



**THE LEGAL FRAMEWORK FOR
INCORPORATION OF ISLAMIC VENTURE
CAPITAL IN NIGERIA: THE MALAYSIAN
MODEL**

BY

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for the degree of Doctor of Philosophy (Law)**

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ABSTRACT

The ultimate objectives of this study are twofold. The first is to examine possible incorporation of Islamic venture capital in Nigeria. The second is to examine whether the Malaysian regulatory model would be appropriate in the Nigerian milieu. Since Islamic venture capital is a new phenomenon, this study provides an overview of conventional venture capital as a precursor of the Islamic model. Furthermore, this study provides some introductory remarks on the development of Islamic venture capital while focusing on recent trends and regulatory policies. This includes pre-Islamic partnership modes, early Islamic partnership modes, modern evolution and application of venture capital, and contemporary application of Islamic venture capital. With special emphasis on Islamic venture capital, the study examines Sharī'ah modes of investment, Sharī'ah compliance requirements and legal requirements for incorporating Islamic venture capital followed by allied matters. The methodology used in this study involves both doctrinal and non-doctrinal methods. It employs qualitative method using phenomenological research based on purposefully selected samples for interviews on the Malaysian regulatory framework for Islamic venture capital with a view to assessing its appropriateness for Nigeria. In the Nigerian context, the descriptive approach of doctrinal research is applied. The research findings reveal that the Malaysian model is appropriate for Nigeria. Nevertheless, the study also finds that the major constraints of Islamic venture capital in Nigeria are political will, regulatory requirements and poor infrastructures. However, there are some essential issues to be addressed in addition to legal and regulatory amendments for incorporating Islamic venture capital in particular and Islamic financial system in general. First, there must be political will to incorporate the principles of Islamic finance into the Nigerian financial system. Second, the right technical infrastructure for a sound and robust socio-economic environment that is conducive for venture capital, whether Islamic or conventional, is of paramount importance.

ملخص البحث

هذا البحث المتواضع يهدف إلى تحقيق هدفين رئيسيين من خلال هذه الدراسة. الأول هو دراسة إمكانية ممارسة الاستثمار عبر استثمار رأس المال المخاطر الإسلامي في نيجيريا. والثاني يقصد إلى دراسة صلاحية التنظيم المالي ليكون نموذجاً يحتذى في نيجيريا. ولما كان استثمار رأس المال المخاطر الإسلامي ظاهرة حديثة، قدّم البحث لمحة عامة عن رأس المال المخاطر التقليدي تمهيداً للنموذج الإسلامي. علاوة على ذلك، فإنّ هذا البحث قدّم بعض مقدمات تاريخية حول نشأة استثمار رأس المال المخاطر الإسلامي مركزاً على الاتجاهات الحديثة والسياسة التنظيمية، وهذا يشمل نموذج المشاركة قبل الإسلام، وفي فجر الإسلام. ويشمل كذلك التطور الحديث والتطبيق المعاصر لاستثمار رأس المال المخاطر التقليدي والإسلامي. وأولى البحث العناية لاستثمار رأس المال المخاطر الإسلامي. حيث يدرس العقود الشرعية المطبقة في هذا الاستثمار، والمتطلبات اللازمة ليكون الاستثمار موافقاً للشريعة، والمستلزمات القانونية ليكون نموذج استثمار رأس المال المخاطر الإسلامي موافقاً للقانون المدني وما إلى ذلك. وقد استخدم البحث أسلوب المبدأ القانوني للبحث وغيره. وانطوى المنهج غير المبدأ القانوني على الأسلوب التوعوي مستعملاً أسلوب دراسة الظواهر لاختيار عينات عن قصد لإجراء المقابلة حول التنظيم المالي لاستثمار رأس المال المخاطر وذلك بهدف دراسة صلاحيتها نموذجاً في نيجيريا. وبالنسبة إلى نيجيريا، فقد استخدم البحث المنهج الوصفي لدراسة التنظيم النيجيري الحاكم على استثمار رأس المال المخاطر. وتوصّل البحث إلى أنّ التنظيم المالي صالح ليكون نموذجاً في نيجيريا غير أنّ هناك معوّقات قد تُعرقل تنمية استثمار رأس المال المخاطر الإسلامي في نيجيريا. وأهمّ هذه المعوّقات هي: الإرادة السياسية، والمستلزمات التنظيمية/القانونية، والبنية التحتية السيئة. بناءً على هذه المعوّقات، فثمة أمورٌ ينبغي العناية بها بالإضافة إلى التعديلات القانونية والتنظيمية لإدراج استثمار رأس المال المخاطر الإسلامي بصفة خاصة والتمويل الإسلامي بصفة عامة. أولاً، إرادة سياسية تُرحّب بنظام التمويل الإسلامي في نيجيريا، ثانياً، البنية التحتية والتفنية السليمة التي تُلائم البيئة الاجتماعية والاقتصادية لتنمية استثمار رأس المال المخاطر أمرٌ بالغ الأهمية.

