[Indonesian Journal of International Law](https://scholarhub.ui.ac.id/ijil)

Volume 12 | Number 2 Article 3

1-31-2015

VENTURE CAPITAL: AN AMERICAN CONCEPT AND ITS PROBLEMS OF IMPLEMENTATION IN DEVELOPING COUNTRIES

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Abstract

Venture capital is an American concept. It is an alternative source for financing small businesses, besides other conventional financing sources, such as banking. Among the characteristics of venture capital are the dual-roles of investors, both as capital owners and management of the businesses. The concept has been successfully implemented in the U.S. which can increase investment and job opportunity. However, there are obstacles in implementation of the concept in developing countries, because, among others, lack of conducive environment for its growth including the weaknesses in economic law and its enforcement, and cultural hindrance. This article discusses the U.S. venture capital concept; it's successful in the U.S. and its problems of implementation in developing countries, and alternative solutions for better implementation in the future.

***Keywords**: Economic Law, Venture Capital, Financing, Businesses, Developing Countries.*

I. INTRODUCTION

Small enterprises play an important role in national developing countries.[1]

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In developing countries, small business covers about 98% of the private sector business and contributes to national economic growth, increase job opportunity, develop creative innovation, increase export, and facilitate other areas of development.[2] Therefore, public and private sector in developing countries must support the development of small business. One major weakness of the small business that needs support is inadequate domination of financial policy by large business, the nature of higher degree of small business risks and other obstacles created by bad financial policy and practice.[3] Indonesia, for example, its small businesses less capable in technology creation, less access to financial sources, less bargaining power to win business competition.[4]

It is not only in developing countries, but also in developed countries like in the United States (U.S.), small business plays major role in creating job, enhancing product innovation, and increasing government income from various taxes.[5] For example, in 1970s of 1,332 small businesses financed by venture capital shows larger benefit to U.S. economy growth when view from the amount of investment.[6] These small businesses, among others, created about 130,000 jobs, more than $100 million corporate taxes, 4350 million income tax, $900 million exports.[7] Therefore, providing financial support for small business should become priority, particularly in developing countries.

One alternative from of financing small business is "venture capital". This financial form which was originated from the U.S.[8] is also suitable to apply, with certain adjustment conditions in developing

and Jurnal Ekonomi dan Pembangunan, Bappeda, Provinsi Aceh.

[1] *See* Roger S. Leeds, *Financing Small Enterprises In Developing Nations: Learning From Experience Ix*, Transnational Publishers, 2003.

[2] *Ibid.*

[3] *Ibid.* at ix-x.

[4] Elfraim Landa, *Venture Capital in Indonesia*, at 1-2, at http://globalventurecapital.wordpress.com/2013/05/28/venture-capital-in-indonesia/ 28th May 2013,

[5] Bentley J. Anderson, "Venture Capital and Market Development in Malaysia: The Search for a Functioning Exit Mechanism," *12 WIS. INT'L. L.J. 1*, 1993.

[6] *Ibid.*

[7] *Ibid.*

[8] Martin Kenney, Note on "Venture Capital," 4 in *INTERNATIONAL ENCYCLOPEDIA OF THE SOCIAL AND BEHAVIORAL SCIENCES*, N.J Smelser & P.B. Baltes eds., 2000.

countries.[9] The venture capital which is invested in form of equity such as common stock, convertible debenture, or other commercial instruments exchangeable to common stock when the company sold or perform initial public offering,[10] can supplement conventional method of small business financial through banking institutions. Indonesia with it ranked in the 16th world largest economy and expected of high growth in coming years, and based on Report of World's Economic Forum with it ranked in the 25th on stability of macro economy in 2012, better than in 2007 which was in the 89th, is potential for the venture capital development.[11]

In the U.S. venture capital funds that can be a model for developing countries shows that in the year of 2000 through its small business, venture capital enhanced the U.S. GDP about $1,1 trillion, created job for 12,5 million workers.[12] It also contributed to the increase of sales, taxes, exports, and provided more focus on technology advancement through research and development.[13]

This writing, therefore, examines the U.S. venture capital including its definition, its history and development, and its key features. Then, the article explains venture capital and developing countries including its stage of economic development and its legal infrastructure. Later, it discusses alternative solutions including the need for the increasing role of government, developing stock markets, and legal adjustment. Finally, the article concludes that venture capital even though its present low development in developing countries will become a feasible alternative for financing small businesses in developing countries as a part of their national development programs. The analysis will be stressed mainly from legal perspectives.

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9 http://www.sais.-jhu.edu/bizgovcenter/articles_PEinEmergingMarket.html.
10 Kenney, *supra* note 8, at 2.
11 Landa, *supra* note 4, at 1.
12 Dri-Wefa, *The Economic Impact Of The Venture Capital Industry On The U.S. Economy: Venture Capital Impact, 1*, 2002.
13 *Ibid.*

II. THE U.S VENTURE CAPITAL CONCEPT

A. Definition

What is venture capital? The term "venture capital" refers to "a specific form of finance supporting small privately own companies judged to have a potential for fast growth."[14] Therefore, the venture capital aims to achieve more capital gain compare to general investment by focusing only on selected potential high growth small business.[15] A more complete definition of venture capital is "a professional managed pool of money raised for the sole purpose of making actively-managed direct equity investment in rapidly-growing private companies, and with a well-defined exit strategy."[16] It is a new form of "financial innovation", and dominantly still considered as American concept.[17] One characteristic of venture capital that is generally different compare to other kind of investment as this definition suggested is the availability of exit strategy mechanism.

The investment process of venture capital is not perpetual, but within affixed period of time.[18] Therefore, under the venture capital investment model, there should be a method on how the venture capital companies can resale their investment later through an exit.[19] One of the problems faced by venture capital company in developing is the inadequacy of the exit strategy mechanism.[20] This is because developing countries generally do not have strong stock market and its legal infrastructure supporting modern stock market.

