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LEGAL MECHANISM OF VENTURE CAPITAL COOPERATION FOR SMALL AND MEDIUM ENTERPRISES AT THE REGIONAL LEVEL

Jonner Binton Silaen
Universitas Kristen Indonesia, Indonesia
Email: jonnersilaenn@gmail.com

Abstract

The government faces funding challenges for micro, small, and medium enterprises (MSMEs) due to collateral limitations in financing, requiring appropriate financing solutions. One such solution is venture capital, a long-term investment based on profit rather than interest or dividends. This study analyzes venture capital management in Indonesia and the regulations supporting its development, especially for MSMEs and the creative sector. The research uses a normative juridical approach with qualitative analysis of legal materials from primary, secondary, and tertiary sources. The findings reveal two approaches to venture capital management: the One-Tier Approach and the Two-Tier Approach. No legal distinction between management and venture capital in Indonesia allows for flexible management. Venture capital is regulated by Law No. 40 of 2007 on Limited Liability Companies and other related regulations. The implications of this study highlight the need for legal reforms to support venture capital's role in financing businesses, along with closer cooperation between the Financial Services Authority (OJK), relevant ministries, and other stakeholders, with political support from the DPR to accelerate MSME and creative sector development.

***Keywords**: capital, Venture, Cooperation, Small and Medium Enterprises*

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**Correspondence Author: Jonner Binton Silaen*
Email: jonnersilaenn@gmail.com

INTRODUCTION

The General Elucidation of Law Number 10 of 1992 on the Amendment of Law Number 7 of 1992 on Banking confirms that national development in Indonesia aims to create a just and prosperous society based on Pancasila and the 1945 Constitution, with the primary focus on the economic and financial sectors (Hoyos Giraldo et al., 2024). The economic sector is key to the success of a country's development, and the government and entrepreneurs have an essential role in this process (Alawi, 2021; Distianto, 2014; Reime, 2011). The state regulates economic activities, while entrepreneurs run the financial process. As the leading actor, entrepreneurs need to be active in managing the country's economy and must be able to expand their business, with financing as one of the primary needs (Fitriadi & Subanar, 2017).

To increase capital, companies often need additional funds that can be obtained through loans from financial institutions, which function as a place to store wealth in the form of financial assets (Muhammad & Murniati, 2020). These financial institutions are divided into three categories: banking financial institutions, non-banking institutions, and financing institutions such as pawnshops, insurance, pension funds, and financing institutions that provide various types of credit (Muhammad & Murniati, 2020).

Micro, small, and medium enterprises (MSMEs) are important to the Indonesian economy, as they can increase employment and people's income. However, MSMEs face many obstacles, such as limited capital, weak management, and constraints in production, marketing, and technology (Fadhilah, 2023). These classic problems in the business world stem from a lack of quality formal education and insufficient access to resources to develop businesses.

In addition to internal problems, MSMEs are often hindered by 'structural poverty' in society, which makes it difficult for them to grow despite their hard work (Haras et al., 2023; Purwatiningsih et al., 2022). Many rules that are considered detrimental to MSMEs should be reorganised so that they can function better (Sumardjan, 2013)The minister in charge of cooperative development stated that two things need to be done to create conditions favourable to the growth of small enterprises: removing obstacles to their development and creating conditions favourable to their growth (Tjakrawerdaya, 1994).

While banking institutions have introduced various credit packages to support MSMEs, many still need additional capital and are bank-qualified. Therefore, the government also guides small and medium entrepreneurs, although the focus should not only be on capital injection, but also management guidance and access to marketing.

Venture capital emerged as a solution to support MSME business activities. It is not just a loan but equity participation that assists in management. In the provisions of Article 1 letter (h) of Ministerial Decree No. 1251/KMK0.13/1988 concerning Provisions and Procedures for the Implementation of Financing Institutions, venture capital is a business institution that passes investment and can offer management support to business partner companies, providing opportunities for them to develop. This pattern of venture capital cooperation is also applicable in various developing countries with difficulty obtaining access to financing.

Venture capital firms are regulated by law and must provide guidance for partner companies to grow. They also face risks because if the partner company fails, they can suffer losses as well (Kadarisman, 1995). Despite challenges related to investor interest in private equity investment, venture capital remains important in creating more equitable business opportunities in Indonesia.

The funding challenges faced by micro, small, and medium enterprises (MSMEs) in Indonesia are primarily due to limitations in collateral for financing, making it difficult for these businesses to access capital from financial institutions. One solution to this problem is venture capital, which provides equity-based financing and management support. Despite the significant potential of MSMEs in Indonesia's economy, they face many structural and regulatory barriers that hinder their growth, even though they work hard to develop their businesses.