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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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This research is dedicated to my roots, my mother, my father, grandfathers and grandmothers, and my great grandfather. May their souls rest in peace. May Allah grant them eternal bliss in His paradise (al-jannah).

إِذَا مَا تَابَ ابْنُ آدَمَ انْقَطَعَ عَنْهُ عَمَلُهُ إِلَّا مِنْ ثَلَاثَةٍ إِلَّا مَنْ صَدَقَ جَارِيَةً، عِلْمٍ يَنْتَفِعُ بِهِ،

وَأَدِّ حَالِحٍ يَدْعُو لَهُ.

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- Banking and Other Financial Institutions Act (BOFIA) 1991.
- Capital Market and Services Act, 2007.
- Capital Markets and Services (Amendment) Act 2010, [ACt A1370].
- Central Banking of Nigeria Act (CBN) 2007.
- Companies Act , 1990 [Act 441].
- Companies and Allied Matters Act (CAMA), 1990.
- Foreign Exchange (Monitoring and Miscellaneous Provision) Act 1995.
- Insurance Act 1996.
- Investment and Securities Act 2007.
- Islamic Banking Act 1983, [Act 276].
- Nigerian Investment Promotion Act 2004, [Cap 117] .
- Offshore Banking Act 1990, [Act 443].
- Offshore Companies Act 1990, [Act 441].
- Securities Industry (Central Depositories) Act 1991, [Act 453].
- Takaful Act 1984.
- The Constitution of the Federal Republic of Nigeria (CRFN) 1999.

LIST OF ABBREVIATIONS

AAIOFI	Accounting and Auditing Organization for Islamic Financial Institutions.
ACA	African Capital Alliance.
ADR	Alternative Disputes Resolution.
AGCC	Arab Gulf Corporation Council.
ARDC	American Research and Development Corporaton.
BMA	Bahrain Monetary Agency.
BNM	Bank Negara Malaysia.
CBN	Central Bank of Nigeria.
CDC	Commonwealth Development Corporation.
CIMB	Comerce International Merchant Bankers Bhd.
DCF	Discount Cash Flow.
EU	European Union.
FDYP	Fund for Youth Project.
FSMT	Financial Service and Markets Tribunal.
GEM	Global Emerging Market.
GEMG	Global Emerging Market Group.
H & Q	Hambrecht & Quist.
H.T.N	Helios Towers Nigeria.
IBC	International Business Classification Code.
ICT	Information and communications technology industry
IDCC	Industrial Development Coordination Committee.

Islamic ETFs	Islamic Exchange Traded Funds.
IFSB	Islamic Financial Services Board.
IPO	Initial Public Offer.
Islamic REITs	Islamic Real Estate Investment Trusts.
IST	Investment and Securities Tribunal.
I.T	Information Technology.
KFH	Kuwait Finance House.
KLSE	Kuala Lumpur Stock Exchange.
LLC	Limited Liability Corporation.
LOFSA	Labuan Offshore Financial Services Authority.
LTAT	Lembaga Tabung Angkatan Tentera.
LUTH	Lembaga Urusan Tabung Haji.
MAVCAP	Malaysian Venture Capital Management Berhad.
MCs	Muḍārabah Certificates.
MCos	Muḍārabah Companies.
M.D.e.C	Multimedia Development Corporation.
MENA	Middle East and North Africa.
MENASA	Middle East, North Africa, South Asia.
MESDAC	Malaysian Exchange of Securities Dealing Automated Quotation.
MIT	Massachusetts Institute of Technology.
MTDC	Malaysian Technology Development Corporation.
MTV-1	Malaysian Technology Venture One.
MVCA	Malaysian Venture Capital Association.