A venture capital investment is a risk capital investment because of its involvement in a high risk environment.[21] It is "unusually complex, time consuming, skill-intensive, and involved more risks than a loan for

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[14] Kenney, *supra* note 8, at 2.
[15] Kenney, *supra* note 8, at 2.
[16] William L. Megginson, *Towars a Global Model of Venture Capital?*, 3 in Venture Capital and Private Equity, in CORPORATE FINANCE (Scott B. Smart et al., South-Western Publishing Company, forthcoming 2003).
[17] *Ibid.*
[18] Anderson, *supra* note 5, at 2.
[19] Anderson, *supra* note 5, at 2.
[20] Anderson, *supra* note 5, at 2.
[21] *See* Leeds, *supra* note 1, at xvii.

both the company and the investor."[22] Therefore, it is should be manage by professional entrepreneurs who have adequate skills and experience on venture capital funds and its operation.

The definition of capital can also be seen from the perspective of investor who "search (es) for significantly above-average investment returns through equity ownership and involvement in dynamic (typically start-up and emerging) young companies believed to have experienced management and proprietary or innovative products or services useful in rapidly growing market".[23] The term venture capital is often used interchangeably with the broader term of "private equity", the latter means "a method of financing for earlier and later stage private companies by third party investors who are seeking high rates of return based on risk profile of the companies and the near term illiquidity of the investments."[24] The venture capital in a narrower term is that which only involved in earlier stage of private equity investment.

B. History and Development

The earlier development of venture capital in U.S. was initiated by wealthy individuals who were willing to invest in high risk investment with intention to gain high rate of returns.[25] One kind of such investment performed by informal investors named "angels" who invest to back the investment of entrepreneur in manufacture and technology.[26]

Later, in 1930's, a greater concern on financing small business was arisen, and there was no consensus on the best method for the financing of small business.[27] Before World War II, only a few wealthy family investing on start-up companies, but at the beginning of World War II, several New York wealthy families started hiring professionals to man-

[22] Leeds, *supra* note 1, at xviii.
[23] Anderson, *supra* note 5, at 2.
[24] Leeds and Sunderland, *supra* note 9, at 16, *see also* Alex Bance and Ubs Warburg, *Why And How To Invest In Private Equity, 3*. An AVCA Relations Committee Paper n.d.)(explaining the stages of private equity based on the life circle of private equity includes seed, start-up, expansion, and replacement capital.
[25] Kenney, *supra* note 8, at 4.
[26] Kenney, *supra* note 8, at 4.
[27] Kenney, *supra* note 8, at 4.

age their funds, as the first family venture capital.[28]

In 1946, the American Research and Development Corporation (ARD), a public venture capital firm was established in New York city, as an effort in fulfilling the financial need of small business.[29] Besides providing capital investment, another major goal of ARD is to provide managerial assistance for new businesses.[30]

In 1959, the Small Business Investment Companies (SBICs) was established which is licensed by Small Business Administration (SBA).[31] SBICs in its operational obtained government support in from of SBA loan and also tax benefits.[32] However, the government also controls the use of fund by providing limitation on the size another control of investee companies.[33]

During 1970s, the development of venture capital marked by the increasing number of venture capital limited partnerships.[34] During these years, however, the venture capital development was slow because of, among others, recession and weak financial market.[35] One most important change was regarding the elimination of "prudent man" investment requirement, limiting pension fund investment in venture capital.[36] In 1980, another regulatory change is the elimination of requirement that obligated general partners to register as investment advisors in Small Business Investment Incentive Act of 1980.[37] The regulatory changes together with the development of limited partnership contribute significantly to the boom of venture capital in 1980s and 1990s.[38]

The 2000 report notes that 5.9 percent of U.S workforce employed in venture capital back companies, the U.S. Company contributed 13.1

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[28] Kenney, *supra* note 8, at 5.
[29] George W. Fenn Et Al. *The Economics Of Private Equity Market, 7*, Board of Governors of the Federal Reserve System, 1995.
[30] *Ibid.*
[31] *Ibid.* at 8.
[32] *Ibid.* at 8.
[33] *Ibid.* at 8.
[34] *Ibid.* at 9.
[35] *Ibid.* at 10.
[36] *Ibid.* at 10.
[37] *Ibid.* at 11.
[38] *Ibid.* at 11-12.

percent of U.S. GDP during the last 30 years, and created 7.6 m jobs in the U.S.[39] The venture capital companies invested for the total $40bn per year.[40]

Instead of its development two features remain the same in venture capital, i.e., the focus of investment remain the technology innovation and the active role of investors, both in providing capital and management expertise.[41] The role of technology is becoming more important in this information age which opens the opportunity for both venture capital and technology development. Management skills are also becoming more important in this free trade era because small business is open to wider competition than ever before in market places. This expertise cannot be obtained by small business through traditional financial methods.

C. Key Features of U.S. Venture Capital

Several key features that shapes the U.S. venture capital concept relate to several element includes forms of funds, sources of investment, types of investee, structure of organization, methods of structuring investment, and strategies of exit.[42]

1. Forms of Funds

Venture capital in the U.S. can be categorized into institutional venture capital and individual venture capital.[43] Institutional venture capital includes limited partnership as the largest form in U.S. which the funds are invested primarily limited partners (investors) and managed by general partners; corporate venture capital which the funds are originated from industrial firms other than financial corporation's; financial venture capital which the funds are obtained from financial institutions, and government support venture capital (SBICs) which the funds are from government loan through the Small Business Administration Act

[39] Joseph W. Barlett, "Venture Theory: Private Equity in Emerging Market" *Private Equity International 35, 36*, 2002.
[40] *Ibid.* at 36.
[41] Megginson, *supra* note 15, at 7.
[42] *See* Megginson, *supra* note 15, at 7-42.
[43] Megginson, *supra* note 15, at 7.

of 1958.[44] Whereas, the individual venture capital raise funds from wealthy individuals ("angels") on permanent basis who does not form business association.[45]

The strengths if limited partnership as a preference forms of fund compare to other rested on its flexibility in finding sources of funding, without conflict of interest with parent institution like in other institutional venture capital, and its flexibility structuring adequate compensation or incentive packages.[46]

2. Sources of Investment

The rank of sources of investment on venture capital has been as follow:

