destroyed<sup>39</sup>.

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<sup>39</sup> As an illustration, see El-Gamal (2006), pp. 107-113, for a full discussion of such a *sukuk ijara* issued by Qatar in 2003.

### 8.2.2. Common Equity

Common equity is characterized by Islamic finance jurists as the ownership of underlying assets of the company by individual shareholders, based on the classical concept of *mudaraba*. Different classes of shares however are seen by contemporary Islamic finance jurists outside Malaysia as a violation of the principle of fairness. According to them, two persons paying the same price for a share should receive the same share of profit. Moreover, rights are not considered valid objects of sale.

In venture capital, different classes of shares are used mostly in staged financing or to manage exits. They matter especially for their attached liquidation, pay-to-play and anti-dilution rights. Interestingly, in our interviews, we have seen these rights used as part of the shareholders' agreements even without the formal existence of different classes of shares, rendering the prohibition of different classes purely conceptual. Therefore, the common equity securities used are the same in conventional venture capital as in IVC, resulting in the same payouts.

### 8.2.3. Preferred Equity

As mentioned in the previous section, different classes of shares with different payouts are not accepted in Islamic finance. Malaysia IVC has been using the MRCI in lieu of convertible preferred equity. Thus, we will use the MRCI security as a reference against preferred equity, ignoring its convertibility feature which we will examine in the next section.

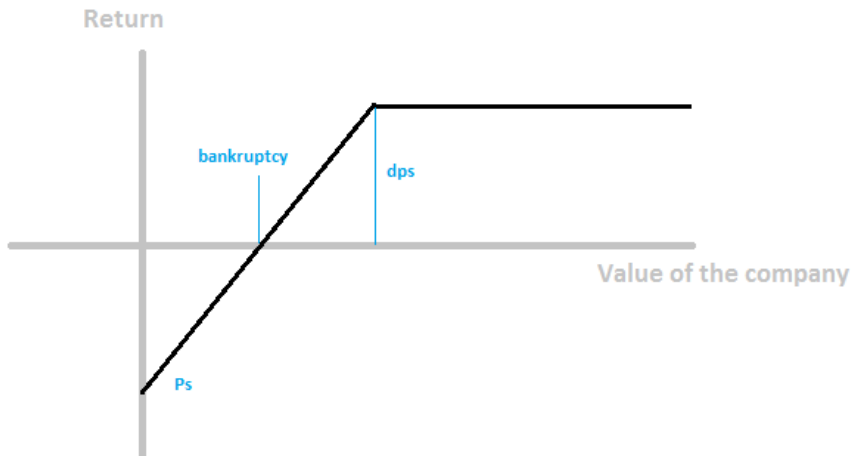


Figure 6: payout of a preferred share

$P_s$  is the par value of the preferred shares.  $dps$  is the return of the preferred shares.

Now, let  $C$  be the cost of acquisition of object of sale in the case of the MRCI,  $p$  the profit of the *murabaha* transaction. Let  $d$  be the expected dividend gifts.

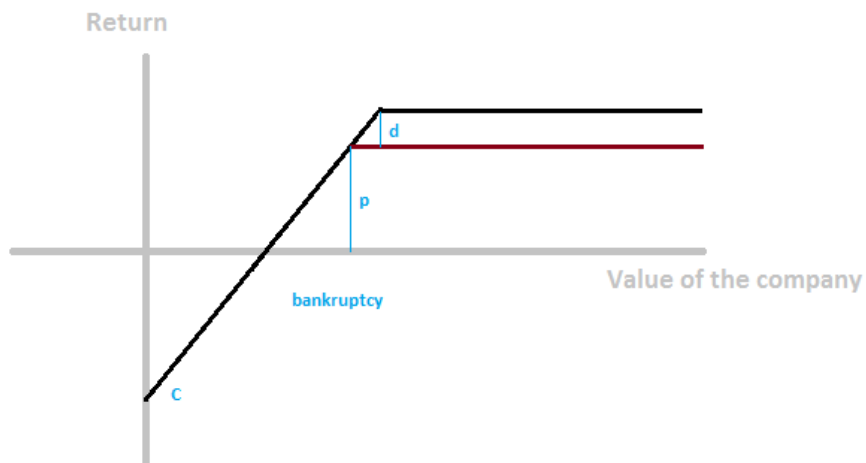


Figure 7: payout of the MRCI, ignoring its convertibility feature.

