Asian Journal of Comparative Law (2023), **18**, 362–388
doi:10.1017/asjcl.2023.24

ASIAN JOURNAL OF COMPARATIVE LAW

CAMBRIDGE UNIVERSITY PRESS

ARTICLE

Venture Capital Law in Cambodia: Engineer the Regulatory Framework to Promote the Startup Ecosystem

Tharith Soeun*

Keio University, Tokyo, Japan
E-mail: soeuntharith@gmail.com

(Received 9 February 2022; revised 30 October 2022; accepted 24 November 2022; first published online 12 September 2023)

Abstract

As the startup ecosystem emerges, Cambodia requires a distinct set of legal frameworks to promote many regulatory aspects to boost national innovation and strengthen the connection of key players in the ecosystem. One of them is financial support for startups, 'Venture Capital Law'. Therefore, this paper studies the current existing legal framework of Venture Capital (VC) in Cambodia, key bottlenecks that VC encountered, comparative analysis with other countries such as the United States, Japan, and China, and then propose new regulatory frameworks which solve the key bottlenecks and aim to optimise the growth of a startup ecosystem. The finding is that different stages of VC present different bottlenecks such as fundraising (funding source), startup investment (investment readiness of the startup, and deal structure), and exit (immature the capital market for startup's IPO and lack of regulations for Merger and Acquisition (M&A)). The new regulatory frameworks should endorse the use of pension funds as a source of VC funds in the future, encourage private corporations to invest in startup causes, include regulations to promote the readiness of founders, encourage the use of convertible notes, and fasten the regulation governing M&A with the balance of antitrust law.

Venture capital, which originated in the United States (US), is a form of financing that provides funds to early-stage startups, small businesses, and emerging companies with high growth potential.[1] Unlike other types of financing, the venture capitalist (VC) provides not only financial but also managerial and networking support to the startup founders. This form of financing is recognised as a powerful driving force for national innovation, job creation, and economic growth.[2] Curiously, Cambodia is still relatively new to the concept of venture capital despite the tech startup ecosystem emerging several years ago. Currently, there is no specific law on monitoring and promoting venture capital and startups yet. On the other hand, the US pioneered the VC and startup regulation in 1959.[3] Thereafter, many nations, such as

*LLM Graduate, Law School, Keio University. The author is deeply grateful to Professor A Reid Monroe-Sheridan of Keio University Law School for his valuable comments on and supervision of this research. Please take note that some sources cited were accessible when the author was a student at Keio University in 2021, and may no longer be available online.

[1]Andrew Loo, 'What is Venture capital?' (Corporate Finance Institution, 28 Apr 2023) <https://corporatefinanceinstitute.com/resources/capital-markets/what-is-venture-capital/> accessed 2 May 2023.

[2]Ronald J Gilson, 'Engineering a Venture Capital Market: Lessons from the American Experience' (2003) 55 Stanford Law Review 1067, 1067–1068.

[3]George W Fenn et al, 'The Economics of Private Equity Market' (Board of Governors of the Federal Reserve System, Dec 1995) <https://www.federalreserve.gov/pubs/staffstudies/1990-99/ss168.pdf> accessed 2 May 2023. In 1959, the Small Business Investment Companies (SBICs) were established with the incentives of government loans and tax benefits. This form is promoted under the Small Business Administration (SBA); moreover, the US also created the Small Business

Germany,[4] Australia,[5] Japan,[6] China,[7] and Singapore,[8] tried to replicate the system. Some replications worked well, while others unfortunately led to disasters.[9] Therefore, with the startup wave just arriving in Cambodia, what regulatory framework can the government prepare to support the flourishing of this VC-startup trend?

This article will seek to explore the engineering of the VC community from a regulatory perspective, and propose a supportive policy and regulatory framework to promote the flourishing of this VC-startup trend. Specifically, the article seeks to answer three main questions:

1. How do the current regulations in Cambodia affect VC activity?
2. What are the current bottlenecks for VC in Cambodia?
3. What could possible regulatory solutions be for the VC community?

First, the article focuses on the current regulatory framework that monitors investment activities in Cambodia. It starts with a short history of the nation and then explains how the nation bootstrapped its economy before discussing the need for venture capital in Cambodia. Subsequently, it scopes down to current legal frameworks that are particularly important to venture capital, namely corporate law, tax law, and other laws. This section will end with three major reasons of why the government and legislators should put effort into engineering the concrete regulatory framework for VC. Lastly, it divides VC activities into three stages: formation, investment, and exit. In each stage, the regulatory bottlenecks will be analysed with comparison to the US, China, and Japan; and finally, the author will propose the regulatory framework that best fits Cambodia's situation.

Current Investment Regulatory Regime in Cambodia

After two decades of civil war from 1970 to 1990, Cambodia fell to 'ground zero'. The infrastructures were destroyed. Many educated people were lost. Ultimately, Cambodia signed the *Paris Peace Agreement* in 1991 to stop the war, and initiated the rehabilitation process. In 1992, the United Nations Transitional Authority in Cambodia (UNTAC) worked on the Constituent Assembly elections to ensure a free and fair process. As Cambodia had just woken up from a long war, globalisation and regionalisation arrived at the nation's doorstep. From 'ground zero', this fragile post-war nation had to restore the situation in multi-sectors including agriculture, education, tourism, manufacturing, technology, and more. Then, the country had a choice: whether to keep a closed door and start building everything from scratch on its own, or to open the door and take advantage of globalisation by allowing foreign investors to enter and develop businesses on the territory. Each choice

Innovation Research (SBIR) Program to advocate the development of tech firms by providing a capital-intensive risk to the innovators long before the products become financially viable.

[4]Gilson (n 2) 1094–1096.

[5]The Treasury and the Department of Industry, Innovation, Science, Research and Tertiary Education, 'Review of Venture Capital and Entrepreneurial Skills' (2012) <http://ict-industry-reports.com.au/wp-content/uploads/sites/4/2013/09/2012-Venture-Capital-and-Entrepreneurial-Skills-DIISRTE-Dec-2012.pdf> accessed 2 May 2023.

[6]Zenichi Shishido, 'Why Japanese entrepreneurs don't give up control to venture capitalists' (SSRN Electronic Journal, 30 Mar 2009) <https://dx.doi.org/10.2139/ssrn.1370519> accessed 2 May 2023.

[7]Lu Haitian, Tan Yi & Chen Gongmeng, 'Venture Capital and the Law in China' (2007) 37 Hong Kong Law Journal 229.

[8]Lin Lin, 'Venture Capital in Singapore: The Way Forward' (2019) 5 Journal of Business Law 363–387.

[9]An example of this shortfall can be viewed from China. See Hu Caihe, 'Three Generations of Mainstream VCs Direct the Venture Capital Investment in China' (New Fortune, Jul 2004) 155–161. China Hi-Tech Venture Capital Corporation ('CHVCC'), the first joint-stock venture capital firm in VC's China Investment, was set up. The fund can be set up in the form of Venture Capital Funds (VCF). As a result, the CHVCC still barely hit their standard because the investment usually fell to the sector of real estate and listed securities instead of high-tech and high-growth companies. A few foreign venture capitalists gave China some trial investment; however, most of them still perceived the Chinese market as immature.

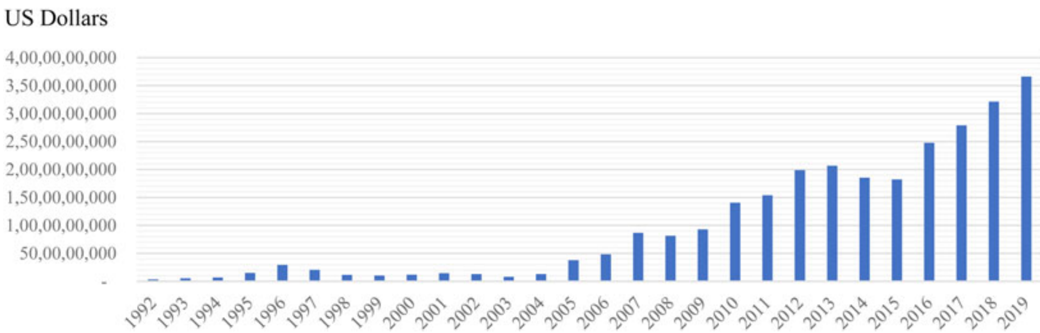

Figure 1. Cambodia's Foreign Direct Investment, net inflow
Source: World Bank Data[10]

had its costs and benefits. However, with the right policies, the nation might catch up with richer nations.[11]

In 1993, the new Constitution was adopted to set Cambodia as a kingdom of democracy and pluralism,[12] with a market economy system.[13] Many regulations were established in the aftermath of the civil war to attract foreign investors. The *Law on Investment* (LoI) was established in 1994 and then got amended in 2003.[14] The amendment opened the nation to potential foreign investment by establishing an investment licensing system to regulate the approval process for foreign direct investment (FDI) and create incentive packages[15] to attract potential global investors. Looking at the effects of this law on the actual economy, the annual FDI from 1994 to 2004 is seen to barely hit USD 150 million; however, after 2005, the FDI grew from USD 131 million in 2004 to USD 3.6 billion in 2019 (see Figure 1). This increase in FDI suggests that Cambodia has an open policy to foreign investors, and that the amendment of the LoI in 2003 did create a positive impact on the economy.

While FDI attraction has been a great starting point to boost Cambodia's economy until recently, it is time for the nation to take further steps[16] by enabling the untapped local talents to reach their potential. This simply means that new policy should strengthen and encourage local human resources to be the backbone of the economy rather than relying mainly on foreign investors who may pull out of the country when there are some adverse situations. In the last 20 years, the youth in Generation Z has had the opportunity to take proper education locally and

[10]For more detailed and up-to-date information, please visit: The World Bank, 'Foreign direct investment, net inflows (% of GDP) – Cambodia' <https://data.worldbank.org/indicator/BX.KLT.DINV.WD.GD.ZS?locations=KH> accessed 4 Jul 2023.

[11]Siphana Sok, 'Role of Law and Legal Institutions in Cambodia Economic Development: Opportunities to Skip the Learning Curve' (PhD thesis, Bond University School of Law 2009) 85–86.

[12]Constitution Law 1993, art 1.

[13]ibid, art 56

[14]Law on Investment (amended 2003). This law stipulates the investment procedure, investment guarantees, investment incentives, and land ownership restriction. Then, the new Investment Law was promulgated, replacing both the 1994 Investment Law and its amendment in 2003, in order to provide more rigid approval framework and incentives for specific sectors; however, since its effect cannot be clearly assessed yet due to its short period of implementation, this article will analyse only the effect of the 1993 Investment Law and the amendment in 2003.

[15]Articles 13 & 14 of the LoI provides the exemption, in whole or in part, of customs duties and taxes such as the tax on profit for the investor.

[16]Sangeetha Amarthalingam, 'Is Covid-19 testing Cambodia's financing model?' (Phnom Penh Post, 22 Jul 2021) <https://www.phnompenhpost.com/special-reports/covid-19-testing-cambodias-financing-model> accessed 2 Aug 2021. Due to Covid-19, the FDI dropped off 23.6%. This fall somehow is unsurprising because Cambodia has heavily relied on investment in global value chain industries which get hard hit. The concentrated reliance on China and the graduation from the Least Developed Country (LDC) status impose a big threat to the future of the FDI. This requires the nation to evolve and structure its financing model to be self-sustained rather than reliance on external sources.

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

internationally. This proper education and some professional experiences are a great reservoir for the local talent to break the norm by starting their businesses with breakthroughs and ultimately boosting the national economy from within. With a population of 17.2 million,[17] the internet penetration rate abruptly jumped from 6.8% in 2013 to 78.8% in 2022.[18] Since the 4G LTE network was introduced to the nation in 2014, tech businesses have begun to emerge. In 2018, more than 300 active technology startups were operating in the kingdom.[19] In late 2020, Cambodia successfully trialed the first Standalone (SA) 5G site reaching a speed of 1.6 Gigabits per second (Gbps).[20] This will create a core infrastructure for more internet-intensive startups in the future.

Nevertheless, based on the report of 'Cambodia's Ecosystem for Technology Startups'[21] in June 2022, early-stage startups reported having difficulties raising funds.[22] This statement emphasises that financial support is the common bottleneck for most founders around the world for startups. Due to its high-risk characteristic and lack of collateral, startups usually have difficulty getting financial support. That is where venture capital comes in and provides financial support, validates the business model, liaises with the startup to the potential network of partners, and, most importantly, assists founders in the business direction. More than just being a fund provider, VC also catalyses startup success through industry knowledge, networking, and management support.[23] However, only 1 in 10 startups in Cambodia received funding from the VC.[24] Given the stage of market development, Cambodia only has several VC funds available.[25] Those funds are invested differently based on the stage and field of the startup.[26]

Although there is no specific law to regulate and promote VC activity yet, the existing business-related regulations generally still influence the VC market. The following section will discuss the VC regime under current regulations.