1. Pension funds (private and public) as the first largest, account for 30-40%;
2. Financial and non-financial institutions, as the second largest, account for 15-30%;
3. Foundations and endowments as the third largest, account for 10-25%; and
4. Individuals and families account for 15-25% of the total venture capital finding.[47]

3. Types of Investee

Even though not totally true, the venture capital image often associated with initial investment for start-up and seed stages.[48] In fact, venture capital also plays its role in financing later stage of investments through buyouts, acquisitions, and other.[49] In practice, it is often that the

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[44] Megginson, *supra* note 15, at 8.
[45] Megginson, *supra* note 15, at 7.
[46] Megginson, *supra* note 15, at 9.
[47] Megginson, *supra* note 15, at 10.
[48] Megginson, *supra* note 15, at 11; *see also* Fenn Et Al., *supra* note 28, at 4 (listing investors as investment sources nclude corporate pension funds, public pension funds, endowments, foundations, banking holding campanies, investment banks, non-financial corporations, and other investors).
[49] Megginson, *supra* note 15, at 12.

venture capital investing in earlier stage of a company, then continues to be involved in succeeding stages of investment during its development until mature enough to exit.[50]

Several considerations involved when making investment decision in investee companies, includes the amount of investment proposed, the level of technology used, the stage of companies development and the profile of companies management.[51] One characteristic of venture capital investment is the involvement companies not only by providing financial contributions, but also management and marketing.[52] The venture capitalist, therefore, is the owner and/or the manager of the investee company.[53]

4. Structure of Organization

Majority of venture capital in U.S. is organized under limited partnership.[54] The key success factor of choosing this structure of organization lies on the following reasons:

1) The ability to concentrate on investee company, as an independent entity, different from corporate and financial institution that have to accommodate the interest of both investee and parent company; and
2) The benefit of limited life and limited investor's liability, and the tax policy compare to corporation.[55]

In this type of organization, the control of the investment decision, and the monitoring of fund are conducted by general partners (GP), and the limited partners (LP) is not allowed by existing law to participate in the daily operation of the limited partnership.[56] The duration of the

[50] Megginson, *supra* note 15, at 12.
[51] Anderson, *supra* note 5, at 4; *see also* Bance, *supra* note 23, at 13 & 18 (describing the need to conduct due diligence "the investigation of a management team's characteristics, investment philosophy, and terms and conditions prior to committing capital to the fund").
[52] Anderson, *supra* note 5, at 4.
[53] Anderson, *supra* note 5, at 4.
[54] Megginson, *supra* note 15, at 12.
[55] Megginson, *supra* note 15, at 12.
[56] Ronald J. Gilson, "Engineering a Venture capital Market: Lessons from the American Experience" *Standford Law School John M. Olin Program in Law and Economics, Working Paper 248*, November 2002, at 6-7, *at* http://issrn.com/abstract_id+353380.

limited partnership is limited usually for 10 years that provide high incentives for GP to create the fund investment in investee companies to become liquid vastly.[57]

5. Methods of Structuring Investment

Structuring the investment involved considerations on allocating risk, return, and control between venture capital and investee companies usually regulated in an investment agreement.[58] Several factor involved in the allocation of risk, return, and control includes investee experience and reputation, the prediction of rate of return, the company's development stage, the skills of parties in negotiation, and the market condition.[59]

To lower degree of investment risk, parties may stipulate in an investment agreement that the investment in structured based on stages or rounds.[60] The benefit of the staged or rounded financing is in its reduction of uncertainty.[61]

In venture capital investment, the preference form of equity is convertible securities, not the common stock, for the following reasons:

1) To obtain control with common stock depends on majority ownership, which is expensive and higher risk for investors; and
2) The create priority claim compare to other claims.[62]

The control of investee as an answer for problems of agency relationship and unbalance information for investors can be solved through adequate periodical monitoring, involvement in management, and use of negative covenants.[63]

57 *Ibid.*, at 11.
58 Megginson, *supra* note 15, at 14; *see also* David M. Toll, Edwards & Angell, Llp, *Private Equity Partnership Terms And Conditions: For Venture Capital, Lbo, Mezzanine, And Funds Of Funds*, 19-66 (Jim Beecher 3d ed. n.d.)(explaining private equity terms and conditions issues include concerning fund formation and operation, fees and expenses, profit sharing and distributions, and corporate governance).
59 Megginson, *supra* note 15, at 14-15.
60 Gilson, *supra* note 55, at 17.
61 Gilson, *supra* note 55, at 17.
62 Megginson, *supra* note 15, at 18.
63 Gilson, *supra* note 55, at 21-22.

6. Strategies of Exit

Venture capital investment requires exit of the investment in investee companies after certain period of time, usually 7 to 10 years.[64] Successful exit strategy is a form of incentive for investors by providing prospective rate of return and by raising more capital.[65] For investors, an exit is an achievement of its objectives by gaining returns in form of cash, based on risk accepted and opens the opportunity for subsequent investment.[66]

There are three alternative exit strategies: initial public offerings (IPOs), trade sales, and put options.[67] The IPOs are the most used in the U.S. involving unlisted securities in major stock exchanges called over the counter (OTC) transactions by listing shares in the National Association of Security Dealers Automated Quotation (NASDAQ) system.[68] Trade sale is the sale of company to other company usually bigger entities seeking "market share or product line."[69] Put options are "the right, but not the obligation, to sell a security at a price (or range of prices) in given period."[70]

As a comparison, the U.S. venture capital model above in my aspects has similarities with that of Europe and developing countries, because all provide equity funding to private enterprises organized by professional investors and the availability of monitoring mechanism to assist the enterprises.[71] Because the venture capital firm has provided capital for portfolio companies, the right to control the operation of the company as mechanism to guarantee the return of investment and its profit is on the venture capital firm. This kind of control is also beneficial for the portfolio company because it provides valuable manage-

[64] Rafael Hernandez Mayor Et Al., Morrison & Foerster Llp, Impediments To Risk Capital In Argentina, Chile, Elsavador And Mexico, 10 (Multilateral Investment Fund n. d.).