NEEDS	Economic Empowerment and Development Strategy.
NIPC	Nigerian Investment Promotion Commission.
OSIC	One-Stop Investment Centre.
OSL	Outsourcing Services Limited.
OSP2	Second Outsource Partners Programme.
PBT	Profits before Tax.
PBUH	Peace and Blessing be upon Him.
PE	Private Equity.
PLS	Profit and Loss Sharing.
PUNB	Perbadanan Usahawan Nasional Bhd.
SAC	Shari‘ah Advisory Council.
SAT	Securities Appellate Tribunal.
SC	Securities Commission Malaysia.
SEAVI	South East Asian Venture Investment.
SEC	Securities and Exchange Commission.
SIC	Standard Industry Classification Code.
SMEs	Small and Medium Enterprises.
SMEIS	Small and Medium-Scale Industries Equity Investment Scheme.
SIMs	Small and Medium Industries.
SPV	Special Investment Purpose Vehicle.
SRI	System of Rice Intensification.
TTMAMC	Trailing Twelve-Month Average Market Capitalisation
TTMM	Two Tier <i>Muḍārabah</i> Model.
USA	United States of America.

VCBank	Venture Capital Bank.
VC	Venture Capital.
VCAN	Venture Capital Association of Nigeria.
VCC	Venture Capital Corporations.
VCMC	Venture Capital Management Corporations.

TRANSLITERATION

b	=	ب	z	=	ز	f	=	ف
t	=	ت	s	=	س	q	=	ق
th	=	ث	sh	=	ش	k	=	ك
j	=	ج	ṣ	=	ص	l	=	ل
ḥ	=	ح	ḍ	=	ض	m	=	م
kh	=	خ	ṭ	=	ط	n	=	ن
d	=	د	ẓ	=	ظ	h	=	ه
dh	=	ذ	‘	=	ع	w	=	و
r	=	ر	gh	=	غ	y	=	ي

CHAPTER ONE

BACKGROUND TO THE STUDY

1.0 INTRODUCTION

Venture capital (VC) is an attractive financing tool widely used in the United States of America (USA) and European Union (EU) Countries. This financial instrument is less known and used in Asia¹ as well as Africa. The need for growth-oriented entrepreneurial ventures in every society is a must especially in the Muslim world. The venture capital forms a great influence in an economy because it creates innovations, new jobs, income and not the least wealth.² In addition, it is also a significant vehicle for promoting entrepreneurial growth. The common example for this is transfiguration of innovative ideas from universities and Research and Development (R & D) laboratories in the US economy into high growth companies such as the Intel Corporation, Cisco System, Microsoft, Oracle, Amazon.com, Yahoo! and others.³

However, venture capital may not be a recent phenomenon after all. This is because since ancient times, private individuals do invest in high risk projects.

¹ Michael Prah, Michael Rogero and Patrick Turner, *The Climate for Venture Capital and Private Equity in Asia*, (Singapore: INSEAD, Asia Campus, (2006), 3.

² Hans Landström. "Pioneers in Venture Capital Research" in *Handbook of Research on venture capital* edited by Hans Landström, (U.K.: Edward Elgar Publishing, 2007), 3.

³ Maula, M.V.J., E. Autio and G.C Murray, "Corporate Venture Capitalists and Independent Venture Capitalists: What do they know, who do they know, and should entrepreneur care?" *Venture Capital*, (2005), 7 (1), 3-21; Josh Lerner, Felda Hardyman and Ann Leamon. *Venture Capital and Private Equity: A Casebook*, (USA: John Wiley & Sons Inc., 4th edn. 2009), 1-6, 321; Hans, 3.