Current Venture Capital Regulation in Cambodia

Despite the absence of a VC law in Cambodia, its relevant rules are scattered in various laws, mainly the *Law on Commercial Enterprise* (so-called Company Law or LCE), *Trust Law*, and *Tax Law*.

[17]Worldometer, 'Cambodia Population (live)' <https://www.worldometers.info/world-population/cambodia-population/> accessed 10 Sep 2022.

[18]Datareportal, 'Digital 2022: Cambodia' (Feb 2022) <https://datareportal.com/reports/digital-2022-cambodia> accessed 4 Jul 2023.

[19]Bora Kem et al, 'Startup Kingdom: Cambodia's Vibrant Tech Startup Ecosystem in 2018' (Mekong Strategic Partner and Raintree Development, 1 Jan 2019) 11 <https://static1.squarespace.com/static/56a87acd05f8e263f7b16c7f/t/5c8a98caec212db15379299d/1552586969710/Cambodian_Tech_Startup_Report_Final_150319.pdf> accessed 1 Jun 2023.

[20]Cellcard, 'Cellcard first to launch real 5G trials in Cambodia, with speeds reaching 1.6Gbps' (30 Nov 2020) <https://www.cellcard.com.kh/en/media-center/news/post/cellcard-first-launch-real-5g-trials-cambodia-speeds-reaching-1-6gbps/> accessed 2 May 2023.

[21]Sopheara Ek & Paul Vandenberg, 'Cambodia's Ecosystem for Technology Startups' (Asian Development Bank, Jun 2022) 38 <https://www.adb.org/sites/default/files/publication/804931/cambodia-ecosystem-technology-startups.pdf> accessed 2 May 2023.

[22]ibid.

[23]See NMP Bocken, 'Sustainable venture capital – catalyst for sustainable start-up success?' (2015) 108 Journal of Cleaner Production 647–658. This article proves that sustainable venture capitalists help to prove the success of the business format. In its Table 3, it assesses the key success factors that VC can contribute. They are the innovation in business model (for instance, novel partnerships and value propositions), collaboration (across small and large companies and industry), and strong business case.

[24]ibid; Quynh Nguyen, 'Cambodian VC Firm Scouts for Late-Stage Deals to Grow Profitability' (Nikkei Asia, 3 Mar 2021) <https://asia.nikkei.com/Spotlight/DealStreetAsia/Cambodian-VC-firm-scouts-for-late-stage-deals-to-grow-profitability> accessed 2 May 2023. Until 2021, only 30 tech startups are disclosed with institutional capital investment. There is a belief that early-stage firms still lack understanding of what 'investment readiness' means and what conditions are demanded to close the deal with institutional, corporate or even angel investment.

[25]ibid.

[26]Kem et al (n 19).

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

Table 1. The structure status of some VCs in Cambodia[27]

No	Organisations	Registered status[28]
1	Mekong Strategic Partners (including Smart Axiata Digital Innovation Fund)	Company
2	OOCTANE	Company
3	Uberis Capital	Commercial Representative office
4	Insitor	Commercial Representative office
6	Small World Venture	Company
7	OBOR Capital	Company

Company Law

Cambodian Company Law consists of 8 chapters.[29] This law mainly governs the structure of the partnership or company, its registration procedure, compliance, and some miscellaneous issues.

This law regulates how VCs establish themselves legally. Based on their Company Law, there are three main types of structure such as a sole proprietorship, partnership, and company. To be recognised as a legal company, the VC has to file a registration application with the Cambodian Ministry of Commerce (see Table 1 for registered VC companies).

Meanwhile, it is interesting to note that the Limited Liability Partnership (LLP) structure is a popular structure to set up VC funds in the top VC nations like the United States, China, and Japan. The *Small Business Investment Act* of 1980 in the United States originated this business structure of 'limited partnership', which then significantly contribute to the boom of venture capital between the 1980s and 1990s.[30] This structure increases the choice of funding sources without conflict of interest with the parent institution (institutional VC), enhances the flexibility to structure adequate compensation or incentive packages for VC, provides the benefit of pass-through tax compared to corporate, and has the limited life and liability of investors.[31] Usually, under this form, the general partners have complete control over investment decisions, while the limited partners are restricted from daily operation.[32] Seeing this, Japan[33] and China[34] also established a similar form imitating the US limited partnership. It did not work well at first (as explained in footnote 34); however, the condition has been improved after some revisions to the regulation.[35]

27For the list of organisations, see Ek & Vandenberg (n 21) 16.

28This registered status is based on the online search in the database of the Ministry of Commerce. See Ministry of Commerce, 'Business Registration' <businessregistration.moc.gov.kh> accessed 2 May 2023.

29Law on Commercial Enterprise 2005; Amendment on Law on Commercial Regulations and the Commercial Register 2022.

30Fenn et al (n 3) 11–12.

31Sanusi Bintang, 'Venture Capital: An American Concept and Its Problems of Implementation in Developing Countries (2015) 12 Indonesian Journal of International Law 186.

32Ronald J Gilson, 'Engineering a Venture Capital Market: Lessons from the American Experience' (Stanford Law School John M Olin Program in Law and Economics, Working Paper no 248, 2002) 6–7.

33Akio Nishizawa, 'Evolution of Japanese-style venture capital and its limitation: Why non-linear VC model emerged in Japan' (2009) 4 International Journal of Entrepreneurship and Innovation Management 9.

34Decision on the Reform of Science and Technology System (promulgated 1 Jan 1985) introduced a new form of Venture Capital Funds (VCF) in China. However, the result is not satisfied due to the traditional investment mindset. In 2006, China adopted the new form of Limited Partnership in its *Partnership Law* (2006 Revision). Currently, venture capital funds are organised as offshore funds or onshore funds. The offshore funds are generally established in a tax heaven jurisdiction such as the Cayman Islands. It can be in the form of a limited partnership or corporation. The funds were invested in Chinese companies through a variable interest entity (VIE) structure. The offshore fund can in principle invest and exit tax-free, however still subject to the tax regulation of the investor's jurisdiction. In contrast, the onshore VC fund is established within China and is subject to Chinese regulation.

35ibid.

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

Fortunately, Cambodia has already had a similar form of LLP in place since the inception of the LCE in 2005. 'Limited Partnership', in chapter 2 (Part II) of the LCE, is defined as 'a contract between one or more general partners who are the sole persons authorised to administer and bind the partnership, and one or more limited partners, who are bound to contribute to the capital of the partnership.'[36] The next step is to see if this form realises the spirit of the US Limited Liability Partnership or not. First, there are two key differences between the general partner and the limited partner – the degree of liability and management obligation. The limited partner must contribute money or property to the partnership, and his/her liability is only to the extent of that invested money and property.[37] On the other hand, general partners' liabilities are extended to that of the partnership to the third parties jointly and severally.[38] This unlimited liability of the general partner might be due to its non-inference management right to the partnership fund.[39] In a VC's Limited Liability Partnership, the general partner is the VC who manages the fund and decides which startup company to invest in. The limited partner, in this VC case, are the fund investors. The investors have no discretion in fund management. If the investors violate this rule and join the management, their liability may extend to the obligation of the partnership resulting from the acts.[40] If the frequency of involvement indicates that the limited partner acted as a general partner, the liability will extend in the same manner as the general partner.[41] These two critical differences between limited partners and general partners encapsulate the US Limited Liability Partnership's key spirit, which is limited investor liability. Unfortunately, the benefit of pass-through tax is unlikely to be applicable for Cambodia's VC Limited Partnership because of the tax on capital gain[42] that the General Department of Taxation in Cambodia will implement from 2024 onward (see below for further explanation).

Tax Law

The most relevant taxes for the VC are tax on capital gain and tax incentives for small businesses. Tax on capital gain is significant because, during an exit, the capital gain from the investment will be the taxable subject. Tax incentive for small business also plays a significant role because startups usually go through an intense period of cash-burning, at least in the first few years. Therefore, the VC must understand how a startup should deal with the taxation aspects.

[36]LCE 2005, art 64.

[37]LCE 2005, art 72 ('Liability of Limited Partner').

[38]ibid, art 75 ('Liability of General Partner'). The general partner has the rights and obligations in managing the partnership without inference from the limited partner.

[39]ibid, art 74 (Power, rights, obligations of a general partner); ibid, art 79 (Management-Limited Partners). Although limited partners cannot make decisions in the management, they can examine the reports and progress of the partnership and may give advisory opinions.

[40]ibid, art 79 (Management – Limited Partner); Lin Lin, *Venture Capital Law in China* (Cambridge University Press 2021). Interestingly, in China's Partnership Enterprise Law, there is no such extension of obligation in case the limited partner involves in the decision. This lacking point creates many issues because the limited partner in China usually used the pressure on the VC to listen to their decision. Sometimes, all the investment decisions must go through a vote to make investment decisions.

[41]ibid. The Cambodian LCE does not specify clearly what activities can be included as management involvement. This will be the court's discretion. However, the Delaware Code §17-303 (2017) stipulates in detail what activities should be included as management involvement such as to be an independent contractor; to act as surety, guarantor or endorser for a limited partnership or a general partner; to call, request, or participate in a meeting of the partners; etc. For more detail, please see (Title) 6 Delaware Code §17-303 (2017).

[42]Curtis J Milhaupt, 'The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate' (1997) 91 Northwestern University Law Review 865. In 1998, the 'limited partnership fund' was established under the Japanese-type Limited Partnership Act to realise the advantages of flow-through tax treatment and limited liability. However, the tax treatment was criticised as not serving its full purpose because the Ministry of Finance imposed a withholding tax on the fund with ten or more limited partners.

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

Tax on capital gain is a matter under Cambodian Law on Taxation and the *Prakas*[43] No 346 on Capital gain tax. Capital gain, by the *Prakas*, is applicable when there is a sale or transfer of ownership rights.[44] In the case of a VC, this should occur when the VC sells or transfers the share in the portfolio company (the startup) and realises the gain.[45] The gain will be subjected to a fixed tax rate of 20%.[46] This rate was supposed to be put into force from 1 July 2020; however, it has since been delayed twice and will only be in force from January 2024.[47] Meanwhiles, for a VC company, this tax has already been in place in the form of income tax.[48]

The tax incentive for small and medium enterprises was strongly advocated in Cambodia even before it became a reality on 2 October 2018 under *Sub-decree No 24 on Tax incentives for small and medium enterprises in the prioritised sector* (Sub-decree). This Sub-decree is enforced to stimulate local productivity and enhance job creation in Cambodia. This article will first seek to discuss how the Sub-decree defines Small and Medium Enterprise (SME) to see if the startup company is also subjected to this incentive, and then explain what the incentive is.

Based on Article 4 of the Sub-decree, the definition of small and medium revolves around (i) the number of employees in the company; and (ii) Annual Turnover or Asset, whichever is higher (see Tables 2, 3, and 4). However, not all SMEs receive the tax incentive; only SMEs that operate in the prioritised sector will be eligible for the incentive.

The definition of an SME was updated in January 2021,[49] with more specific terms based on different sectors such as agriculture (Table 2), industry (Table 3), and service and commerce (Table 4).

Table 2. Definition of Small & Medium Enterprise in the Agriculture Sector

	Number of Employees	and	Annual Turnover (USD)	or[50]	Asset
Small	5–49		62,250–250,000		50,000–250,000
Medium	50–199		250,001–1,000,000		250,001–500,000

Table 3. Definition of Small & Medium Enterprise in the Industry Sector

	Number of Employees	and	Annual Turnover (USD)	or	Asset
Small	5–49		62,500–400,000		50,000–500,000
Medium	50–199		400,001–2,000,000		500,001–1,000,000

Table 4. Definition of Small & Medium Enterprise in Service and Commercial

	Number of Employees	and	Annual Turnover (USD)	or	Asset
Small	5–49		62,500–250,000		50,000–250,000
Medium	50–99		250,001–1,500,000		250,001–500,000

[43]The Arbitration Council, 'Prakas' <https://www.arbitrationcouncil.org/resources/laws-regulations/prakas/> accessed 11 Jul 2021. 'Prakas' are issued by the Ministry in charge. It is a secondary source of regulations but is considered to be the primary source for decision-making's purpose.

[44]*Prakas* No 346/20 MEF on Capital Gain Tax, art 6.

[45]The gain here is subject to the deduction of expense first. In a way, it is similar to profit.