[65] Josh Lerner & Felda Hardymon, *Venture Capital And Private Equity: A Casebook Volume Ii, 10*, John Wiley & Sons, Inc., 2002.

[66] Anderson, *supra* note 5, at 6.

[67] Mayoral, *supra* note 63, at 10.

[68] Anderson, *supra* note 5, at 5.

[69] Mayoral, *supra* note 63, at 12.

[70] Lerner & Hardymon, *supra* note 64, at 481.

[71] Josh Lerner & Antoniette Schoar, *Private Equity in the Developing World: The Determinants of Transaction Structures*, 6 (Harvard University, MIT, and NBER n. d.).

ment skills.

The differences between the U.S. model and the European model can be seen in several aspects includes the sources of investment, the organizational structure, the type of investee enterprise, and the way of obtaining return by investors.[72] The U.S. model is the most successful venture capital funds internationally. Other countries may have different model of venture capital, such as European countries. The difference is related to many factors, includes the difference of business, legal, and cultural environment in different countries.

In general, the degree of disparities among venture capital throughout the world is dictated by economic, cultural, and legal features such as entrepreneurial and risk taking habit, legal protection for investors, the role of government, legal system, labor market, and the strength of institutional investors.[73] These factors contribute to the degree of successful of venture capital practices in many countries. These factors may provide positive or negative impact toward the development of venture capital.

III. VENTURE CAPITAL IMPLEMENTATION IN DEVELOPING COUNTRIES

A. Economic Development

Developing countries have different stage of economic development than that in developed countries. This stage of economic development influences the need and the development of venture capital. Therefore, the degree of successful of venture capital companies in developing countries is low.[74] In general, these developing countries, according to the World Bank have the following characteristics: income per capita of its population either low or medium level, capital markets are not devel-

[72] *See* Megginson, *supra* note 15, at 22 (explaining that in Europe the main source of finance is obtained from financial institutions rather than limited partnership, its investment is more focus on later stages of investment such as buy-outs, and IPO is not a preferred strategy of exit).
[73] Megginson, *supra* note 15, at 27.
[74] Megginson, *supra* note 15, at 26.

oped, and/or are not industrial countries.[75] The international financial institutions, such as the International Financial Corporation and European Bank for Reconstruction and Development support the venture capital in developing countries through subsidizing venture capital fund because it is considered suitable for developing countries.[76]

There are reasons justifying the need of venture capital in developing countries, i.e. change in developing countries themselves that are now closely integrated into liberalized world economy, and the circumstances in developed countries that need new place to invest because of less attractive investment in developed world caused by less return.[77] In fact, now more country becoming part of multilateral, regional, and bilateral trade agreement which open more their markets to foreign direct investment. One of the biggest is the World Trade Organization (WTO). Under the WTO that is established to create trade and investment liberalization, the movement of capital becoming easier in efforts to obtain more profits or returns.

According to the International Monetary Fund (IMF), between 1990 and 1999, these countries have rapid economic growth at 5.8% annual rate, compare to 1.9% in developed countries become attractive place for investment.[78] In Asia, the development of technology business is a positive tendency toward venture capital fulfillment of capital for this new kind of business.[79] Each country may has its own comparative advantages, therefore, can concentrate on certain technology business that are stronger than that of other countries.

In India, for example, the need for venture capital is related to the development of software industries.[80] However, the difference both in degree of economic development and of business environment effect the degree of successful achieved.[81] In India, the development of venture capital started during 1980s with the characteristics of govern-

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[75] Lerner & Schoar, *supra* note 70, at 5.
[76] Lerner & Schoar, *supra* note 70, at 1.
[77] Lerner & Schoar, *supra* note 70, at 5.
[78] Lerner & Schoar, *supra* note 70, at 6.
[79] Mike Wright Et Al., *Venture Capital Firm Internationalization And Monitoring High Tech Enterpreneurship: The Case Of India, 3* (n. d.).
[80] *See Id.* at 5.
[81] *Ibid*., at 4.

ment support venture capital companies and capital gain tax incentives for venture capital investment.[82] In India, the venture capital company dominantly invests in earlier stage of investment.[83] India, started liberalization and deregulation effort in 1991, which can accommodated more venture capital development.[84]

Economic development in Malaysia has also attracted foreign investment.[85] This caused by several factors, among other, the Ringgid undervalue currency, the low cost of labor, the low inflation rate of 4%, and its membership of the Association of South East Asia Nation (ASEAN) which support the trade liberalization.[86] Since 1989, Malaysia has venture capital industry, even though in its earlier stage of development.[87]

In Indonesia, on the whole, the role of venture capital is still limited, that is only about 1,5 % of the total role of venture capital in developing small and medium businesses.[88]This is not only related to the stage of economic development, but also cultural hindrance. This includes the fact that majority of Indonesian companies is owned by families, which prefer obtain financial support from conventional loans, such as banking rather than venture capital because of reluctant to accept other individuals to be involved within the management and decision making process of the companies.[89]

In general, however, when it is compared to developed countries, the development of venture capital companies in developing countries is low.[90] In these countries the venture capital investment is still considered high risk financing, and it is likely that in the near future the

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82 *Ibid*., at 4.
83 *Ibid*., at 4.
84 *Ibid*., at 11.
85 Anderson, *supra* note 5, at 12.
86 Anderson, *supra* note 5, at 12.
87 Anderson, *supra* note 5, at 3.
88 Sri Lestari Rahayu, "Analisis Peranan Modal Ventura dalam Mengembangkan UKM di Indonesia," *Kajian Ekonomi Dan Keuangan 81* (Edisi Khusus 2005).
89 Hasanuddin Rahman., *Segi-Segi Hukum Dan Manajemen Modal Ventura Serta Pemikiran Alternatif Ke Arah Modal Ventura Yang Sesuai Dengan Kultur Bisnis Indonesia 150* , PT Citra Aditya Bakti, 2003.
90 *See* Megginson, *supra* note 15, at 27.

expected growth will still be small.[91] This can be understood because in general the development of business activities and technology sector is lower in developing countries compare to that of developed countries.