Examples of entrepreneurs raising capital from private investors were found in the Babylonia era, in early age of Islam⁴ and in early medieval Europe.⁵ The idea of venture capital emanates from *mudārabah* contract and spreads to Europe with the spread of Islam.⁶ Thus the venture capital investment is not unique to the US; hence corresponding stories and traces in many other countries are noticeable.⁷ This is in spite of the fact that the private equity industry was, in its initial decades, a predominantly American phenomenon. Since, it was first pioneered by the family agencies that managed the wealth of high-net-worth individuals in the last 1990s and early 2000s.⁸ Wealthy families such as the Phippes, Rockfellers, Vanderbilts and Whitneys invested in, and advised a number of business enterprises, including the predecessor entities to AT&T, Eastern Airlines, and McDonnell Douglas.⁹

Venture capital industry is an offshoot of the informal venture capital market that is gradually becoming more professional, employing outsiders to select and manage the investments, to form the nuclei for what ultimately becomes an independent venture capital group.¹⁰ Boston was the home of the first venture capital in the US,¹¹ because it was also the first region that showed some degree of an organized venture capital. This is when the Boston Chamber of Commerce provided financial and technical assistance to a new venture in 1911.¹² Subsequently, the New

⁴ Murat Cizacka, *A Comparative Evolution of Business Partnerships: The Islamic World and Europe, with Specific Reference to the Ottoman Archives*. (New York: E.J Brill, 1996), 201-203.

⁵ Hans, 10.

⁶ Ibid.

⁷ Rind, K.W, "The role of venture capital in corporate development", *Strategic Management Journal*, 2 (2), 1981, 169-80

⁸ William D., Bygrave and Jeffrey A. Timmons, *Venture Capital at the Crossroads*. (USA (Boston): Harvard Business School Press, 1992), 16-20; Josh Lerner, Felder Hardyman, & Ann Leamon, (2005), *Venture Capital and Private Equity: A casebook*, (U.S.A: John Wiley & Sons, Inc.), 1-2.

⁹ Ibid.

¹⁰ Gompers P. and J. Lerner, 'Equity financing', in *Handbook of Entrepreneur Research*, (Boston M.A: Kluwer Academic Publishers, 2003), 67-98.; Hans, 11.

¹¹ Hans, 11.

¹² Ibid.

England Industrial Development Corporation was launched in 1940 to provide similar assistances.

However, the idea of venture capital came from Ralph Flanders¹³ when he proposed fiduciary funds to enable institutional investors to invest up to five percent (5%) of their assets in equity of new ventures.¹⁴ General Georges Doriot, Carl Campton¹⁵ and some local business leaders supported the proposal.¹⁶ Then venture capital markets emerged across the globe between 1990s and 2000s with the total investment in the US exceeding \$ 100 billion, while the corresponding figure in Europe worth £35 billion.¹⁷

Additionally, venture capital industry grew significantly in Asia between 1995 and 2000s. The venture capital markets in Asia are heterogeneous but some countries like Japan and Australia have long established market economies. Whereas some newly industrialized countries such as China, India, Malaysia and Vietnam have demonstrated emerging market economies.¹⁸ In general, there is promising venture capital market in Asia especially in India and China but the institutional framework should be updated to support venture capital investment.¹⁹

Venture capital firms differ from traditional banks that value collateral, balance sheets and past performance as criteria for financing emerging companies. However, those factors are less important than the quality of the management team

¹³ Ralph Flanders was the president of the Federal Reserve Bank of Boston and one of founders of ARDC 1946. George W. Fenn, Nellie Liang, and Stephen Prowse, *The Economics of the Private Equity Market*, Washington: *Federal Reserve Bulletin*, 1996, p.10. <http://www.federalreserve.gov/pubs/staffstudies/1990-99/ss168.pdf>. (Accessed on 29 April 2013).

¹⁴ This was when he perceived the lack of new company formation and inability of institutional investors to finance new ventures. Bygrave and Timmons, 17-18; See Hans, 11.

¹⁵ The President of Massachusetts Institute of Technology, USA. Hans, 11.

¹⁶ Ibid.

¹⁷ Megginson, W.L. and S.B. Smart, *Introduction to Corporate Finance* (Mason, O.H: Thomson South Western, 2006), 20; See Hans, 14.

¹⁸ Lockett, A. and M. Wright, "Venture Capital in Asia and Pacific Rim", *Venture Capital*, 4 (3), 2002, 183-95.