[46]*Prakas* No 346/20 MEF on Capital Gain Tax, art 10.

[47]ibid, art 18; GDT Notification No 4577 on the Second Postponement of the implementation of the Capital Gain Tax (22 Mar 2022).

[48]For more detail, see Prakas MEF on Tax on Profit 2003.

[49]Notification No 36 from the Council of Ministers 2021.

[50]Whichever higher between Annual Turnover and Asset is used.

The prioritised sectors include Research and Development (R&D) of information technology (IT), or the supply of IT-based service; agricultural products; food manufacturing or processing; manufacturing of a local product; waste recycling; tourism product; and enterprise located in the SME Cluster Zone.[51] Therefore, whether the startup is subject to this incentive or not depends on three main factors, as explained above. If the asset, annual turnover and number of employees are within the threshold outlined in Tables 2, 3 and 4, and its operation is within the prioritised sectors, then the startup is availed to the incentive. Cambodian law does not draw a clear distinction between startup and SME; hence, until a clear position of the laws and regulations is established, its interpretation will be based on the competent authority (in this case, the 'tax authority'). The next question is about the incentive scheme itself. Assuming that the startup is within the definition of SME and operating in the prioritised sector, what will be that incentive? Based on Article 6 of the Sub-decree, the startup can enjoy the exemption on income tax for three years for newly registered enterprises or from the date of tax registration update for the existing enterprise.[52] The exemption period can be extended up to 5 years if the business meets one of the following criteria: (1) it utilises up to 60% local raw materials, (2) it increases the number of employees by at least 20%, or (3) it is located within the SME Cluster zone.[53] On top of that, there are incentives for deductible expenditure such as 200% weighted tax-deductible expense for IT-based accounting software and staff training; and 150% weighted tax-deductible expense for equipment or new technology that enhances productivity.[54]

Trust Law

The concept of the 'trust', which generally exists in common law nations, also finds its way into this civil law nation. The Cambodian Trust Law was established and entered into force in 2018. Under this Trust Law, trust is classified into four categories: commercial trust, public trust, social trust, and personal trusts.[55] Trust activities include the transfer of the trustor's assets to the trustee for management, disposal, and maintenance for the interest of the beneficiary.[56] This trust concept is relatively new but has developed at a fast pace recently; as of the date of this article, it is still not clear whether all the VC funds shall be established and managed under this trust concept. Based on the definition above, it highly suggests that the trust law should apply to VC funds because the VC fund's investors (like a trustor) put their funds with the VC (trustee) to manage and generate profit for the beneficiary, which is the investors themselves. Therefore, this article assumes that trust law applies to VC funds, unless future laws and regulations clearly state otherwise.

The trust shall be made in writing and registered with the Cambodian Ministry of Economy and Finance (MEF).[57] The trustee who manages the trust shall undergo training with the MEF[58] and obtain the trustee license.[59] During the management of the trust, the activities of the trustee shall be made with care and prudence.[60]

[51] Sub-decree No 24 on Tax incentive for small and medium enterprises in the prioritised sector, art 5.

[52] ibid, art 6; Clint O'Connell (DFDL), 'Cambodia Tax Update: SME Tax Incentives Announced' (Asia Law Network, 2 Nov 2018) <https://learn.asialawnetwork.com/2018/11/02/cambodia-tax-update-sme-tax-incentives-announced/> accessed 1 Jun 2023.

[53] ibid.

[54] ibid.

[55] Trust Law 2018, art 9.

[56] *Prakas* No 003 on Mechanism in management, organisation and acts of the trust 2022, cl 4.

[57] Sub-decree No 114 on Registration of Trust 2019, art 7.

[58] ibid, art 11.

[59] *Prakas* No 003 on Mechanism in management, organisation and acts of the trust 2022, cl 12.

[60] Trust Law 2018, art 22.

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

Miscellaneous laws and regulations

Pertaining to M&A regulation, it is vastly important for the VC because, at the end of the day, it governs the exit strategy of the VC. Presently, Cambodia has already put into force their anti-trust law, but still lacks 'Merger Control' law and other ministerial regulations (eg, Sub-decree and *Prakas*) to govern its specificity yet; most M&A governances are regulated under Company law or sectoral laws. The anti-trust law's purpose is to prohibit any acts that prevent, restrict, and distort competition.

Prior to proper registration of their business with the competent ministry (eg, the Cambodian Ministry of Commerce), startup founder(s) usually just kickstarted their venture project as individual(s) or natural person(s) by using their own moneys and/or loans from family and friends.[61] In such a case, personal insolvency law can also affect the levels of venture capital finance because a 'harsh' bankruptcy regime may discourage the potential entrepreneurs that want to found their ventures. Further, if the entrepreneurs try but fail to prosper their venture due to unforeseen circumstances, market conditions or other reasons, the financial rehabilitation of bankrupt individuals will exclude those talented entrepreneurs from the start-up arena in future.[62] John Armour has argued that the 'severity' of a personal insolvency law is based on three main factors: (1) the ability to return back to the marketplace free of obligations for a fresh start; (2) the range and restrictiveness of the disabilities imposed upon an insolvent person; (3) the level of exemptions (if any) of property from the estate.[63] In Cambodia, there is no specific personal insolvency law yet; however, the insolvency law which came into force in 2007 governs both businessmen and legal entities that own assets in Cambodia.[64] With respect to its severity of treatment of personal property, until further laws and regulations are put in force, the current insolvency law does not stipulate clearly regarding the ability to return back to marketplace for a fresh start, nor the restrictiveness of disabilities for the insolvent businessman.[65] Therefore, this can be subject to the actual court decision during the liquidation proceeding. However, the current law does allow some exemption to the estate of a debtor who is a natural person, such as a primary place of residence worth up to USD 5,000, and any other asset, right or claim exempted from execution against the debtor under the Cambodian *Code of Civil Procedure*, including a limit for salary[66] and other daily necessary items.[67]

The above are just some overviews of the existing laws which regulate fund structure and taxation for VC. However, many other activities or potential growth of VC are still left unregulated or are not well-regulated yet.[68] A more strategic regulatory framework should be formulated, and some existing regulations should be revised for a VC to smoothly and optimally create a robust community to boost national innovation and economic growth.[69] A solid regulatory framework is essential to allow

[61]Matthieu de Gaudemar, 'Startups discuss local challenges' (The Phnom Penh Post, 25 Apr 2017) <https://www.phnompenhpost.com/business/startups-discuss-local-challenges> accessed 25 Oct 2022.

[62]John Armour, 'Personal Insolvency Law and Venture Capital' (2004) 5 European Business Organization Law Review 87, 109.

[63]ibid. The finding of this article indicates a negative correlation between severity of personal insolvency law and levels of venture capital investment.

[64]Insolvency Law 2007, art 3.

[65]Regarding some professional occupation which requires the practitioner to obtain the license, such regulatory mechanism can be found in the relevant Sub-decree or *Prakas* instead.

[66]Code of Civil Procedure 2006, art 382.

[67]Code of Civil Procedure 2006, art 380. The Property exempt from attachment includes clothing, bedding, furniture, tools, net, fishing equipment, book, fire-fighting equipment, etc. See also Insolvency Law 2007, art 20.

[68]The United States is the father of venture capital. In the US, by 2000, venture capital enhanced the US GDP by USD 1.1 trillion and created new jobs for 12.5 million workers. This result is not coincident. Instead, it is a vision strategically built by the US government and legislators from the 19th century to promote technological and financial advancement.

[69]James Okrah, Alexander Nepp & Ebenezer Agbozo, 'Exploring the factors of startup success and growth' (2018) 9 The Business and Management Review 229. The regulation can revolutionise the entrepreneur culture of a country by fostering a climate in which entrepreneurship is viewed as a means to create value for the economy and attract investment opportunities.

for the emergence and success of VC.[70] The engineering of the VC market should be prioritised on the agenda of government and legislators for three main reasons. First, the VC will then be able to meet the capital demand of startups and promote on emerging innovative causes to improve the national economy, as discussed earlier. Second, it will allow this financial tool (the VC) to achieve its optimal result for individual, institutional investors, and the VC themselves. Third, the growth of local talents will allow for a more sustainable economic approach.

Some of the activities in the VC market are still operating in a regulatory vacuum without a clear governing legal framework. This absence of regulatory oversight might lead to fraud and scandals in the startup community.[71] On the other hand, with a clear strategic direction, the VC market can develop at a faster pace and reap better fruit for the startup ecosystem. To draft an effective regulatory framework, the government should first understand the activities of VC operations and discover the problems that legal tools could solve. The section below will explore the current bottlenecks for VC in Cambodia and its related regulations in greater depth.

Current Bottlenecks for Venture Capital in Cambodia

In order to engineer a successful VC market, Ronald J Gilson modelled a theory of 'Simultaneity' which states that a venture capital market requires (1) entrepreneurs; (2) investors with funds and taste for high-risk, high-return investments; and (3) a specialised financial intermediary.[72] The market requires the simultaneous availability of all three factors where one may only exist with the availability of the other two.[73] In order to organise this section in chronological order, it classifies VC activities based on stages: the fundraising stage, startup-investment stage, and exit stage. Each stage has different challenges. The fundraising stage looks at the fund investor with a high-risk appetite (ie, requirement 2 of the Simultaneity theory). The startup-investment stage focuses on the investment readiness of the entrepreneur (ie, requirement 1 of the Simultaneity theory) and VC-startup deal structure (ie, requirement 3 of the Simultaneity theory). Lastly, the exit stage provides for the different routes for a VC to pull out, depicting the great incentive for a VC to select the great startups and assist them all the way to exit (ie, requirement 3 of the Simultaneity theory).

Cambodia's situation is not unique. There are many other developing nations that have gone through the same, or at least similar, issues and have attempted various approaches in designing their regulations to solve those issues. In fact, Cambodia has late-mover advantages and is able to study others' experiences, solutions, and follow their blueprints, if applicable. As aforementioned, the US is the father of VC regulations that many other nations tried to replicate, and the US has already succeeded in boosting the startup economy to reap great fruit of results. China, moreover, has shown incredible results in recent years. This nation has replicated some regulations from the US, with some of them not leading to favourable consequences; however, China does not stand still but continues to architect additional law or amend the current one to deal with the issue quickly. Hence, this indicates a great lesson for Cambodia that would like to follow suit. Third, Cambodia's legal framework is significantly influenced by Japan's legal framework, unsurprisingly, since Japan

See also Ken Colwell & VK Narayanan, 'Foresight in economic development policy: Shaping the institutional context for entrepreneurial innovation' (2010) 42 Futures 295.

[70]Tereza Tykvová, 'Legal framework quality and success of (different types of) venture capital investments' (2018) 87 Journal of Banking & Finance 333. Tykvova used the data of 8,270 companies from 41 countries to explore the relationship between the success of venture capital investment and legal frameworks in the investment countries. Her finding is that legal framework quality is linked to the success of such investments, but this effect varies with the deal types. She also finds that International VCs usually exit the startup abroad mostly due to the weak legal framework of the investment nation.

[71]Lin, *Venture Capital Law in China* (n 40). There are many frauds and scandals that emerged in China from 2011 due to a lack of regulatory oversight in the VC sector. These issues involve illegal fundraising, abused power from the limited partner in the investment decision, unqualified investors with a low-risk tolerance, and so forth.

[72]Gilson (n 2).

[73]ibid.

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

assisted Cambodia in drafting the latter's current *Civil Code*.[74] Thus, as one of the top economic nations, the legal blueprint from Japan could serve as the starting point for Cambodian VC's legal framework.

This article will point out some main bottlenecks in each stage before conducting a comparative analysis of other countries such as the US, China, and Japan. Finally, it will propose legal opinions from regulatory standpoint.

Fundraising Stage

Like a startup that needs funding, the VC needs to do fundraising as well. In general, common bottlenecks that occur in this stage are the lack of funding source(s), investor accreditation, the discretion of the VC in an investment decision, and the VC's management fee. Since Cambodia is still working to build its venture capital community, this article is going to discuss only one critical bottleneck: the lack of funding sources for the VC's formation.

Currently, the source of VC funds is dominated by private corporations, eg, Smart Axiata,[75] Forte, and World Bridge[76]. On the bright side, the corporation can provide tremendous support to the VC to find portfolio companies and train them. Additionally, the reputation of big companies under the belt also creates an excellent impression on the fund. However, when the source of funds is concentrated in a small group of investors, the VC's discretion to invest can easily be distorted due to the need to accommodate the private corporations' interests.[77] This issue is a key bottleneck for VC to form their fund. In Cambodia, ordinary individuals and most companies still prefer traditional investments such as real estate.[78] Before proposing solutions to this issue, it is helpful to understand how other countries like the US, China, and Japan deal with the same issue.