Several factors of U.S. succeed, which does not owned by developing countries include high degree of cooperative entrepreneurs, conducive public policy, strong legal system, economic and political stability, and modern stock exchange.[92] One of the major weaknesses of present situation in developing countries which need to be addresses in the weakness of legal infrastructure.

B. Legal Infrastructure

Not only the stage of economic development, but also the legal infrastructure influences the development of venture capital in developing countries. Adequate legal infrastructure can create supportive environment for stimulating the growth of venture capital.[93] Indonesia, for example, has promulgated the Act Number 20 of 2008 on Micro, Small, and Medium Businesses (AMSMB). Article 22 of AMSMB provides that "in an effort to increase access to capital for micro, small and medium businesses, Government support the development of venture capital institutions". Besides, as implementing regulations, the Government of Indonesia has also promulgated the Presidential Regulation Number 9 of 2009 on Financial Institutions and the Regulation of Ministry of Finance Number 18/PMK.010/2012 on Venture Capital Company. However, these legal infrastructures do not used maximally to increase venture capital activities in practice.

Generally, the right legal environment for venture capital development may includes secular state, stable government, judiciary freedom, constitutional right for free inquiry, freedom of expression, and property protection.[94] Besides, investors and creditors need adequate protection in the event of bankruptcy, and adequate dispute resolution and exit strategy mechanisms.[95]

In fact, among the differences between venture capital in develop-

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[91] Megginson, *supra* note 15, at 27.
[92] Leeds & Sunderland, *supra* note 9. At 6.
[93] Barlett, *supra* note 38, at 40.
[94] Barlett, *supra* note 38, at 40.
[95] Barlett, *supra* note 38, at 42-43.

ing world and developed countries includes fund structure.[96] In U.S. the dominant organizational structure for venture capital is limited partnership, which in developing world such as Asia, there are limitations on establishment of this form of company.[97] This form of organization has certain advantages include the ability to focus more on financing process, investor's limited life and liability, and tax incentives.[98] These advantages may not be obtained by investors when other forms of business associations are used.

Other legal infrastructure limitation includes exit mechanism.[99] In developed world the preference form of exit strategy is through initial public offering (IPO).[100] Developing countries usually lack of IPO mechanism, because the weakness of their capital market.[101] This will create problem of fair value, because the portfolio company has to sell the company to strategic investors which usually attract only small number of them.[102] In many developing countries, the legal infrastructure is not supportive to the development of venture capital, because they have not equipped by comprehensive and modern stock exchange low to provide viable strategy of exit for venture capital companies.

Another critical issue is concerning property protection.[103] The degree of property protection differs from one company to another, which can be seen both in its legislation and its legal enforcement by government authorities.[104]

The country report of the Multinational Investment Fund (MIF) also notes several areas relating to legal infrastructure includes regulatory obstacles, investment structures, accounting procedure, corporate governance and minority right, contingent liabilities, waiver preemptive right, voting right, investment regulation, stock market, and pension

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[96] Lerner & Schoar, *supra* note 70, at 6.
[97] Lerner & Schoar, *supra* note 70, at 6.
[98] Megginson, *supra* note 15, at 12.
[99] Lerner & Schoar, *supra* note 70, at 7.
[100] Lerner & Schoar, *supra* note 70, at 7.
[101] *See* Lerner & Schoar, *supra* note 70, at 8.
[102] Lerner & Schoar, *supra* note 70, at 8.
[103] Lerner & Schoar, *supra* note 70, at 10.
[104] Lerner & Schoar, *supra* note 70, at 10.

fund law.[105]

The restriction of foreign investment can be conducted through the control of capital and restriction of specific industries through registration and approval requirements.[106] The limitation on investment structure, among other, is in form of restriction of the creation of various stocks, such as options and warrant, authorizing the holder to buy stocks at specific amount, time, and price.[107] Lack of accounting procedure is because certain developing countries do not have certain standardized principle of accounting which can be used as manual for companies.[108] The inadequacy of minority share holders protection can occurs when the legal regimes and enforcement do not adequately protect minority share holders, such as the nonexistence of "any recourse when economic value of the share is higher than book value."[109] The absence of standardized contingent liabilities creates difficulties when valuating companies including back due taxes, social security payment, and environment expenditures.[110] There are also restriction on "the circumstances under which preemptive right can be waived," therefore, less flexibility for investors in structuring its target for better return.[111] There are also inflexibility for investors because the restriction on the freedom of structuring the way shareholders voting their rights.[112] Some laws are excessively restrictive on investment fund which make investors unattractive to invest.[113] The stock market in developing countries may not equip with adequate exit strategy mechanism for risk capital investors which create disincentive for investors.[114] Lastly, different from the U.S. much legislation in developing world do not permit pension funds to be invested in venture capital.[115]

105 Lerner & Schoar, *supra* note 70, at 11-12.
106 Mayoral, *supra* note 63, at 7-8.
107 Mayoral, *supra* note 63, at 6.
108 Mayoral, *supra* note 63, at 3.
109 Mayoral, *supra* note 63, at 5.
110 Mayoral, *supra* note 63, at 3.
111 Mayoral, *supra* note 63, at 3.
112 Mayoral, *supra* note 63, at 6.
113 Mayoral, *supra* note 63, at 4.
114 Mayoral, *supra* note 63, at 4.
115 Mayoral, *supra* note 63, at 4; *see also* Fenn Et Al., *supra* note 28, at 45-46 (noting that corporate and public pension funds are the largest investors in private equity in the U.S.).

IV. ALTERNATIVE SOLUTION FOR DEVELOPING COUNTRIES

The make the U.S. venture capital model work in developing countries, several alternative actions should be taken to create supportive environment or circumstances for venture capital. This includes, among other, the following various efforts.

A. Increase The Role of Government

The government both in national and local level need to play more roles in supporting the development of venture capital. Even in the U.S. Small Business Investment Corporation (SBIC) has played big role in promoting venture capital.[116] In this program, the U.S. government provides fund partially as part of the SBIC fund rising.[117] Now, the venture capital industry in U.S. is dominated by private sector, and government is now playing lesser role in the overall picture of the U.S. venture capital industry.