¹⁹ Ahlstrom, D. and G.D. Bruton, "Venture capital in emerging economies: networks and institutional change" in *Entrepreneurship: Theory & Practice*, March, 2006, 299-320; Hans, 15.

and of the product's marketability and the expected profits in the eyes of venture capitalists. Therefore, the venture capital industry encourages entrepreneurs, creates jobs and wealth, and fosters the development of high technology.

Venture capital, historically started with the *muḍārabah* concept; a form of partnership used even before the advent of Islam by Arab traders. Ibn Rushd said: Muslims are unanimously allowed to use *muḍārabah*. The statement of Ibn Rushd shows that *muḍārabah* has been practiced by Arabs before Islam. Meanwhile, Islam adopts it by eliminating mechanisms contrary to the rules of Shari'ah.²⁰ Even the Prophet himself (peace and blessing of Allah be upon him (PBUH)) acted as *muḍārib* with Khadijah prior to being appointed as messenger. Al-'Abbās ibn 'Abdul-Muṭṭalib also practiced *muḍārabah* without any objection from the Prophet (PBUH). Thus, the contract has been adopted in Shari'ah. Subsequently, jurists just formalized and detailed its concept in *Fiqh* (Islamic jurisprudence).

As Islamic culture spreads across the globe *muḍārabah* went along and continued to be used by Muslim businessmen in different forms. The Italians took up *muḍārabah* contracts in the 10th century and spread it over the Europe. *Muḍārabah* was developed and reformed in Europe to suit their contractual needs but it remained undeveloped in the Muslim world.²¹ With the advent of Islamic banking and finance in the last quarter of 20th century and its adherence to the rule of profit and loss sharing, (which is also applicable to venture capital), the rationale that Islamic finance system should take up the establishment of venture capital sector has been advertised. Hence, Islamic venture capital is an affluent area that can be further developed. In addition to that the investors show a great interest in this investment for the purpose of

²⁰ Ibn Rushd, *Bidāyat al-Mujtahid wa Nihāyat al-Muqtasid*, (Beirut: Dār Ibn Ḥazmi, 1999), 597.

²¹ M. Mizanur Rahman, "Venture capital, its perspective and potentials in Islamic finance", <<http://www.thefinancialexpress-bd.com/2008>> (accessed on 7 October, 2011).

minimizing the traditional investments' reliance on mutual funds, equities and bonds. Islamic banks and other financial intermediaries are encouraged to expand their capabilities thorough the diversification of investments to mitigate risks.²² It would be the best option for profit and loss sharing by providing financial and managerial support to entrepreneurs via *muḍārabah* and *mushārah* instruments.²³

Islamic and conventional venture capital structures share many similarities in terms of equity investment in investee companies, sharing of risk and reward between the parties involved, performance based returns, investment horizon and the involvement of venture capitalists in the management of the business venture financed.²⁴ Albeit there are some factors that contravene the rule of Sharī'ah these factors can be easily adjusted without compromising the positive aspects of venture capital.²⁵ This is to streamline the activities of venture capital investment to fulfil the Sharī'ah requirements.

The Malaysian government²⁶ plays a significant role in promoting and fostering the development of the Islamic capital market. One of the best examples of this role at this juncture is the initiative taken by the Securities Commission Malaysia, which issued “Guidelines and Best Practices on Islamic Venture Capital” on the 7th May 2008 to develop the Islamic venture capital industry. Moreover, the Guidelines

²² Malaysia Sponsored Section –Securities Commission-, Islamic Venture Capital in Malaysia, Islamic Finance Asia, Feb/Mac 2009.

²³ Ibid.

²⁴ Malaysia Sponsored Section –Securities Commission-, Islamic Venture Capital in Malaysia, Islamic Finance Asia, Feb/Mac 2009.

²⁵ Sami al-Suwailem, “Venture Capital: A potential Model of Mushārah”, JKAU: Islamic Econ., vol.10, (1418 A.H/1998, A.D), 3-20.

²⁶ Elina Badri, Awang Adek: “Islamic VC should be nurtured”, Islamic Finance News, Wednesday, 20 May 2009, 22:36. “The government is encouraging the growth of Islamic venture capital here because the sector is still new and needs to be nurtured... the first and only Islamic venture capital fund was set up by Malaysia Venture Capital Management Bhd (Mavcap) in July last year whereby Mavcap allocated RM 30 million to be injected into the fund.