First, the US does not rely heavily on private corporations as a source of VC funds. In the last ten years, the combination of the public and private pension funds has become the most significant source of funds, followed by the foundation as first runner-up, and then the corporate investor and insurance companies as second runners-up (see Figure 2 below). However, this situation did not come about organically. As is well known, the pension fund, based on the theoretical view, is supposed to be a low-risk investment. This pension fund is paid monthly by employees for years so that they can be financially supported for life when they retire. However, VC investment somehow does not carry this low-risk yet fixed-return characteristic that the pension fund aims for. In fact, it used to be illegal to invest pension funds into risky portfolios like VCs. Hence, how can pension funds become the top source of funds for VCs in the US today? Dated back to 1959, the *American Small Business Investment Companies (SBICs) Act* was established with incentives of government loans and tax benefits.[79] In the 1970s, the surge of VC development was visible

[74] 'A look at the history of implementing the Civil Code on its 10th anniversary' (The Phnom Penh Post, 23 Feb 2022) <https://www.phnompenhpost.com/supplements/look-history-implementing-civil-code-its-10th-anniversary> accessed 9 Oct 2022.

[75] See Smart Axiata 'Home' <https://sadif.com.kh/> accessed 4 Jul 2023. Smart Axiata Digital Innovation Fund (SADIF) is a 5-million-dollar VC fund established to promote the digital ecosystem in Cambodia. The fund is created by the Smart Axiata, and then co-invested by Forte Insurance and Mekong Strategic Partners.

[76] See Occtane fund <www.ooctane.com>. OOCTANE is a 55-million-dollar VC fund aiming to invest in technology-enabled businesses founded in Cambodia or by Cambodians. The fund is chaired by *Oknha* Sear Rithy, Chairman of the Worldbridge Group. This link was cited when the author was a student at Keio University in 2021; however, it is no longer accessible on 4 July 2023. Some information is available at <https://dev.worldbridge.com.kh/portfolio/ooctane/>. However, there is no public news updated on the status of this fund.

[77] Bintang (n 31) 187.

[78] Banking deposit is fixed and more certain. The upward potential of real estate investing is still promising despite the pullback in the last few years. Also, there is no platform for ordinary people and those traditional companies to invest money in VC yet.

[79] Fenn et al (n 3). The form of this company is promoted under the American Small Business Administration (SBA).

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

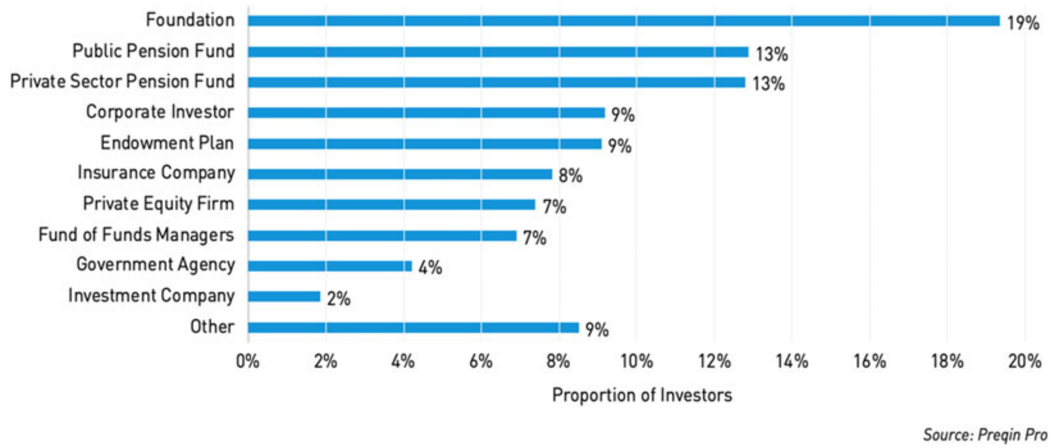

Figure 2. Investors in US-Based VC Funds by Investor Type (Vintages 2010–2019)[80]

but still hindered due to recession and a weak financial market.[81] To boost this growth of VC to an optimal level, the legislature eliminated the 'prudent man' investment requirement[82] and lifted the restriction of pension fund's investment in venture capital.[83] After this amendment, pension funds were allowed to invest in VC funds and ultimately became a leading source of investments for VC funds.

In Japan, the source of funding for VCs is mostly from private placement.[84] The most active investors are financial institutions (such as banks, insurance, and securities firms) and corporate investors (listing companies).[85] The Japanese Corporation also hands into the fund for open innovation.[86] The Japanese Small & Medium Enterprises and Regional Innovation (SMRI), which is the extension of the Japanese government, also takes a portion of the pie.[87] The Japanese Pension Fund, formerly banned from VC investment, has started showing positive interest in VC.[88]

In China, from 2011 to 2017, the capital for VC is raised from listed companies, public pension funds, sovereign wealth funds, and investment companies.[89] Interestingly, in China, only 'accredited investors' are allowed to invest in VCs under the China Securities Regulatory Commission (CSRC) rules.[90]

These three nations allow us to understand that many sources of the fund can be injected into the VC fund formation.

[80]Chart from Preqin & First Republic Bank, 'Preqin and First republic update: US Venture Capital in 2019' (2019).

[81]ibid 10.

[82]The 'prudent man' rule restricts the fund investor from investing in the high-risk portfolio. Since the nature of a VC fund is to invest in the high-risk startup to generate an unexpectedly high return, this rule hinders the choice of the fund manager. Removing this rule allows VC to have a bigger pool of companies to do fishing.

[83]ibid.

[84]Mikito Ishida, 'Venture capital investment in Japan: market and regulatory overview' (2020) <https://content.next.westlaw.com/6-504-1281?__lrTS=20201014143156245> accessed 27 Dec 2020.

[85]ibid

[86]ibid.

[87]ibid.

[88]ibid.

[89]Lin, *Venture Capital Law in China* (n 40) 68–70 (see Table 2.4: Percentage of capital raised by LPs in China's VC and PE market (by investable amount) (2011–2017)).

[90]ibid 66. The accredited investor is an institution or individual with a certain amount of wealth and investment experience. For details, please see Measures for the Suitability Management of Securities and Futures Investors 2016, China Securities Regulatory Commission, No 130 (effective 1 Jul 2017) (People's Republic of China), arts 8 and 1.

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

Viability of utilising pension funds as a source of VC formation

As discussed above, private corporations are not the sole source of funds but merely one of them. Understanding this is an important step forward; however, the key question is 'can Cambodia utilise the same sources?'. Currently, the answer is 'no'. US and China have the pension fund ready for VCs to use while Japan has big financial institutions and already shows great interest to amend the law to allow pension funds to be used for VCs. The problem with Cambodia is that the pension fund is not well established yet. A public servant has a pension scheme (usually known as retirement salary) directly from the government, while employees of private companies and informal economies usually save money by themselves. Despite the current absence of pension funds, the future might shed a glimpse of light on this. On 4 March 2021, the *Sub-decree implementing a pension scheme in Cambodia* (Sub-decree 32) was issued to oblige companies to register with the Cambodian National Social Security Fund (NSSF). All employees are required to register for the pension scheme within three days from the date of employment.[91] The contribution by all employees in Cambodia to the social security scheme on pension commenced on 1 October 2022.[92] This scheme will create a big pool of money for a pension fund in the next five or ten years. At that point, the pension fund could then be one of the sources that VCs can tap into.

However, the current Cambodian Trust Law[93] still requires the trustee[94] to manage the trust property (the pension fund) with care and prudence.[95] This leads to another question of whether the pension fund should be invested in a VC fund. This is a very critical question. As already discussed, it is allowed in the US, China, and Japan. Cambodia is still very new to the concept of a pension fund; its citizens, especially the members who contribute to the pension scheme, require more time to gain confidence in this pension scheme. If the fund is invested in VCs and fails to recover its principal, this will surely affect the mentality and confidence of the scheme payer. This article advocates that the trustee should first maintain the 'prudent manner' rule to gain confidence from its citizens. In future, when the startup ecosystem is more mature and supported infrastructures are in place, the 'prudent manner' rule could be lifted, and the pension fund could be allowed to be invested into the VC fund to maximise the potential return and fuel the innovation engine for the economy.

Private placement

Since the pension fund is not available shortly, the next alternative is domestic private companies and wealthy individuals. Many companies have their cash reserves invested in other instruments such as real estate or, in some cases, have been left sitting in their bank accounts with no use at all. Therefore, these cash reserves can be the new driving force to fuel the VC fund and ultimately innovation in the startup industry. There is already a trend in Cambodia that private companies allocate a portion of their budget to invest in VC funds. For example, the Smart Axiata Digital Innovation Fund (SADIF)[96] is a USD 5 million VC fund co-invested by Smart Axiata, a

[91]Matthew Rendall et al, 'Pensions Schemes are now implemented in Cambodia' (Sok Siphana & Associates, 2021) <soksiphana.com/resources/alerts/pensions-schemes-are-now-implemented-in-cambodia> accessed 2 May 2023. In the first five-year, 4% of the gross monthly salary will be contributed to the scheme. Half of the four percent is from the employer and the other half is from the employee. This rate will increase every five years.

[92]*Prakas* No 170 on Commencement Date of Payment of Contribution of Social Security Scheme on Pension under Compulsory Contribution and Voluntary Contribution 2022, cl 2.

[93]In December 2018, the trust law was approved to be implemented in Cambodia. This law stipulates a trust could be established in four types such as commercial trust, public trust, social trust, and individual trust. This commercial trust will bring a new form of saving which is a pension fund to this kingdom.

[94]In this context, the trustee is referred to the manager of the pension fund itself.

[95]In the future, should the VC intend to fundraise from public, the regulations pertaining to collective investment scheme will apply. See *Prakas* No 003 on Granting license and Management of Collective Investment Scheme 2018.

[96]See Smart Axiata (n 75).

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

telecommunication company, and Forte Insurance. Another example is the Ooctane fund,[97] a USD 55 million VC fund backed by Worldbridge Group, a local logistic company. These initiatives represent a great starting point, but the future could be even better. Companies and individuals from other sectors such as the banking, insurance, logistic, investment, education, and transportation industries should also allocate their funds to the VC initiatives. This begs the question of how to encourage other companies to follow the same path.

For Japan, funding is largely from private placements such as banks, securities firms, and listed companies.[98] Compared to the US and China – which is usually funded mostly by pension funds and foundations – Japan shows a distinct characteristic. As a fast-growing nation of technological innovations, Japanese corporations with eyes on open innovation are increasing their interest in investing in VCs.[99] Also, the Japanese government introduced the 'angel tax system'[100] to encourage investment in startups for wealthy individuals (see Table 5). The plan allows corporations to deduct 25% of the investment money on startup from their taxable income.[101] This tax deduction is predicted to increase the investment fund for startups by at least JPY 100 million.

Despite bypassing the VC fund, this tax incentive lays a great blueprint for Cambodia to see how foreign nation motivates investment in innovation. While the investment in either startups or VCs is risky, a portion of the downside might be offset by these tax incentives as well. This article supports a similar tax incentive scheme to promote investment engagement from large corporations and wealthy individuals to VCs or startups in Cambodia. The other lesson that Cambodia can

Table 5. Angel Tax Incentive[102]

Age of invested Startup	Tax Incentive Scheme
Less than 3 years (In case of gain return)	Full investment is deductible from the gross taxable income of that year after payment of a mere 2,000 JPY fee (roughly USD 20)
3 to 7 years (In case of gain return)	The invested amount is deductible from capital gains of other investments without a ceiling.
Up to 7 years (In case of loss return)	There are two measures in case of loss depending on the accumulated return[103] of multiple investments: 1. If the accumulated return is positive, the aggregation of profit and loss[104] is applied. 2. If the accumulated return is negative, the deduction of carryover of loss[105] is applied.

[97] Ooctane fund (n 76).

[98] Mikito Ishida. 'Venture Capital Investment in Japan: Market and Regulatory Overview Market Overview' (Thomson Reuters, 1 May 2020) <https://uk.practicallaw.thomsonreuters.com/6-504-1281?transitionType=Default&contextData=(sc.Default)&firstPage=true> accessed 2 May 2023.

[99] ibid.

[100] For detailed information, see Small and Medium Enterprise Agency, 'Guidance on the angel tax system (investment before March 31, 2020)' <https://www.chusho.meti.go.jp/keiei/chiiki/angel/index.html> accessed 30 Jun 2021.