The governments in developing countries need to play central role as initiator and sponsor for developing venture capital at the beginning of its application in that country.[118] This role includes designing macroeconomic policy, establishing incubators for high technology, providing funds, and providing tax privileges.[119] The incubators program was quite distinct in venture capital in certain developing countries, where the government provides funds and assist scientists and engineers in the beginning stage of a project that is commercially prospective.[120] Another successful program in can be supported financially by government called Yozma starting in the 1990's[121] the main goal of this program is to stimulate international enterprises to invest in technology firms and to motivate the private sector venture capital through transfer of expertise, human resource development, and better connection with international

[116] Leeds & Sunderland, *supra* note 9, at 13.
[117] Leeds & Sunderland, *supra* note 9, at 13.
[118] Noam Wasserman & Daniel Nye, "Pattern of VC Evolution: Comparing Israeli and Indian Venture Capital Industries, 3" *THE JOURNAL OF PRIVATE EQUITY: STRATEGIES AND TECHNIQUES FOR VENTURE INVESTING 16*, 1999.
[119] *Id*., at 27.
[120] *Id*., at 28.
[121] Leeds & Sunderland, *supra* note 9, at 13.

venture capital industries.[122] Besides, the government also provides tax incentives, such as providing grants for foreign investors the opening their operation.[123]

In India, even though venture capital is not as successful as in certain other developing countries, the role of government also inportant in respect to establishing new technology investors, investing fund in government initiative venture capital industries, and promulgating new patent law.[124] Compare to many other developing countries, India has relatively more comparative advantages in technology sector.

In an effort of attracting foreign investment and stimulating technology innovation, the Indian government established several Enterprise Processing Zones (EPZs), including Software Technology Parks (STPs) and Electronics Hardware Tecnology Parks (EHTPs)[125] Here, the investors enjoy: tax shelters" and "tax holidays".[126] Through these industrial zone, the government of India can develop both technology innovation and venture capital finance.

In Malaysia, the government also play crucial role in developing venture capital industries.[127] Here, the government involved in larger number of existing venture capital companies.[128] Because the growth of venture capital in developing countries is still low, more attention and involvement of government agencies are needed, both directly and indirectly. Besides providing funding and designing supportive economic and legal environment, government can play role in socialization and training programs. Training programs will provide qualified human resources who are capable of operating and developing countries. Because this area is still nwe and unique, transferring and mastering its knowledge and skill are essential. This is particularly important for developing countries that are still in their initial efforts to introduce the establishment of venture capital practices.

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[122] Wasserman & Nye, *supra* note 115, at 28.
[123] Wasserman & Nye, *supra* note 115, at 28.
[124] Wasserman & Nye, *supra* note 115, at 38.
[125] Wasserman & Nye, *supra* note 115, at 38.
[126] Wasserman & Nye, *supra* note 115, at 38.
[127] WREIGHT ET AL., *supra* note 78, at 6.
[128] WREIGHT ET AL., *supra* note 78, at 6.

B. Developed Stock Markets

Stock market is important to venture capital development because it provides infrastructure for exiting strategy. Exiting strategy is "a fund's intended method for liquidating its holding while achieving the maximum return possible"[129] Exiting strategy through IPO in stock market is preferable because it is often provide better price.[130]

Different from developed countries, developing countries generally do not have strong stock markets.[131] Strong stock markets will create favorable environment for institutional investors to invest in venture capital.[132] A developing countries can develop strong venture capital because, among other, its major stock market, developed countries, such as the U.S. is strong and provide cross-list for its public companies with stock markets.[133] A developing country which has good business connections with the U.S. will has its strength compare the other developing countries which have not in developing venture capital.

India has also several major stock markets, includes Delhi Stock Exchange (DSEs), Bombay Stock Exchange (BSE), and the Regional Stock Exchange (RSE).[134] How ever; these stock markets have weakness, among other, subjected to inefficient operation, vulnerable because of past market disadvantages, and not transparence governance.[135] And majority of companies listed on stock market has low degree of liquidity.[136] Malaysia as many other developing countries also has weak stock market. To be succeed in developing venture capital in developing countries, this weakness should be minimized.

C. Adjust The Law

Legal adjustment can be provided through legal revision, legal reform, legislation of contractual right in civil law countries, promptness of legal enforcement process, and creating specialized dispute settle-

[129] Bance, *supra* note 23, at 18.
[130] Mayoral, *supra* note 63, at 12.
[131] Mayoral, *supra* note 63, at 11.
[132] Leeds & Sunderland, *supra* note 9, at 12.
[133] Wasserman & Nye, *supra* note 115, at 29-30.
[134] Wasserman & Nye, *supra* note 115, at 41.
[135] Wasserman & Nye, *supra* note 115, at 42.
[136] Wasserman & Nye, *supra* note 115, at 42.

ment agencies.[137] Even though the aim is the same, civil law countries have different method with common law countries rely more on legislation rather than court decisions as in common law countries. However, what ever legal tradisions adopted by developing countries, the intention should be the same, that is, accommodating the needs to support business activities, including the venture capital activities.

The existing laws which are not supportive to venture capital development need to be adjusted to provide viable exit strategies, protection for minority share holders, standardizing good corporate governance (including accounting standard, auditing, and board of directors duties), promoting foreign direct investment, and strengthening capital market.[138] Other related laws include legal structure for establishing limited partnership, authority for pension funds to invest in venture capital, and greater degree of protection, and contract enforcement.[139]

Providing viable exit mechanism can be achieved through adjusting the existing security law.[140] The law provides adequate conditions in it sections regarding the IPOs procedures and practices. When the IPOs existed, then, stock exchange and business community, particularly venture capital companies can utilize it for the purpose of selling and buying stocks of venture capital backed companies at their maturity. Inadequate rules of the IPOs operation will create obstacle to investors and venture capital companies in selling the stocks of portfolio companies, as the last part of the venture capital activities.[141]

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[137] Mayoral, *supra* note 63, at 13-14.