Ignoring convertibility, the MRCI reproduces the behavior of a preferred share by setting  $C = P_s$  and  $dps = p + d$ , with two slight differences. Bankruptcy can be forced by the MRCI holder if returns are



below  $p$ . Moreover, if the cost of not honoring the expected dividend gifts is lower for the entrepreneur than  $d$ , then the payout of the MRCI becomes  $p$  for the venture capitalist outside of states of bankruptcy. There is therefore a theoretical price for this inefficiency, relative to the exact behavior of a preferred share, that could be priced in depending on who would bear it.

#### 8.2.4. Convertible Preferred Equity

The convertibility of preferred equity impacts its payouts at higher values of the company. The same goes with MRCI. Compared to last section, the new payout functions become:

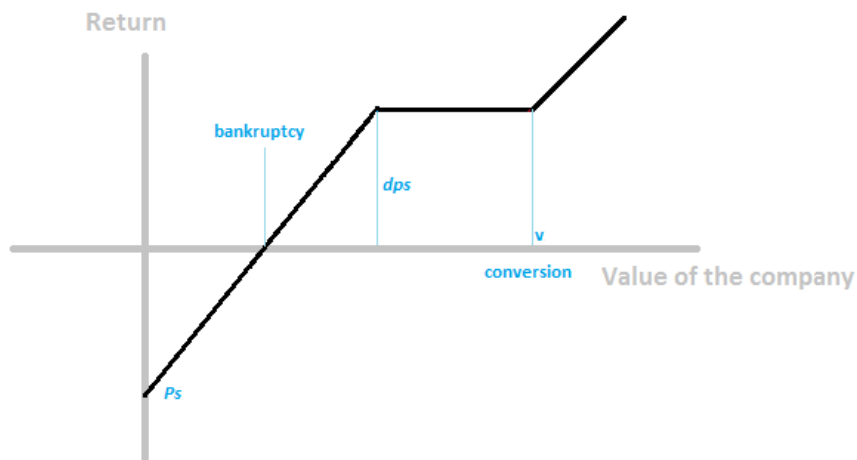


Figure 8: payout for convertible preferred shares

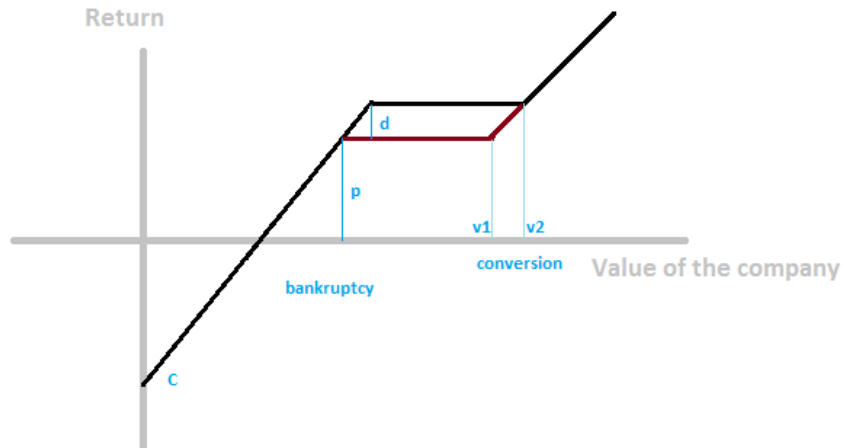


Figure 9: payout for the MRCI

In the case of the preferred shares, the conversion is exercised when the value of the company reaches  $v$ . This same value in the case of the MRCI is represented by  $v_2$ . Like in the previous section, the MRCI has an additional state though, represented by the brown line, which is when the entrepreneur's cost of not honoring the expected dividend gifts is lower than  $d$ . In that state, the value  $v_1$  at which the conversion option is exercised is lower than  $v_2$ .

### 8.2.5. Convertible Debt

Convertible debt is economically equivalent to the MRCI without the expected dividend gifts. Let's assume an IVC investment based on an MRCI instrument with an understanding that no dividend gift will be granted. Assuming unsecured MRCI and debt, the payouts for the convertible debt and the MRCI instrument are therefore:

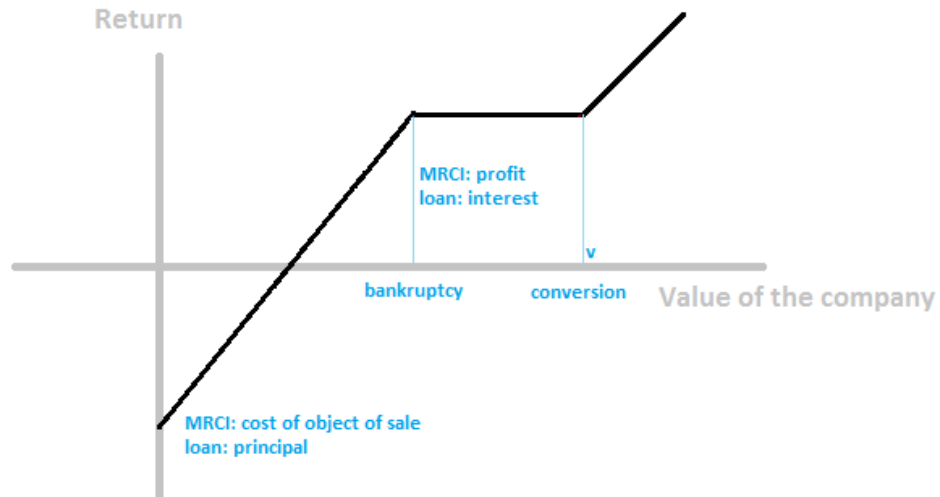


Figure 10: payouts of convertible debt vs. MRCI without expected dividend gifts

### 8.2.6. Options and Warrants

Options have been prohibited by contemporary Islamic finance jurists on the basis of *gharar*, the uncertainty surrounding objects of sale and their terms. Classical Islamic jurisprudence however have contracts such as the *urbun*<sup>40</sup>, or downpayment with no obligation on the buyer to proceed with the purchase, and *salam*, or forward sale of fungible goods, both of which are accepted by contemporary Islamic finance jurists and used to synthesize derivatives. We will use the simplest of the two structures, the *urbun*, against call options to illustrate the economic equivalence between IVC and conventional venture capital in this case. Warrants differ from call options in that they have a dilutive characteristic for the payout.

Let  $K$  be the strike price of a call option and  $c$  its value.

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<sup>40</sup> See El-Gamal (2006), pp. 91-96 for a more complete discussion of the use of *urbun* contracts as option instruments.

Let  $d$  be the downpayment for a *urbun* contract, and  $P$  the price of its object of sale. The economic behavior of the call option is reproduced by setting  $d=c$  and  $P=K+c$ . The payout function is therefore:

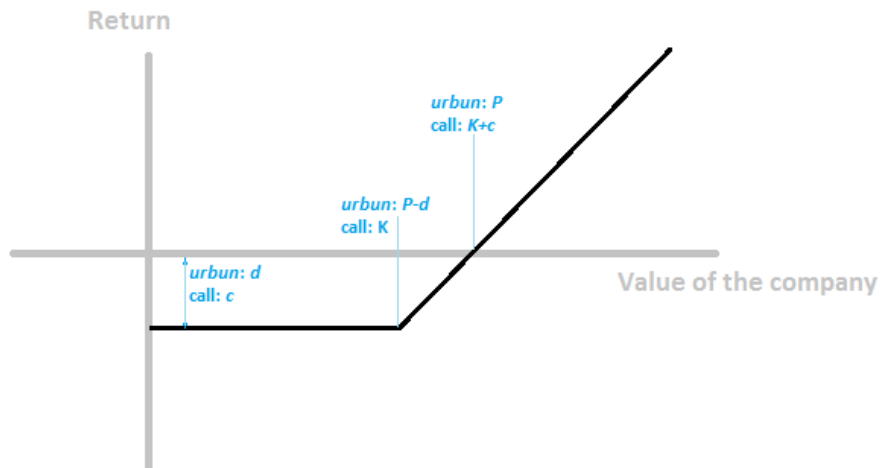


Figure 11: payout of a call option vs. *urbun*

When the company value is below  $K$  the conventional venture capitalist loses  $c$ , the Islamic venture capitalist loses  $d$ . When the company value is at  $K$ , the call option is exercised. Likewise, then the value of the company is equal to the purchase price  $P$  set for the *urbun* contract minus the down payment  $d$ , the venture capitalist proceeds with the purchase. Break-even is reached in the case of conventional venture capital when the company value is equal to  $K+c$ , itself equal to  $P$ .

## **9. Conclusion**

Through our Grounded Theory research methodology, we explored the determinants of financial contracting in the world of IVC. We found that most findings in conventional venture capital apply as well to IVC, as the two are economically near-equivalents. Several of our hypotheses could be later tested quantitatively, provided data becomes available. However, given the size of the industry and its early age, by the time such quantitative data becomes available, the industry itself may evolve and the conclusions in this study may need review.

## **10. Appendix: Interview Guideline**

### **10.1. Questions**

#### **10.1.1. Malaysia specifics**

- Under Federal Constitution, Islamic law is a matter falling within State list. How does it reconcile with the Central Bank's SAC mandate? Can a state challenge its authority when it comes to SAC resolutions?
- Where are legal challenges settled?