[101] 'Japanese Government May Offer Companies 25% Tax Break on Investment in Startups' (The Japan Times, 7 Dec 2019) <https://www.japantimes.co.jp/news/2019/12/07/national/politics-diplomacy/japan-might-offer-companies-25-tax-break-investment-startups/> accessed 2 May 2023.

[102] See Yuri I Misaki, Joe Bryer & Emiko Tanaka, 'A Guide to Japan's Amazing Tax Exemption Scheme for Investment by Individuals' (Tsunagu Local, 7 Apr 2021) <https://www.tsunagulocal.com/en/72530/> accessed 2 May 2023.

[103] Offset return here refers to the consolidated return of multiple investments. For example, Mr X buys Stocks A and B, which gains 50,000 JPY and losses 20,000 JPY respectively. Therefore, the offset return for Mr X is 30,000 JPY.

[104] In case of aggregation of profit and loss, the loss invested amount can be deducted from the capital gain of the winning investment.

[105] In case of deduction of carryover of loss, all the losses (net loss) can be carried over for 3 years.

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

learn here is regarding open innovation. As mentioned, most corporations are engaging with startups due to knowledge or technology transfer. Therefore, the Cambodian government should establish a regulatory framework and policy to promote the industry-startup relationship and create a platform for them to connect. Once there is traction, corporations will ultimately see the potential value that startups can contribute to their corporations. This will further build trust and confidence for the big corporations to invest their money with VCs, and in turn invest in the startup.[106]

Foreign funds

Lastly, the next alternative is cross-border investments. As a developing country, Cambodia utilises an open policy to create a friendly environment for foreign investors. Since the amendment to its Law on Investment in 2004, the regulatory tool has significantly driven FDI since 2005 (see Figure 1). This abrupt growth is a testament that the regulatory framework strongly influences the investment landscape in Cambodia. Under this law, foreign investors are allowed to have 100% ownership of the business. Moreover, it also allows the free flow of remittance.[107] This simply means that foreign investors can transfer the money to invest in Cambodia and do outward transfers of their gained capital and proceed from liquidation.[108] To smoothen the investment process, the process should be designed to reduce the red tape for compliance.[109]

In this case, the regulatory framework is not the main attraction, but the growth potential of the local startups and innovation themselves is.[110] The role of the regulatory framework should focus intensely on creating an 'enabling ecosystem' with a strong connection between key players including entrepreneurs, universities, industrial corporations, VCs, and incubators.[111] In late 2020, the Cambodian government partnered with 500 startups to create 'Angkor 500' to promote the startup ecosystem in Cambodia.[112] Cooperation with such a world-class VC firm also enables knowledge transfer and raises the global profile of Cambodia's startups. Until now, Angkor 500 has already trained batches of the startup acceleration programme.[113]

Startup-investment stage

After securing funding, the next step is to wisely choose which startup the money should be invested in. This section deals with two bottlenecks: the investment readiness of the startup and the deal structure. Simply put, it is about which team to invest in and how to invest in them.

Investment readiness of the startup

According to the report 'Startup Kingdom: Cambodia's Vibrant Tech Startup Ecosystem in 2018', challenges in the country's nascent startup ecosystem revolve around 'investment readiness'

[106]This relationship will also pave the way for the future acquisition of the startup, which is one way of the exit as well.

[107]See also Law on Foreign Exchange 1997.

[108]Law on Investment 1993 (amended 2003), art 11.

[109]To reduce the compliance cumbersome, the Japanese government by reducing the tax filing for the non-permanent establishment (non-PE) investors who hold less than 25% of the partnership interest in the fund.

[110]See Larry W Schwartz, 'Venture abroad: Developing Countries Need Venture Capital Strategies' (1994) 73 Foreign Affairs 14.

[111]ibid.

[112]Tun Yong Yap, '500 Startups launches Angkor 500 to accelerate the development of Cambodian startups' (e27, 23 Nov 2020) <https://e27.co/500-startups-launches-angkor-500-to-accelerate-the-development-of-cambodian-startups-20201123/> accessed 1 Jun 2023. This is a two-year partnership that aimed to gather founders from across the kingdom to create startups and host boot camps to strengthen the readiness of local startups for engagement with international markets and investors.

[113]Brian Badzmierowski, 'ANGKOR 500 Opens up Applications for Startup Acceleration Programme' (Khmer Times, 9 Jun 2021) <https://www.khmertimeskh.com/50870838/angkor-500-opens-up-applications-for-startup-acceleration-programme/> accessed 1 Jun 2023.

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

Table 6. Four main criteria to determine investability of the business[114]

Criteria	Key Components
1. Investor's Investment parameter	■ Sector or Industry of the startup (eg, real estate, FinTech, Artificial Intelligence, Big data) ■ Stage of startup ■ Size of investment (seeking amount) ■ Location
2. Founding team	■ Who is/are the founder(s)? Director? Or CEO? ■ Who are technical members? What are their skills? ■ Credential and knowledge of the team in the involved industry ■ Visionary and execution quality of the team
3. Market-related factor	■ Product innovation ■ Size of the potential market ■ Realistic expectation of market response ■ Attractiveness of the market ■ Key information on target customers ■ Potential adoption from the customers (including user traction) ■ Go-to-market strategies
4. Financial factor	■ Credible revenue model ■ Realistic assumptions and information ■ Internal Rate of Return (IRR) & Return on Investment (ROI) ■ Accounting report ■ Financial literacy of the founder

issues.[115] This issue is critical; in fact, it is even more important than the VC's lack of funding sources. Although the number of VC funds has increased, real innovation's impact can still be hindered if the startup is not ready enough to receive investment. This issue could be seen as the Ooctane fund was scouting for 'late-stage investment opportunities due to lack of quality deals in the early stages'.[116] At the end of the day, all these VC funds can only impact the actual innovation growth if the startup is ready enough to claim the investment.

What does 'investment readiness' mean? Despite being repeatedly uttered by the VC and startup community, there is no agreed definition of the term yet in the Cambodian context.[117] According to the Organisation for Economic, Co-operation and Development (OECD), this term can be explained based on three dimensions: equity aversion, investability, and presentational failures.[118] First, equity aversion happens when entrepreneurs have a negative attitude towards equity finance,[119] and when the entrepreneurs lack information about the financing source's characteristics and availability.[120] Second, it is the investability of the businesses that seeks financing. Investors usually evaluate the startup based on four main criteria: (1) the investor's investment parameter, (2) founding team, (3) market-related factors, and (4) finance (see Table 6 for details).[121] Lastly,

[114]This table is inspired by the Report from the Organisation for Economic, Co-operation and Development and the presentation by Trisha Mani, VC Fund associate at UBERIS fund, at 'Private Equity Venture and Capital Webinar: Outlook of the Agribusiness Sector in Cambodia'. The components listed in each criterion are not absolute components but are usually subjected to changes based on the needs of the investors and the interpretation of individual.

[115]Kem et al (n 19).

[116]'Cambodian VC Firm Scouts for Late-Stage Deals to Grow Profitability' (Nikkei Asia, 3 Mar 2021) <https://asia.nikkei.com/Spotlight/DealStreetAsia/Cambodian-VC-firm-scouts-for-late-stage-deals-to-grow-profitability> accessed 1 Jun 2023.

[117]This can be because different VCs or individuals define the term 'investment readiness' differently.

[118]Organisation for Economic, Co-operation and Development (OECD), 'Facilitating Access to Finance: Discussion Paper on Investment Readiness Programmes' (OECD) <https://www.oecd.org/global-relations/45324336.pdf> accessed 1 Jun 2023.

[119]The negative attitude can be due to the reluctance in surrendering ownership and control of the startup.

[120]ibid.

[121]ibid.

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

the third dimension is presentational failing. Sometimes the business model and market are promising; however, the ability of founders to pitch their business to an investor is not convincing at all. The common issues are the inability of a founder to demonstrate a strategy to attract sufficient paid customers to recoup the costs of business and a unique selling point. This poor presentation skill is interpreted by investors as a warning sign to invest: 'if he cannot sell to investors, how can he sell to the customer?'; this rhetorical question is usually raised in this circumstance.[122]

Having defined 'investment readiness', it seems that all those bottlenecks are business issues rather than legal issues. Hence, how can government and legislators directly or indirectly catalyse the building of a startup ecosystem and innovation for VC investment? Table 7 utilises the three main criteria (founding team, market-related factor, and financial factor)[123] to propose the regulatory tools to promote a startup's investment readiness.

Table 7. Summary of a proposed regulatory framework to enhance the investability of the startup

Criteria	Regulatory framework
1. Investor's investment parameter	▪ Already covered in the section above
2. Founding team	▪ Promote university-industry technology transfer to boost innovation and encourage university spin-off venture.[124] ▪ Strengthen the enforcement of intellectual property protection ▪ Establish government-funding for research & development (could be from the pension fund newly established in the recent regulations). ▪ Immigration law: easing the process of obtaining a visa for high-tech skilled workers who want to work in Cambodia. ▪ Introduce 'startup visa' to allow the team who want to pilot their product from the territory of Cambodia. ▪ Reverse brain-drain by attracting foreign talents and Cambodia who live in a foreign nation to come back to Cambodia. ▪ Void the non-compete clause[125] to allow the labour movement from one venture to another.

(*Continued*)

[122]ibid.

[123]This does not include the 'investor's investment parameter' because the previous section has discussed heavily the investor side how to increase the variety of VC. This section focuses only on the startup condition and their bottleneck in relation to the VC investor.

[124]This regulatory framework is inspired by the 'Cloning Silicon Valley Policy' adopted by Japan in the late 1990s. This policy centers on university-industry technology transfer and facilitates university spin-off ventures with the driver of cutting-edge research innovation developed in universities. To support this initiative, the technology licensing organisation system was established. For more details, see Akio Nishizawa, 'University startup ventures and clustering strategy in Japan' (2007). Currently, there is an absent connection between the universities and the real industry. This is not full use of human resources because universities are the place that bred new breakthrough innovation and this innovation should be realised to be the real business to help society. Moreover, this innovation might be the way for Cambodia to increase the pie of the economy by selling the products or services to other nations and improving the balance of trade. However, to continue the sustainable growth of this university innovation, the enforcement of intellectual property is also a key factor to strengthen too.

[125]Currently, there are only approximately 50,000 people in the STEM industry. Due to the lack of human resources in technical skills, it is more suitable for the government to eradicate the tradition of using non-compete clauses in employment contracts because it blocks the free movement of labour from one startup to another. In recent years, there are many academic studies advocating the elimination of the non-compete clause to boost the flow of innovation. However, it is noteworthy that Japanese VCs usually include the non-compete clause in the investment contract to ensure the founder's commitment to the startups. See Joseph McCahery, Luc Renneboog & John Armour, 'Law, Innovation, and Finance', in Joseph McCahery & Luc Renneboog (eds), *Venture Capital Contracting and the Valuation of High-Technology Firms* (Oxford University Press 2003) 151. This study quotes the study by Jeng and Wells (Leslie A Jeng & Philippe C Wells, 'The determinants of venture capital fundraising: evidence across countries' (2000) 6 Journal of Corporate Finance 241), which shows the labor market rigidities

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

Table 7. (*Continued.*)

Criteria	Regulatory framework
3. Market-related factor	▪ Further gather market data and simplify the accessing process. ▪ Create an enabling environment for startups by providing solid infrastructure such as speedy internet. ▪ Expand the international network with other nations that open opportunities for a local startup to expand their business to other nations.
4. Financial factor	▪ Streamline the process of company registration[126] to reduce the cost and complication. ▪ Avoid unnecessary licensing registration by introducing a regulatory sandbox for new innovative products, the process of which should not be cumbersome. ▪ Simplify the accounting report and tax filing process. ▪ Establish a one-stop service to provide compliance advice on company registration, book-keeping, and tax filing.

To improve the presentation skill of the team, NGOs, universities, and incubators can play essential roles. Currently, in Cambodia, many business competitions aim to encourage university students to develop new innovative ideas and undergo an Entrepreneur Bootcamp.[127] The candidates get to learn what the investors want to see and practise their presentation skills as well. Currently, the conversion rate of a startup from ideation to investable business in the long term is not yet satisfactory.

Deal structure

In Cambodia, the startup fundraising process is still relatively new for most entrepreneurs.[128] To remedy the situation, investors play a role in educating entrepreneurs on various types of deal structures (eg, convertible note, equity, etc).[129] Basically, there is no one right structure for all types of deals because it depends on the parties' circumstances. In the VC-startup deal, the top two popular structures are equity investments and convertible notes. Equity investment is where the VC invests an amount of money in return for a percentage of stock (either common stock or preferred stock). The common stock exposes the investor to higher risk while the preferred stock is excessively time-consuming and involves costly negotiations.[130] Also, the startup that sells common stocks in seed rounds has a constraint to issue the stock option that limits its ability to incentivise key employees.[131] Additionally, when using this equity structure, the key negotiation revolves around the valuation of the company where the startup founders ask for a high valuation and the investors try to lower the valuation down. In some unfortunate cases, this valuation negotiation might as well

were negatively correlated with venture capital investment. It also adds that the labor movement creates the benefit of information transfer which might open new discoveries to be exploited.