[138] Mayoral, *supra* note 63, at 10-12; *see also* Dawn Sylvester & Fuad Egeli. "Selling Africa to the World: The Emergence of Private Equity in Subsaharaan Africa, 3" *The Journal Of Private Equity: Strategies And Techniques For Venture Investing 41*, 2000. (discussing that Africa needs to moderate its law to promote transparency, certainty in property and contracts protection, guarantee public disclosure of information, transparency of trading in capital market, prevent unfair practices by intermediary and insider, and more open the markets to foreign investment).

[139] Lerner & Schoar, *supra* note 70, at 6-10.

[140] *See* Richard Dale, *Risk And Regulation In Global Markets 6*, John Wiley & Sons, 1996. (arguing that new financial market trends also have regulatory implications, "the difference in business characteristics of bank and securities firms have important policy consequencies where considering the need for regulation, the objectives of regulation, and the appropriate techniques of regulation").

[141] *See* Randy Charles Epping, *Beginner's Guide To The World Economy 65*, Vintage Books, 2001. (explaining two major advantages of IPOs: accessing to large pool of

Protecting minority shareholders is also supportive to venture capital development. Therefore, the exiting corporate law in developing countries need to provide adequate and effective law and regukation to guarantee the protection of these minority shareholders.[142] This can be achieved through providing conditions regulating how they are protected against unfair practices of corporations or majority shareholders. Minority shareholders are weak when facing with majority shareholders who have more voting rights. Because minority shareholders are naturally weaker bargaining position, they should be safeguarded by the law to achieve justice and to motivate their investment.

Standardizing corporate governance can be conducted by adopting accounting and auditing standards nationally based on international recognized standards. Besides, the exiting corporate law need also to regulate in detail duties and responsibilities of board of directors.[143] Board of directors as an organ of a corporation play a crucial role in the management of a corporation. These duties and responsibilities relate to the interests of share holders or investors against fraud, unfair practices, embezzlement, and other corporate misconducts. To obtain greater degree of certainly from those risks in effort to protect share holders or investors, the corporate law in developing countries need to accommodate these matters.

Promoting foreign direct investment (FDI)[144] can be achieved through adjusting law to meet the need of foreign investors. These includes, among other, tax law, real property law (regulating land and

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investors and putting a large sum of fund on original owners of the company).

142 *See* Epping, *supra* note 138, at 54 (starting that "by limiting downside risk for shareholders, companies are able to attract equity investors and raise a large amount of money".).

143 *See* Robert I, Tricker, International Corporate Governance: Text, Readings, And Cases 4-6, Prentice Hall, 1994. (outlining issues in corporate governance includes "the emergence of private companies, the scale of complexity of corporate groups, the significance of institutional investors, the hostile activities of predators, the criminalization of insider dealing, litigation against directors, call for more checks and balances at board level, change in the world of international auditing, newly corporatized and privatized corporate entities, and rethinking the nature of the company).

144 *See* Epping, *supra* note 138, at 134 (explaining two methods of FDI "includes" green-field investment such as new factories and power plan, and "paper" investments, such as buying shares of existing companies").

building), licensing law, and zoning regulation.[145]

These laws should be supportive,[146] such as by providing stipulations on tax incentives or tax holidays for foreign investors that meet certain criteria;[147] providing other facilities in relation to the application of licensing and zoning regulations.[148]

There are various alternatives on what form of business association can be chosen by investors or shareholders. Each form has its strengths and weaknesses. One of this alternatives is limited partnership that in U.S. venture capital practices have become the dominant form of venture capital companies.[149] In the limited partnership business association, the investors comprise of general partners (GPs) and limited partners (LPs). They faces risks and opportunities differently in the everyday business operation, where the limited partners have limited responsibility based on the value on their shares. Developing countries can adopt similar business association in their corporate law to support venture capital practices.

Pension funds have become major investors in the U.S. venture cap-

[145] *See* Ronald A. Brand, "Fundamentals Of International Business Transactions 975" *Kluwer Law International,* 2000. (presenting various factors lead to investment abroad includes more sources of raw materials, more tax and other investment incentives, less labor and transportation costs, nearer markets for selling products).

[146] *See id*., at 975-976 (explaining that the risks of investment abroad include "the increased risks of compliance with local regulatory restrictions on foreign investment).

[147] *See* Yang Wang, "Chinese Legal Reform: The Case Of Foreign Investment Law 124" *Routledge & The European Institute of Japanese Studies*, 2002. (describing that majority of developing countries provide tax holidays to attract FDI, with different level of standards and the tax incentives often based on such as to those who invest in high technology, certain industries, and/or particular locations or industrial zones).

[148] *See* Hun-Je Suh, Current Legislation Changes in Korea's Foreign Trade and Investment Sectors, in "Recent Transpormations In Korean Law And Society 264-265", Dae-Kyu ed., South National University Press, 2000. (analyzing incentives for foreign investments in Korea includes lessen restrictions on objectives and standards of foreign capital investment, simplify of procedure of capital investment, expansions of investment incentives, and providing one-stop service center for investments).

[149] *See* Dennis Hynes, *Agency, Partnership, And The Llc In A Nutshell 205*, West Publishing Co., 1997. (defining the limited partnership as "a form of doing business made available by statute that allows the investor participation in profits in an ownership capacity in a partnership, thus enjoying the benefits of partnership taxation, plus freedom from personal liability for the obligation of the business.").

ital. As in its earlier development of venture capital companies in the U.S., the regulatory regimes in developing countries may prohibit pension funds to invest in venture capital companies because of its higher degree of investment risks. The pension funds law should be change to accommodate recent development in venture capital investment. Investment in venture capital is prospective in gaining higher rate of return for pension funds. Therefore, the law should permit and encourage pension funds investments in venture capital companies.

