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Venture Capital: A Potential Model of Musharakah

Comments:

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In this paper, the author summarizes a collection of articles on venture capital. In general, the author, recording the existing literature, explains how a venture capitalist (firm) reduces the moral hazard arising from the principal-agent problem. Namely, venture capital firms pool the resources of their partners and the funds to help budding entrepreneurs start a new business.

In exchange for the use of the venture capital, the venture capitalist receives an equity share in the business. Venture capital firms usually insist on having several of their own people participate as members of the managing body of the firm, the board of directors, so that they can keep a close watch on the firm's activities. Furthermore, when a venture capital firm supplies start-up funds, the equity in the firm is not marketable to anyone, but the venture capital firm itself. In this way, other investors are unable to take a free ride on the venture capital firm's verification activities. Consequently, the venture capital firm is able to get full benefit of its activities and, therefore, is given the appropriate incentives to reduce the moral hazard problem.

The author states that the activities of venture firms (capitalists) are very close to *musharakah* (Islamic partnership)¹. However, the paper does not explain either *musharakah* nor the relationship between venture firms' models and the Islamic model of partnership.

The author explains the moral hazard problem associated with venture capital arrangements. However, it would have been quite useful to explain how such a problem could be reduced in Islamic partnerships. The author explains how the adverse

1. A *musharakah* transaction is one in which a group of investors participate in varying proportions in a promising business. Profits and losses are shared strictly in relation to the respective capital contributions. Under a *mudarah* arrangement funds are made available by the owner to the entrepreneur to be invested in a productive economic activity in return for a predetermined share of profits earned. Financial losses are borne exclusively by the lender. The borrower loses only the time and effort invested in the venture. The essential differences between these two forms of financing is the number of parties involved in the transaction and indeed *musharakah* financing corresponds closely to an equity market. (Khan and Mirakhor, 1987).

selection of moral hazard facing venture firms can result in the breakdown of venture capital markets, without explaining if this situation is also possible in *musharakah*.

There are benefits and costs in venture capital markets according to the literature. The author, using the existing literature, explains these benefits and costs very carefully without, however, making any attempt to discuss whether or not profit-sharing arrangements in an Islamic system also create those benefits and costs or if they have different characteristic. Namely, the author could have elaborated on how in an Islamic environment the costs and benefits of venture capital activities are reduced or enhanced. Furthermore, no study related to *musharakah* or to profit-sharing arrangements in an Islamic system was referred to. The author could have incorporated in his survey, *inter alia*, Khan and Mirakhor (1987), Khan (1983 and 1987), Ul Haque and Mirakhor (1987), Choudhury (1992, especially pp. 165-167 and 248-251). Finally, I think that even though this paper ignores the relevant studies related to *musharakah* or *mudarabah*, it has its own merits, as it is a comprehensive review of the literature on venture capital.

References

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