[126]Many startups in Cambodia have claimed the company registration to be their bottleneck in accessing legal recognition due to the high cost and complicated process of registering. Some are also afraid that this registration will create more burden rather than benefit toward their businesses. Therefore, most of them decide not to register instead at the early stage. However, this non-registration coupled with lack of solid financial report is the key bottleneck for the VC to access their performance. Without the registration, it shows a lack of seriousness that the team has toward the business. Without a formal financial statement, there is no assurance whether the number is true and correct or not.

[127]See Facebook, 'BMC Cambodia Startup Accelerator & Competition'<https://www.facebook.com/BMCCambodia2017/> accessed 1 Jun 2023; SmartStart Young Innovator Program, <https://smartstart.com.kh/yip> accessed 1 Jun 2023; Reverse Innovation, 'Frequently Asked Questions' <https://ri.techostartup.center/faq> accessed 1 Jun 2023.

[128]Kem et al (n 18).

[129]ibid.

[130]John F Coyle & Joseph M Green 'Contractual Innovation in Venture Capital' (2014) 66 Hastings Law Journal 133, 159.

[131]ibid.

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

become a deal-breaker for both parties. On the other hand, convertible notes largely solve these problems.[132] In essence, this structure is a corporate promissory note that converts into Series A[133] preferred stock when the startup reaches Series A financing.[134] This form allows the VC and founder to leave the valuation negotiation to Series A to avoid the increases in the appraised value of the company's common stock and allow the VC to get favourable terms given to Series A's investors.[135]

In the US, the investment is usually divided based on stages or rounds to reduce uncertainties.[136] The preferred form of deal for seed-stage investments is not the common stock but convertible securities. In 2013, the startup accelerator Y Combinator introduced the new 'Simple Agreement for Future Equity' (SAFE), which offers a simpler and faster approach for the startup.[137] The usage of this agreement has been spread to many nations outside of Y Combinator.[138]

Interestingly, Japanese VCs still prefer common stock rather than convertible notes, and they usually invest in seed-stage companies.[139] Preferred stock has gradually picked up the pace to surpass common stock in the past few years.[140] Despite not being mainstream yet, the convertible note has become an increasingly popular structure[141] during seed financing in Japan, while the typical structure is corporate promissory notes paired with stock warrants.[142]

In China, convertible preferred shares were not legalised at first.[143] To replicate convertible share characteristics, special contract terms such as a liquidation preference,[144] redemption rights, and anti-dilution protection came in.[145] At first, China's Company Law and Securities Law only recognised equity instruments like ordinary shares. The laws were silent regarding the preference share or convertible share and even stock option.[146] Then, the interim measure for the Startup Investment Enterprises[147] was added to set a clear ground that a 'Venture Capital Fund may make investments in the unlisted enterprise by way of its stock rights, preferred stocks, convertible preferred stocks, and

[132] ibid 161.

[133] Investopedia, 'What is Series A Financing? Process, Definition, and Example' <https://www.investopedia.com/terms/s/seriesa.asp#:~:text=Series%20A%20financing%20refers%20to,after%20seed%20and%20angel%20investors.> accessed 3 Jul 2023. Series A financing is an investment stage upon the seed stage and angel investor. Usually, it is privately held by the startup after having some progress on showing the traction of its business model and demonstrate its growth potential to earn revenue.

[134] A Reid Monroe-Sheridan, 'Promoting Legal Innovation in Japanese Startup Financing' (2019) 10 George Mason Journal of International Commercial Law 26, 26.

[135] ibid.

[136] ibid.

[137] ibid.

[138] ibid.

[139] Yukihito Machida, 'Shinkabuyoyakukentsukishasai no katsuyo nitsuite no ikkosatsu (jo) [Observations Regarding the Use of Corporate Bonds Paired with Stock Warrants (Part 1 of 2)]' (15 Jul 2017) 2139 Shoji Homu 20, 21–22; Monroe-Sheridan (n 135) 41.

[140] Venture Enterprise Center, 'VEC Yearbook 2016', I-30; Nobuki Takeuchi & Shuya Ogawa, 'Shoki Raundo ni Okeru Shikin Chotatsu no Jitsumu to Kadai [Issues and Practice Relating to Initial Fundraising Rounds]' (15 Dec 2015) 2087 Shoji Homu 37, 43. The classified stock can be structured to serve as convertible equity.

[141] Takeuchi & Ogawa (n 141) 42.

[142] Machida (n 140) 23.

[143] See Opinion on Pilot Program of Preferred Shares by the State Council (State Council (2013) No 46), effected 30 Nov 2013, Central People's Government (2013) <www.gov.cn/zwgk/2013-11/30/content_2539046.htm> accessed 30 Jun 2023; William W Bratton, 'Venture Capital on the Downside: Preferred Stock and Corporate Control' (2002) 100 Michigan Law Review 891.

[144] Liquidation preference creates a distribution waterfall that allows investors to have a fixed return prior to payments to common shareholders in the event of sale or liquidation.

[145] Lin, *Venture Capital Law in China* (n 40) 149; Curtis J Milhaupt, 'The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate' (1997) 91 Northwestern University Law Review 887.

[146] Isozaki (n 85) 261.

[147] Interim measure for the Administration for the Startup Investment Enterprise (2006), art 22 <http://www.asianlii.org/cn/legis/cen/laws/iamftsie766/> accessed 1 Jun 2023.

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

quasi stock rights.'[148] China amended the Company Law in 2005 by adding a new provision that allowed companies to repurchase their share under circumstances where the 'company wants to reward employees by way of granting shares' to pave the way for employee's stock options.[149]

Currently, in Cambodia, there is no legal restriction on using this convertible note. The author advocates the use of this form in Cambodia's VC startup investment. Given that Cambodian startups are still small in investment size, the investment process should be fast, simple, and easy for both parties. The key benefits are to bypass the negotiation on valuation, to give more protection to investors, and to let the investors have more preferential terms when startups reach Series A financing. As mentioned at the beginning of this section, most founders are still very new to fundraising. To ensure fairness for both parties, the government can follow the footstep of the Y-combinator by creating a Cambodian version of SAFE[150] that balances the interests and obligations of both parties. This allows startups to have more faith in signing the deal as well. However, the VC also brings in non-monetary support such as management support, network, and business advisory. To realise the full potential of the VC investment, both parties can add the contractual rights regarding management rights into the convertible note's contract or SAFE based on their good-faith negotiation. As a more flexible alternative to the Cambodian version of SAFE, the competent authority may issue a *Prakas* to stipulate the minimum clause of the investment agreement for the VC-startup deal and, in the same *Prakas*, may impose some other conditions to ensure the fairness for both parties.[151] In this way, the investment contract can contain a more standard clause while maintaining flexibility for the parties to negotiate.

Exit Stage

Unlike a limited corporation with infinite life, a VC fund is usually established within its limited time, approximately seven to ten years.[152] At the end of its lifecycle, the general partner (who is a VC) will close the fund, and then the gain will be divided between the VC and the investors based on the terms and conditions outlined in the investment contract. The VC usually treats startups as an investment vehicle where they invest some money and provide some management support to drive up the venture value and then try to achieve a lucrative exit, hopefully with a good reputation. The performance of VC funds is measured by the valuation and the speed of portfolio companies' growth.

Generally, there are four ways for VC to exit their portfolio companies: through an Initial Public Offering (IPO), trade sale, contractual buyback, or write-off. Among these four, an IPO and trade sale are the most popular exits for VCs in many countries.

Initial Public Offering (IPO)

Many studies worldwide have advocated the strong connection between the venture capital market and the capital market.[153] The IPO is the most profitable exit for both the VC and the startup (the

[148]ibid, art 15.

[149]PRC Company Law 2005, art 143.

[150]SAFE stands for Simple Agreement for Future Equity.

[151]For example, Chapter 7 of Prakas No 89 on Management of Real Estate Business 2016 (Cambodia) has clarified in detail what are the minimum clauses to include in the Sale-Purchase Agreement (SPA) of land or house, and also embed other conditions regarding the contract between the parties as well.

[152]Morrison & Foerster LLP (Rafael Hernandez Mayor et al), 'Impediments to Risk Capital in Argentina, Chile, Elsavador And Mexico' (Multilateral Investment Fund, Jan 2001) 10 <https://publications.iadb.org/en/publication/12021/impediments-risk-capital-argentina-brazil-chile-el-salvador-and-mexico> accessed 1 Jun 2023.

[153]Bernard S Black & Ronald J Gilson, 'Venture capital and the structure of capital markets: banks versus stock markets' (1998) 47 Journal of Financial Economics 243, 261; Marco Da Rin, Giovanna Nicodano & Alessandro Sembenelli, 'Public policy and the creation of active venture capital markets' (2006) 90 Journal of Public Economics 1699; Lin Lin, 'Venture Capital Exits and the Structure of Stock Markets in China' (2017) 12 Asian Journal of Comparative Law 1, 5–6; Stefano

'portfolio company').[154] Moreover, this route also helps the founders regain control of the firm.[155] Despite these motivations for startups, not many startups successfully reach the stage of IPO.[156]

Since its inception in 2012, Cambodia's stock market is still considered very young. There are only seven companies listed in the market.[157] All of them could be viewed as blue-chip stocks given their size and performance certainty. However, the stock price does not correlate to any news or activities of the business, which depicts the market's inefficiency. Moreover, the trading volume in the market is still small.[158] More time is needed to educate people and get people to invest in this capital market. Given this situation, is IPO still a viable exit for the VC in Cambodia? To better understand its viability, below is a further analysis of listing requirements and some other mechanisms in Cambodia's stock market.

The Cambodia Securities Exchange (CSX) classifies the listing applicants into two boards: the main-board and the growth board. Looking from the perspective of listing requirements, the main board[159] might be a high barrier for startups due to low shareholders' equity and profit uncertainty, not to mention the small number of shareholders. Although the growth board[160] sets a lower requirement standard, it might not necessarily be the right one for a startup yet. The good news is that this situation is not unusual compared to startups that want to go public around the world. This stringent requirement, especially the financial standard, is necessary to enhance investor protection and prevent underqualified companies from pursuing this route. Back in 2004, when China first launched its SME board, its stringent listing requirement[161] had priced out most of the VC-backed startups due to the nature of its small portfolio startup companies.[162] It was only in 2009 when the 'ChiNext' board[163] was launched on the Shenzhen Stock Exchange, with specific aims to attract firms in the high-growth and high-tech sectors as well as match the demand of startups with difficulties in securing financing. This board placed more relaxed requirements in terms of share capital and profit threshold.[164] As a result, within five years, the board facilitated 519 VC-exits.[165] Despite this inspiring record, this requirement still imposed difficulty for the startup that has yet to be profitable. Since the startup, especially in the high-tech industry, undergoes negative profit for a significant period, this board is believed to have attracted more traditional companies instead.[166]

Bonini & Senem Alkan, 'The political and legal determinants of venture capital investments around the world' (2012) 29 Small Business Economic 997. This study explores the data from 16 countries globally.

[154]Black & Gilson (n 154) 257.

[155]Lin, 'Venture Capital Exits' (n 154) 5–6.

[156]Armin Schwienbacher, 'Innovation and Venture Capital Exits' (2008) 118 The Economic Journal 1888. There are empirical studies that show that only innovative and profitable ventures have a high likelihood to go public.

[157]Cambodia Securities Exchange, 'Home' <http://csx.com.kh/> accessed 1 Jun 2023.

[158]For more detail, see Chhut Bunthoeun, 'Cambodia's young stock exchange looking good' (Khmer Times, 17 Jan 2020) <https://www.khmertimeskh.com/680997/cambodias-young-stock-exchange-looking-good/> accessed 1 Jun 2023.

[159]Listing Requirements and Procedures of Cambodia Stock Exchange, art 8: The requirements of Main Board are: (1) Shareholder's equity shall be at least USD 7,500,000, (2) Net Profit shall be at least USD 500,000 per annum and the aggregate of net profit at least USD 750,000 for the latest 2 financial years prior to filing an application, (3) At least 200 shareholders with less than 1-percent voting rights.