The law of property, including intellectual property[150] (patent, trade mark, trade secret, industrial design, and copyright) need also be accommodative. These business-related laws need to be strengthened to accommodate new need for attracting foreign direct investment in developing countries. Foreign ownership of real property and regulations on mortgages for secured transactions need to accommodate present business needs of freer market competition.[151] The national intellectual property law can be strengthened, among others, through accession and participation in various international conventions. These conventions include Trade-related Aspect of Intellectual Property Rights (TRIPs) as a part of GATT/WTO, the Paris Convention for the Protection of Industrial Property, and the Berne Convention on the Protection of Literary and Artistic Works.[152]

Contract law and enforcement is also crucial for supporting business interests which are not regulated in form of statutory provision can be included in contract. Contracts, therefore, can be complementary for both statutory and judiciary laws. However, the contract law alone is not enough without adequate and effective mechanism of its

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[150] *See* Christoph Antons, "Japan as a Model? Comparing Law and Development in Japan, Singapore, and Indonesia", in *Law And Development In East And Southeast Asia 217,* Christoph Antons ed. IIAS & Routledge Curzon, 2003. (discussing strategies in industrialization process relate to the areas of business law includes intellectual property law).

[151] *See supra* note 138, at 45 (starting that if the country wants to enter into global market, it needs to remove all restrictions in its national markets).

[152] *See* John H. Jackson Et Al., *Legal Problems Of Internationaleconomic Relations: Cases, Materials And Text 960-961*, West Group 4th ed., 2002. (describing international intellectual property conventions and pointing the effectiveness of dispute settlement mechanism for intellectual property rights disputes under the TRIPs/GATT/WTO).

enforcement. Therefore, both aspects, substantive and procedural, laws of contract should accommodate the new need of business developments, particularly venture capital developments.

Another aspect of law which also needs to be adjusted is concerning arbitration and alternative dispute resolution.[153] This is particular relevant for the settlement of international venture capital disputes. There is a tendency in business practice internationally to select non-litigation dispute settlement mechanism, rather than litigation or courts practices. Arbitration, for example, has certain advantages which make it preference for business community, includes speedy, inexpensive, confidential, and internationally enforceable.[154] To guarantee the enforcement of the arbitral awards internationally, developing countries need to ratify the New York Convention on the recognition and Enforcement of Foreign Arbitral Awards.[155]

V. CONCLUSION

Generally, among features of developing countries weaknesses are related to capital and technology. Therefore acquiring capital and developing technology sector are becoming important for developing countries. Among efforts that can be conducted includes attracting foreign direct investment and/or developing venture capital funds to sup-

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[153] *See* American Arbitration Association, *A GUIDE TO MEDIATION AND ARBITRATION FOR BUSINESS PEOPLE 7,* AAA, 2003. (outlining that different from an arbitrator, a mediator does not create binding decision, but providing alternative solutions for parties in disputes).

[154] *See* Thomas J. Stipanowich & Peter H. Kaskell Eds., "Commercial Arbitration And Its Best: Successful Strategies For Business Users: A Report Of The Cpr Commission On The Future Of Arbitration Xxiii" CPR & ABA, 2001. (presenting the findings of the Cornell/PERC survey of reasons of corporations in selecting arbitration rather than courts shows: save money 68.6%, save time 68.5%, more satisfactory process 60.5%, limited discovery 59.3%, neutral expertise 49.9%, preserves confidentiality 43.2%, preserves good relation 41.3%, avoid legal precedence 36.9%, more satisfactory settlements 34.8%, and more durable resolution 28.3%).

[155] *See* ICC International Court Of Arbitration, *International Court Of Arbitration Dispute Resolutin Services: Resolving Business Dispute Worldwide 3,* ICC , 2003. (starting that the 1958 Convention has been signed by more than 130 countries worldwide).

port small business, which play important role in their development programs. The U.S. venture capital model is potential to be developed in their developing countries, as an alternative to traditional financial method through banking institutions for small business.

If small business become one the priority in developing countries national development plan, venture capital should become part of it, because certain advantages can be obtained from venture capital financing method, that is, providing management and marketing skills. This is crucial in developing small business in developing countries, because many small businesses in developing countries subject to these weaknesses.

However, as a new form of financing, the government needs to socialize venture capital in developing countries by various socialization and training programs. The government should also involve directly in initial establishment and in providing adequate funding for venture capital companies to be invested in small business sector.[156] This practice has shown it success in several countries.[157]

The government should also contribute indirect support to venture capital by creating conducive environment for venture capital development, such as increasing economic growth and adjusting economic law and its enforcement. Besides, to accelerate the venture capital development in developing countries, cultural aspect should also be under considerations.[158] This includes promoting entrepreneurship, risk taking

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[156] *See* Fenn Et Al., *supra* note 28, at 22 (showing that in the U.S. venture capital funds invest in various small business sectors includes computer related-software and hardware--, medical and health—biotechnology, medical instruments, and health service--, non-computer related manufacturing, retail and wholesale, telecommunications, and other business services, and others).

[157] *See* Josh Lerner, "The Government as Venture Capitalist: The Long-Run Impact of SBIR Program, 3" *The Journal Of Private Equity: Strategies And Techniques For Venture Investing 58*, 2000. (explaining that theoretically there are at least two justification for government support includes achieving the positive impact of investment for the firms and public, and providing information access for potential investors).

[158] *See* Roberto Charvel & Juan Carlos De Yeregui, Private Equity in Latin America: The Mexican Case, 6 THE JOURNAL OF PRIVATE EQUITY: STRATEGIES AND TECHNIQUES FOR VENTURE INVESTING 30 (Winter 2002) (describing that small business in developing countries generally have lack of "business culture and professional management" and venture capital company can play its strategic role to

habit, and technology mindedness.

International financing institutions committing to development programs in the developing countries should also give their contributions to the development of venture capital in developing countries because of its advantages. These institutions include the World Bank, the International Monetary Fund (IMF), regional development banks, and others. These institutions can provide adequate capital and technical assistance in supporting venture capital funds in developing countries.

All these factors will likely to create positive impact on the growth of venture capital in developing countries, as has been succeed in the U.S. and some other countries. The growth of venture capital will have positive implication for national development in developing countries, particularly through job creation, technology development, income growth and distribution, foreign investment growth, and entrepreneurship mentality.

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help small business by providing skills and experience, including management and networking).

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