#### **10.1.2. Context of LP Contracts and Fund Covenants**

- Are there Islamic Finance (IF) related restrictive covenants regarding the authority of the fund manager (FM) regarding investment decisions? Does the FM have to refer to a sharia board for example? E.g. Restrictions on the FM's investment powers, on the FM's co-investment of personal funds?
- Are there covenants relating to the types of investment? E.g. type of portfolio company, industry, etc.
- Are there covenants relating to the fund's operations? On the FM's extra-fund activities?
- Is the liability – or the limitations thereof – of the FM different in IF?
- Are there IF-specific limitations on who gets to participate as an LP? Do IPEVC funds syndicate with non IPEVC funds?
- Are the covenants adapted to institutional and legal factors (e.g. LP contracts in KSA vs. the UK, would they require different covenants to be deemed Islamic)? Is there a preference for the law of contracting (e.g. create offshore funds in IF friendly legal systems)?

- What are the differences, if any, between institutional investors regarding attitudes and requirements relative to IF contracts and covenants?
- Is priority of claims tolerated in Islamic PE/VC (IPEVC)? If not, how are agency problems/moral hazard between syndicating VCs, VCs and entrepreneurs, VCs and LPs managed?

### **10.1.3. On Sharia Expert Role, Hiring and Compensation**

- How is a typical Sharia Compliance (SC) department organized? What are the operational/other processes?
- How is a SE selected/hired? What's the process? Is there a typical job description? Is it through contacts? Does reputation play a role? Is there a formal process to screen potential candidates?
- Is it easy to find Sharia experts? Are there enough graduates? Experienced professionals?
- How is SE compensation made? In comparison to other conventional positions (directors, compliance officers, lawyers)?
- How do they compare in terms of performance compensation? Is SE compensation linked to performance? How is SE performance measured?
- What is the structure of compensation and pay structure in IF?
- Which part is due to differences in legal conditions (emerging markets, weaker law enforcement, reliability of performance measurability, etc., leading to higher fixed fees for example)?
- What role, if any, does market captivity play on compensation?
- What other role does the SE play in terms of linkage with their environment? Government institutions? Other financial institutions? Other actors?

- How similar is your financial institution's SC organization to other institutions? Which part is the result of regulatory constraints or other external factors, and which part is specific to your institution?
- What do you consider to be particularly important for the credibility of SEs and SC departments? Among professionals? Among consumers? Among investors?
- How does the pressure to compete with conventional banking translate in your everyday operations?
- Is there a professional association for SEs?
- What is with the diversity of interpretations and fatwas on same issues?
- What is the typical composition of a Sharia Supervisory Board (SSB)? Yours specifically? Its terms of reference? What decision making powers does it have? Who has power of appointment and dismissal on the SSB or the SC departments? Who controls SC/SSB fit and develops proper criteria for it?
- Who do the SEs report to? The SC department reports to whom?
- Pros and cons of SEs sitting on only one or several SSBs?

#### **10.1.4. On Sharia Operations**

- Do you have any Sharia audit/review unit? What are its terms of reference? What are the systems of control and assessment?
- What is the Islamic product development process? How is it organized in terms of unit? When are the SEs involved?

#### **10.1.5. Differences Between Conventional Finance (CF) and IF funds**

- How do IF funds usually structure? (LP, corp., etc.)
- Who do they raise from?



- Are the information asymmetries stronger in the case of IF funds (e.g. lack of investor education, new/captive market, lack of finance background of even wealthy investors, etc.)
- Are there constraints on investment exits? (e.g. not sell to certain entities, investor types, anything else?)
- How is the quality certification usually provided by PEVC firms at exits perceived in the context of IPEVC investments?
- According to Abraaj, control is sought to ensure continuous sharia compliance. Isn't this rather a characteristic of emerging markets investments?
- How do IPEVC funds compete with non IPEVC funds – additional research costs and additional specialized skills required? What is the premium, if any, charged compared to similar conventional funds?
- One of the main benefits of traditional PEVC is the added value in terms of company selection capacity, agency reduction, innovation, commercial networks and operational efficiencies. What is the value proposition for IF investors compared to these?
- How are IPEVC investments in a portfolio company valued and reported? What methods are used?

#### **10.1.6. IPEVC Funds/Firms, Industry, Regulatory and Environmental Characteristics**

- Are there different types of IPEVC funds (e.g. CVC, IVC, GVC...)? Which markets do they cater to, in terms of institutional investors? In terms of portfolio companies?
- What are the factors that increase supply or demand for IPEVC?
- What are the geographical areas which are the most active/attractive for IPEVC investors? IPEVC investments? Is there any home bias in this?