[160]ibid. The other board, the growth board, has somehow a bit lower requirement: (1) Shareholder's equity shall be at least 500,000 USD, (2) Positive net profit for the latest financial year, Positive operating cash flow and gross margin of at least 10%, (3) At least 100 shareholders with less than 1-percent voting rights.

[161]Its requirement is similar to the growth board of CSX which requires an existence period, a threshold on profit earning and the number of shareholders, which becomes the bottleneck for startups in China to go public.

[162]Lin, 'Venture Capital Exits' (n 154) 20.

[163]ibid: 'ChiNext' is a portmanteau of the phrase 'China Next' and is also known as the Growth Enterprise Board or *chuangyeban*.

[164]The company is required to have a share capital of only RMB 30 million post-IPO and must have profit for the last two consecutive years, which its net profits in the period must increase continuously and exceed RMB 10 million.

[165]See Zuo Yonggang, 'Five Year's ChiNext: VC/PE is the Biggest Winner [chuangyeban wunian, VC/PE cheng zuida ying-fia]' (Securities Daily [zhengquan ribao], 23 Oct 2014) <http://finance.people.com.cn/stock/n/2014/I23/c67815-2589I7o6.html>. This link is no longer accessible as of 3 July 2023.

[166]Lin, 'Venture Capital Exits' (n 154) 21.

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

In 2013, China launched the National Equities Exchange and Quotation (NEEQ), known as the New Third Board (*xinsanban*). NEEQ is a national over-the-counter (OTC) market that targets 'innovation-oriented, entrepreneur, and growing medium, small, and micro-sized business' instead of mature companies.[167] This board requires the company to have valid existence for only two years.[168] Especially, there are no requirements on cash flow, net assets, or total share capital.[169] To ensure the protection of investors, this board only accepts eligible investors, and the market maker is there to coordinate the trading process. This board does not stand without any problems. There are many concerns raised such as the unintended attraction of many low-quality companies,[170] overvaluation of companies, manipulated supervision of market makers and extremely high volatility of price movement.[171]

In Japan, a Mothers board targets startups with high growth potential that aim to be reassigned to the Main Board in the near future.[172] There is no profit requirement in this board that is best fit for high-tech startups; however, it still requires at least 150 shareholders and JPY 500 million of market capitalisation.[173] On top of that, there is a clause that obliges the founder to make a reasonable effort to go public within a certain period in some shareholder's agreement.[174]

This comparison shows that listing requirements have installed a barrier to many startups from going IPO and reduced profitable VC exits. As seen, China solved this bottleneck with more relaxed requirements. For example, ChiNext with lower requirements and OTC markets like NEEQ established the no-profit requirement for eligible investors. This article, to some extent, does not advocate that the CSX follows this type of no-profit-requirement board at this point because of investors' lack of financial knowledge and the risk tolerance in Cambodia to place their trust in these new startups. Unlike foreign investors in the US, Japan, or China, Cambodian investors are still learning about investing in the capital market. More importantly, they do not possess much money to absorb the loss like other nations' investors yet. Therefore, Cambodia should take careful steps by building a solid capital market first, for at least five more years, before employing high-volatility instruments. At this stage, CSX must build investor sophistication and gain the trust of domestic and international traders to drive up the trade volume in this market first. Making the wrong move in the financial market will destroy the economy in just a blink of an eye. Cambodia's economy, despite having stable growth, is still very small; hence, the collapse or shake of its financial market will drastically affect its economy.[175] Last but not least, despite being the lucrative route for VCs, the IPO is not the only route for exit.[176] In any case, if the startup goes public with no attractive profits in its financial statements or user traction, the stock price will be hampered, making it no longer a lucrative route for the VC to exit.

[167]ibid 23.

[168]This is a more relaxed requirement as the other boards require the existence period to be at least three years.

[169]See *Quanguo Zhongxiaoqiye Gufen Zhuanrang Xitong Youxianzerengongsi Guanli Zanxing Banfa* [Interim Measures for the Administration of National Equities Exchange and Quotations Co Ltd] (promulgated by the China Securities Regulatory Commission, 31 Jan 2013).

[170]Jia Hongyu, 'Is the New Third Board a Blue Ocean or Refuse Dump? [xinsanban shi 'lanhai' haishi 'lajichang'?]' (China Broadcast Net [zhongguo guangbo wang], 28 Jul 2015) <http://finance.china.com.cn/stock/xsb/sc/hoi5o728/3256287.shtml.>. This link is no longer accessible on 3 July 2023.

[171]Wang Yinping, 'New Third Board - A New Opportunity for China's Capital Market [xinsanban, dangdai zhongguo ziben shichang de baofu jihui]' (Huaxia Business [Huaxia Licai], 12 Jun 2015).

[172]Japan Exchange Group, 'Overview of IPO' <https://www.jpx.co.jp/english/equities/listing-on-tse/new/basic/index.html> accessed 1 Jun 2023. The growth potential of the companies is assessed by the lead underwriters based on its business model or business environment.

[173]Japan Exchange Group, 'Criteria for Listing' <https://www.jpx.co.jp/english/equities/listing/criteria/listing/index.html> accessed 1 Jun 2023.

[174]Mikito Ishida, 'Venture Capital Investment in Japan: Market and Regulatory Overview Market Overview' (Thomson Reuters Practical Law, 1 May 2020) <https://uk.practicallaw.thomsonreuters.com/6-504-1281?transitionType=Default&contextData=(sc.Default)&firstPage=true> accessed 1 Jun 2023.

[175]An earlier lesson can be learned through the global financial crisis in 2008. One mistake of mortgage-backed security can destroy the whole economy. Despite being a wealthy nation, this crisis still hurt the US economy badly.

[176]More exit routes will be discussed in upcoming sections.

Merger and Acquisition (M&A)

There is always a debate between scholars on the better exit for VC: an IPO or a M&A. As already discussed, an IPO is typically the most profitable exit for VCs and startups. However, its listing requirements and many other legal mechanisms (such as locked up agreement, duration of the listing process, and financial disclosures) are demotivating factors. A trade sale, on the other hand, is more straightforward, has less legal requirements, and is fast for the VC to realise their gains. A joint study by Harvard Business School and Dan Wang of Columbia University on more than 42,000 new ventures launched between 1982 and 2014 found that a startup funded by a VC who works with the same group of partners is more likely to seek faster exit by trade sale than a startup funded by a syndicated VC with less familiar co-investors; the latter is more likely to seek high-profile exit by IPO.[177] The choice of choosing between an IPO and a M&A is heavily based on more macro-factors including the legal framework surrounding the market, the developmental stage of the capital market, and the solidity of the capital market. In the US, more than 80% of exits are done through M&A[178] (see Figure 3). However, in China, more than 50%, except in 2013, are done through IPO instead[179] (see Figure 4). Most Japanese startups went for IPOs, while the remaining took the M&A approach in 2016. However, this trend has flipped since 2018.[180] Some large corporations have acquired startups as part of their expansion strategy or technological synergy.

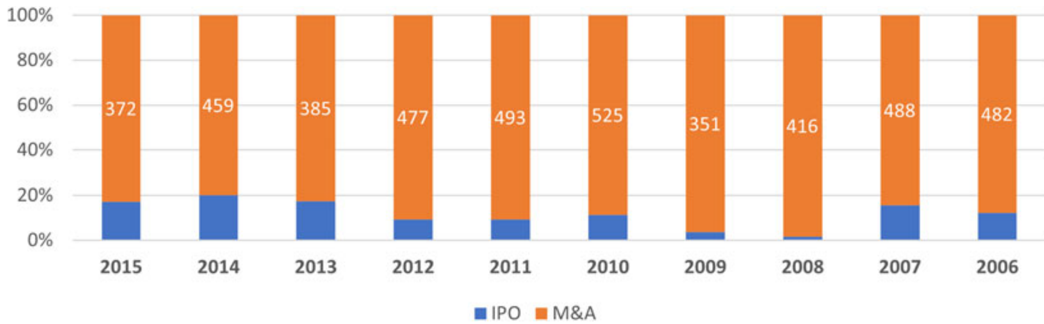

Figure 3. US's VC Exits via IPO and M&A
Data Source: National Venture Capital Association[181]

[177] Rachel Layne, 'IPO or M&A? How Venture Capital Shapes a Startup's Future' (HBS Working Knowledge of Harvard Business School, 27 Apr 2021) <https://hbswk.hbs.edu/item/ipo-or-ma-how-venture-capital-shapes-a-startups-future> accessed 1 Jun 2023. This article also mentioned that when asking the investors whether they prefer IPO or M&A; one investor simply replied that the best outcome is 'money'.

[178] Lin, 'Venture Capital Exits' (n 154). US VCs prefer M&A as an exit because of the booming merger business in contrast to the volatility of the capital markets. Moreover, the VC-backed companies start to receive a better offer from potential acquirers such as financial firms and strategic rivals.

[179] ibid. The lower percentage of M&A incidences are due to (1) higher return from the IPO listing and the government effort to promote the capital market; (2) prolonged approval timeline resulting in negative possibilities such as employee brain drain and variations in acquisition price; (3) stringent control over debt financing. For example, in CBRC, there is a 60% limit to percentage of the loan-to-acquisition price ratio. However, after March 2014, the State Council promulgated a new Opinion – Opinion 92 – to reduce the scope of examined projects. Above that, the mandatory 75% loan-to-deposit ratio was abolished as well. These revisions of the regulatory framework are believed to promote a more friendly environment for M&A.

[180] James Riney, '7 Things Investors & Founders Need to Know about the Japan Startup Ecosystem' (500 Insights, 2016) <https://500.co/blog/japan-startup-ecosystem-founders-investors/> accessed 1 Dec 2020 (Note that this link is no longer accessible on 3 Jul 2023); Ken Sakakibara, 'Startup Japan: Buyouts overtake IPOs as preferred exit' (Nikkei Asia, 21 Jun 2018) <https://asia.nikkei.com/Business/Business-trends/Startup-Japan-Buyouts-overtake-IPOs-as-preferred-exit> accessed 1 Jun 2023.

[181] See Lin, *Venture Capital Law in China* (n 40).

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

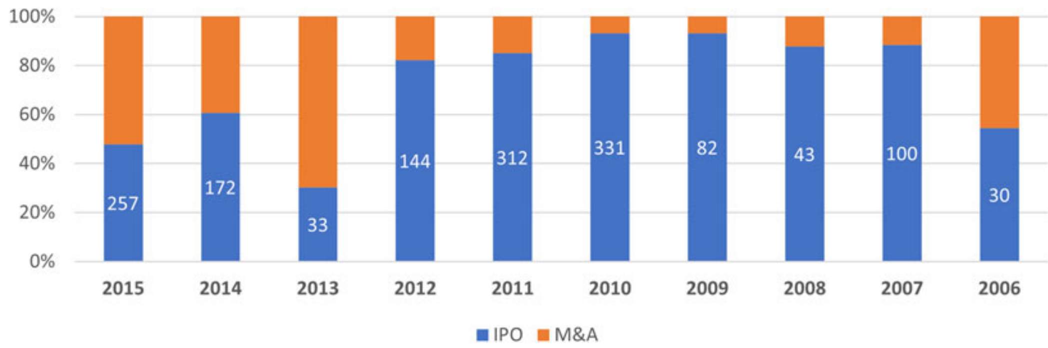

Figure 4. China's VC Exits via IPO & M&A
Data Source: Zero2IPO & China Venture[182]

Seeing this contradictory trend, which route would more likely be the future of VC exit in Cambodia? In the report 'Startup Kingdom: Cambodia's Vibrant Tech Startup Ecosystem in 2018', the survey showed that most investors believe exit opportunity is just a minor issue.[183] Even though the capital market is not robust yet, the trade sale to strategic acquirers and later-stage funds is considered a more direct path for exits.[184] Despite this, there is currently no major development in Cambodia regarding startup exits through M&A, and the current situation gives rise to legal ambiguity for such transactions. To date, there is no law specifically governing M&As.[185] Therefore, what should be the right approach to engineer the related legislation to promote M&A exit for VC-backed startups in Cambodia? The discussion below will address such M&A-related regulations based on three legal frameworks: antitrust law, company law, and tax law.

In a study conducted by Gordon Phillips and Alexei Zhdanov, the authors utilised the dataset from 66,213 firms across 48 countries including the US, Japan, and China to understand the relationship between VC investment and M&A.[186] They found a strong positive relation between VC investments and M&A activity because an active M&A market creates a viable exit opportunity for VC companies.[187] On top of this, the authors also found that VC activities intensify in nations with pro-takeover legislation, while it decreases in nations with stringent anti-trust legislation.[188] This finding is also aligned with recent concern on the antitrust issue that the US will rewrite the antitrust law to limit the M&A activities focused on the acquisition of smaller companies by larger technology companies with the purpose to stifle competition.[189] This change in legislation is expected to hamper innovation and entrepreneurship, according to concerned experts.[190]

---

[182] ibid.