- Is there a typical allocation to IF funds from institutional investors? Do regulatory environments play a role? What about perceived legal or cultural environments? Policies? Bureaucratic red tape? Specifically, taxation or securities regulations?
- Are there direct government investment programs (e.g. SWF) promoting IPEVC?
- Is there a typical allocation of IF funds in investments?
- What are the benefits/drawbacks associated with investing in an IF fund for an institutional investor?
- What are the disclosure standards/regulations/practices? How influential are the regulatory bodies such as the IFSB? Local regulations? Benefits of standard bodies or standardization of regulations?
- Are there organizational characteristics among institutional investors which would favour IPEVC allocations?
- Correlation between IPEVC industry and capital markets?

#### **10.1.7. Financial Contracting and Security Design**

- Do IF funds use debt instruments (or functionally equivalent instruments)? Preferred Equity or economically equivalent instruments?
- How are agency problems and moral hazard mitigated through IF instruments, if at all?
- Aside from compliance to sharia, which other objectives does the design of IPEVC securities try to achieve?
- Different designs attract different types of entrepreneurs in conventional investments. As such, it manages not only agency and moral hazard issues, it also deals with adverse selection problems. How is this reflected in IPEVC?

- What are the constraints and costs of IF instruments compared to functionally equivalent conventional ones in the case in IPEVC?
- How are control, decision, veto, and cash flow rights distributed? How are priorities of claims managed?
- What are the sharia resolutions on contracting based on contingencies (see classification as per Kaplan and Strömberg, 2000) of 1) financial measures performance 2) non-financial measure of performance (e.g. new product version, patent approval, etc.) 3) meeting dividend 4) certain actions being taken 5) offering of securities (e.g. IPO) 6) founder staying with the firm?
- Is the design of securities also used to compensate for weak law enforcement issues?
- What are the main securities used in IPEVC?
- Are pre-planned exits taken into account in the design of IPEVC securities?
- Does IF security design impose restrictions/costs sometimes on how you can exit an investments? Is there some related restructuring done sometimes?
- Which types of IF securities are associated with which types of exits?
- One of the ways FM obtain downside protection and upside incentives for themselves is through convertible securities. How is this done in IPEVC where debt instruments are formally excluded?

## 10.2. Checklist of Common Contractual Rights and Securities

Right or Instrument	Yes	No	Sharia restrictions / alternative
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			or comments?
<b>Liquidation Preference</b>			
Preferential claim up to a certain amount on proceeds in case of liquidity event.			
<b>Pay-to-Play</b>			
Forces other investors to co-finance at their pro-rata of shares or have their preferred shares (and associated rights) converted into common.			
<b>Vesting</b>			
Employees/Managers of investee company gain ownership of their shares progressively with time.			
<b>Employee Pool</b>			
Amount of the company reserved for future issuance to employees.			
<b>Antidilution</b>			
Prior investments are revalued in case new equity is issued at lower price.			
<b>Board of Directors</b>			
Presence on the board of directors.			
<b>Protective/Reservation Provisions</b>			
Veto rights on certain actions/decisions of the company.			
<b>Drag-Along</b>			

Right to force sale or liquidation of company if majority of preferred shareholders agree to it.			
Conversion Right to convert preferred stock into common.			
Redemption Right to force company to pay back investment.			
Put Option Right to sell VC shares to the entrepreneurs.			
Legal Fees and Expenses VCs expenses leading to investment are covered by the investee company.			
Information Rights Access to company information by investors.			
Right of First Refusal Priority of participation in event of new equity issue.			
Special Voting Rights Different voting rights, or different classes with same voting rights, etc.			
Restriction on Sales Right of first refusal on existing equity.			
Proprietary Information and Inventions Ensures intellectual property of the company is continuously protected and owned by it.			

Co-Sale If entrepreneurs sell shares, investors have a right to sell it along.			
Restrictions on Founders' Activities Entrepreneurs have an obligation to devote their full time to the investee company.			
IPO Shares Purchase Right to purchase at preferential price a certain amount of equity issued in the event of an IPO.			
No-Shop Entrepreneurs can't seek other investors anymore while a deal is being closed.			
Indemnification Investee company agrees to indemnify investors for any claims by third party.			
Use of Preferred Shares			
Use of Different Classes of Shares Please Describe.			
Use of Debt Or debt-like instruments such as murabaha			
Use of Convertibility Options in Issued Securities Please describe.			
Valuation Issues General request for comment on valuation issues from a sharia perspective.			

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