[183] Kem et al (n 19) 26.

[184] ibid.

[185] Rajah & Tan Asia. 'Merger control guide – always up-to-date' <https://www.mergerfilers.com/guide.aspx?expertjuris=Cambodia#guidebook> accessed 1 Jun 2023. As mentioned above once, some of the M&A activity are regulated under the Company Law and sectoral laws. After a 15-year delay, the antitrust law was enacted and entered into force in October 2021. We do not expect the Merger control law to take the same amount of time; however, it is still too early for us to predict if or when it may come into force. As of today, there is no news yet relating to the draft of such law.

[186] Gordon Phillips & Alexei Zhdanov, 'Venture capital investments and merger and acquisition activity around the world' (National Bureau Of Economic Research Working Paper No 24082, Nov 2017) <https://www.nber.org/papers/w24082> accessed 1 Jun 2023.

[187] ibid.

[188] ibid.

[189] Gary Dushnitsky & D Daniel Sokol, 'Competition Laws Could Be A Death Knell For Startup Mergers And Acquisitions' (The Hill, 22 Jul 2021) <https://thehill.com/opinion/white-house/564321-competition-laws-could-be-a-death-knell-for-startup-mergers-and?rl=1> accessed 1 Jun 2023.

[190] ibid.

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

Back in Cambodia, the *Law on Competition* was just recently enacted on 5 October 2021. In Article 3 of the Law on Competition, the business combination is defined as acquiring the right of control, voting rights, shares, or assets on other entities that were previously independent of each other.[191] This term is Cambodian law's definition for a trade sale. Since the trade sale involves the selling of VC shares to a third party, it will fall into the definition of business combination as stated earlier; therefore, its implementation will be subject to the law on competition. A potential bottleneck in the trade sale (or M&A) is obtaining antitrust approval from the Cambodia Competition Committee (CCC). However, with the current legal framework, this whole examination process is still undefined. The specification of this approval process will be legislated via a Sub-decree. Hence, since the relevant laws are not officially and widely implemented yet, the author believes that the CCC should take into account the balance between avoiding anti-competition and promoting a friendly M&A environment. Moreover, the approval process should be as short as possible. In the US and Japan, the merger approval is 30 days from the date of application receipt.[192]

Moreover, some existing laws (such as the company law and contract law under Cambodia's Civil Code) are also the main legal frameworks monitoring M&A activities. At this present stage, the target startups or companies to be acquired or merged are still private companies. Hence, the framework is not required to be too cumbersome to regulate this activity. Nevertheless, it is even better for VCs if the regulation can cover some specific issues such as the protection of minority shareholders. VCs typically own the minority share of the portfolio companies.[193] This minority ownership subjects the VC to many risks such as price dilution, squeeze-out mechanism, and lack of board participation. That is why the VC should be provided the minority protection rights such as supermajority voting, dual-class voting right,[194] consent right, information rights, board participation, right of first refusal, pre-emptive rights, tag-along rights, drag-along rights,[195] anti-dilution, and put rights.[196] All of these rights are currently provided based on a contractual agreement between the parties, not by law.[197] Sometimes the VC has a lower bargaining power and fails to procure these essential clauses. Codifying these rights will create a more friendly M&A environment for VCs. In the future, when more startups become public companies, the M&A process may become more complicated. This increase in complication requires the legal framework to evolve to cover more areas such as tender offers, hostile takeovers, and public disclosure. In Japan, the Japanese Financial Instrument and Exchange Act (FIEA) regulates these issues. This can be a good blueprint for Cambodia to draft a law to cover similar matters.

[191]Law on Competition 2021, art 3(3).

[192]Federal Trade Commission, 'Premerger notification and the merger review process' <https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws/mergers/premerger-notification-merger-review> accessed 1 Jun 2023; Japan Fair Trade Commission, 'ICN merger notification and procedures template' <https://www.jftc.go.jp/en/policy_enforcement/mergers/ICNmerger.html> accessed 1 Jun 2023.

[193]J Nicholas Happe, 'What start-ups should know about minority investor rights' (Lexology, 30 Jan 2018) <https://www.lexology.com/library/detail.aspx?g=45938014-a6be-4311-8fb7-55e56477da72> accessed 1 Jun 2023.

[194]LCE 2005, art 145. The Company's Article of Incorporation may put more than one class of shares with different rights, privilege, restrictions and conditions. This may allow the startups to set up two classes of share where one class has greater voting rights than the other; and VC should be provided with a class that has greater voting rights power. Currently, many tech giants use this strategy to maintain the control for the founders, eg, Facebook, Dropbox, GoPro, etc.

[195]Tag-along and drag-along rights allow the minority shareholder like VC to join in and sell the share with the majority shareholders during the trade sale or acquisition.

[196]Alison Bird et al, 'Top ten minority investor protections' (Turinas & Bird LLC, 12 Jan 2016) <https://turinasbird.com/2016/01/12/corporate-law/minority-investor-protections> accessed 1 Jun 2023.

[197]See LCE 2005, art 93. Currently, regarding share transfers, the current regulation requires the parties to discuss during the formation of the corporation and then the agreement will be listed in the company's Article of Incorporation. However, during this period, VC may already or may not yet be a party to the negotiations; but the VC's interest is also on the line. Hence, if the VC insists, the Article of Incorporation might need to be revised. This will create a cumbersome process for all parties, causing more transactional costs to be incurred.

The third aspect is taxation on the M&A activity. Based on the existing law, the transfer of any or all parts of the company's share is subject to stamp duty at a rate of 0.1% of the value of the shares.[198] Currently, there is no public concern raised on this matter yet; hence, it is hard to know whether this rate is appropriate or not.

Interestingly, Singapore formulated a tax incentive scheme to promote M&A activities, especially for Small and Medium Enterprises (SMEs) to internationalise and grow.[199] As a fast-growing nation in Southeast Asia, Singapore grants an M&A allowance, a stamp duty relief, and a Double Taxation Deduction (DTD) on transaction costs.[200] The M&A allowance is up to 25% of the acquisition value at a cap of SGD 40 million. The stamp duty relief comes with a cap of SGD 80,000 for each financial year. The DTD is applicable for legal, valuation, and other professional fees related to the M&A transaction. The deduction is capped at SGD 100,000. In M&A transactions, taxation is one of the key consideration points for both parties. In the worst case, this might be a deal-breaker if the rate is too high relative to the synergy value of the transaction. Hence, from this perspective, the incentive scheme that Singapore sets out might produce an effect in promoting M&A activity in the nation. Nevertheless, taxation is a core revenue for many nations, including Cambodia. The taxation incentive is great, but the government still needs to function, so the tax relief may not be sustainable.[201] With the limited information on this matter, the author advocates reducing the rate of stamp duty, but not providing a complete relief. This duty is fuel for Cambodian ministries to function; cutting out the fuel is not a great idea. However, if some reduction in the rate can increase the number of M&A transactions, this will become a more sustainable approach. Moreover, taxation is just one factor. Another critical factor is the synergy factor between the companies, which is far more important than tax relief.

Contractual buyback

Contractual buyback happens when the startup has the contractual obligation to buy back its share from VC at a future date. This is not a popular option for VC-exit; however, incidences are inevitable. For instance, Japanese VC usually includes the 'buyback' mechanism in the contract.[202] As a result, in 2016, roughly 28% of VCs took that route as an exit;[203] the mechanism devastated the startups.

In Cambodia, the contractual relationship between VC and startups is always kept confidential between the parties. Hence, there is no public information to indicate whether such a method has been utilised or not. VCs do not like this mechanism because it is not profitable. Also, the buyback puts pressure on the startup's cash liquidity. The VC usually considers this an exit reserve if the investment becomes a 'living dead' or 'lifestyle' company that only satisfies the entrepreneur's desire

[198]Law on Financial Management 2013 (Cambodia), art 40. See also 'New amendments on stamp Duty provisions in Cambodia: Legal tax & investment expertise' (DFDL, 22 Jan 2013) <https://www.dfdl.com/insights/legal-and-tax-updates/new-amendments-on-stamp-duty-provisions-in/> accessed 1 Jun 2023.

[199]Startup Decisions, 'The Mergers and Acquisitions (M&A) Scheme' <https://www.startupdecisions.com.sg/singapore/incentives/mergers-and-acquisition-scheme-singapore/> accessed 1 Jun 2023. The scheme is applicable to the M&A execution between 1 April 2010 and 31 March 2015. Then, the application is extended until 31 March 2020.

[200]*IRAS e-Tax Guide, Income Tax and Stamp Duty: Mergers and Acquisitions Scheme* (7th edn, Inland Revenue Authority of Singapore 2023).

[201]William G Gale & Andrew A Samwick, 'Effects of income tax changes on economic growth', in Alan J Auerbach & Kent Smetters (eds), *The Economics of Tax Policy* (Oxford University Press 2017) 13–39. Gale and Samwick found that the tax cuts as a stand-alone policy without expenditure cut will generally lead to an increase in the budget deficit. This increase in the budget deficit will reduce national savings and raise the interest rate, which will negatively affect investment. Some taxpayers might use the saving from tax cuts on economically inefficient things such as modern cars, big houses, and fancy clothes. As the budget deficit grows, future generations will pay for it when the public debt comes due.

[202]Zenichi Shishido, 'Does Law Matter to Financial Capitalism?' (2014) 37 Fordham International Law Journal 1121.

[203]Venture Enterprise Center, *VEC Yearbook 2017: Annual Report on Japanese Startup Businesses* (2018) 1–19.

https://doi.org/10.1017/asjcl.2023.24 Published online by Cambridge University Press

but has virtually no home-run potential.[204] The author does not advocate for using this mechanism because, as discussed above, it drops the cash burden on the startup that already has a hard time surviving, and increases the founder's risk to pursue the startup. This is discouraging for future founders with potential ideas to initiate their ventures.

As a result of the current ecosystem still developing, the startups in Cambodia are very small compared to other nations. Hence, the investment size is not that big for the VC with millions of dollars in funds. Also, VC investment is usually made in stage-financing with concrete milestones for founders to achieve. Therefore, the investment size is somehow even smaller; the VC is left with two options – to put in more money in the next round or not. At this stage, all parties should trust and collaborate at their best for the overall good of the startups rather than securing a backup plan to pull out in case things do not work out. If the parties still want to incorporate this clause into the contract, there should be a condition that this clause can only be triggered if the startup has an amount of excess surplus with no potential plan of usage. With this condition, the startup does not bear the cash-flow pressure and gains back control, while the VC can successfully exit without finding a third party to buy out their share.

Conclusion

Venture capital in Cambodia is still in its early stage. Currently, there is no specific law to regulate the activities of VC, but there are existing laws that govern some activities including company law, tax law, and trust law. This article argues that the government should allocate their resources to create a concrete regulatory framework for the VC community in Cambodia to promote their presence and reduce the key bottlenecks that VCs encounter. The regulatory framework can be classified into three main stages: fundraising, startup investment, and exit. During the formation stage, the lack of funding sources should be solved by creating tax incentives for domestic corporations and wealthy investors to invest in the VC, building more international cooperation agreements with potential partners abroad, and allowing the pension fund (when the size is large enough and the startup ecosystem is more robust) to be invested in the VC. In the startup-investment stage, the regulatory framework should focus on promoting the investment readiness of the startup to get the fund from investors, promote the use of convertible notes during the seed stage, and issue a *Prakas* regulating the minimum term of the investment agreement. Lastly, the current capital market in Cambodia still needs some time. Hence, more efforts should be allocated to create a regulation related to M&A; legislators need to balance between being anti-competition and the promotion of an M&A-friendly environment.

All in all, when it comes to business-related matters, real growth comes from the community itself. The regulator can only indirectly assist by creating an enabling environment to enhance a strong connection of key players such as entrepreneurs, VC, local and foreign talents, government, accelerator, and the university. There is still much effort needed from those key players to achieve the business vision, be open to potential partnerships with one another, and do business in good faith, creatively and diligently for the greater good of the whole nation.

[204] Douglas J Cumming & Jeffrey G MacIntosh, 'Venture capital exits in Canada and the United States' (2003) 53 The University of Toronto Law Journal 101.

Cite this article: Soeun T (2023). Venture Capital Law in Cambodia: Engineer the Regulatory Framework to Promote the Startup Ecosystem. *Asian Journal of Comparative Law* **18**, 362–388. https://doi.org/10.1017/asjcl.2023.24