This research is urgent due to the critical role that venture capital can play in addressing the financing challenges faced by MSMEs. As an alternative financing model that does not rely on collateral, venture capital can help MSMEs, particularly those in sectors that are underfunded by traditional banks, grow and thrive. Therefore, this research is essential in identifying the barriers and solutions related to implementing venture capital to support MSME development in Indonesia.

First, Fuady (2002) explored the impact of venture capital on the development of small and medium-sized enterprises (SMEs), highlighting that venture capital can enhance competitiveness by providing financing and managerial assistance. Second, Simorangkir

(2023) discussed two management approaches for venture capital: the One-Tier Approach and the Two-Tier Approach, each with its strengths and weaknesses in managing funds. Third, Kadarisman (1995) argued that while venture capital presents great potential for SMEs, challenges remain due to the high risks and the lack of understanding among entrepreneurs regarding venture capital management. Fourth, Luth (2022) identified that the lack of regulatory support and unclear regulations have resulted in suboptimal implementation of venture capital to support MSMEs in Indonesia.

Although previous studies have addressed the role of venture capital in MSME financing, few have focused on the legal mechanisms and practical approaches used in venture capital cooperation at the regional level in Indonesia. This research fills this gap by examining venture capital's legal framework and management approaches to support MSMEs in Indonesia, specifically at the regional level.

This research offers novelty by identifying two management approaches to venture capital in Indonesia, the One-Tier and Two-Tier Approaches, and highlights the flexibility in management due to the lack of a clear legal distinction between venture capital and management. This provides new insights into how venture capital management can be optimized for MSME development in Indonesia, contributing to the creation of more effective regulations and policies.

This study aims to analyze the legal mechanisms and management of venture capital in Indonesia, particularly in relation to its role in supporting the development of MSMEs. It will also highlight the existing regulations and potential improvements for enhancing funding effectiveness.

This research contributes to a deeper understanding of venture capital's role in MSME financing and offers recommendations for improving policies and regulations that could strengthen the sector. It also aims to provide a foundation for developing stronger cooperation between venture capital firms and MSMEs while encouraging more investors to engage in funding the creative sector and MSMEs in Indonesia.

RESEARCH METHODS

This research is a normative legal study that identifies legal rules, principles, and doctrines to address legal issues (Hadi, 1983). The research focuses on the legal aspects of partnerships between venture capital companies and small and medium enterprises (SMEs) and the legal challenges and solutions related to developing venture capital for SMEs. The study employs a normative legal approach, specifically concentrating on applicable laws, Mahmud Marzuki (2013) to examine the implementation of partnership agreements between venture capital firms and SMEs (Sidik, 2017).

Secondary data gathered from literature and documents related to the research topic is used in this research. The data includes three types of legal materials: primary, secondary, and tertiary sources (Mahmud Marzuki, 2013). Primary legal materials consist of authoritative documents such as the 1945 Constitution, various banking and venture capital laws, and regulations from financial authorities concerning venture capital companies. Secondary sources include law books, research findings, and academic articles interpreting primary legal materials. Tertiary sources include websites and online resources that help explain primary and secondary legal materials.

Data collection in this research involves conducting a comprehensive literature review and analyzing relevant regulations. The steps include gathering laws and regulations pertinent to the research topic, assessing scholarly works on the subject, and selecting additional reading materials such as journal articles and publications. This research uses a qualitative data analysis method, where the data is presented and analyzed concurrently, following a deductive approach. In normative legal research, secondary data analysis involves categorizing, synthesizing, and interpreting legal sources to address the research questions and objectives (Marzuki, 2005). The findings are then presented in a structured manner, drawing legal conclusions based on the analysis of the collected data.

RESULTS AND DISCUSSION

The Role And Legal Aspects Of Venture Capital Co-Operation For Micro, Small, And Medium Enterprises

1. **Capitalisation of Micro, Small and Medium Enterprises through financing at Venture Capital Companies**

The government and the community work together to achieve national development, with the community as the leading actor and the government directing and creating an enabling environment. Their activities complement each other to achieve the same goal. One of the main objectives of establishing the Republic of Indonesia is to create a just and prosperous society and promote general welfare. The main goal of development is the growth of Indonesian people and society as a whole, guided by Pancasila and the 1945 Constitution. Development in Indonesia covers all sectors, requiring participation from all societal levels. Economic development is expected to drive progress in other areas, and legal development will be critical to ensure fair and effective progress.

Munir Fuady states that economic development should involve all layers of entrepreneurs and social groups, which aligns with Article 33 of the 1945 Constitution (Fuady, 2002). However, this constitution does not guarantee income equality, thus encouraging various efforts to balance economic growth with income equality. One approach is to use venture capital to support small businesses. It is important to recognise that venture capital and other businesses aim to make a profit, so they are fundamentally business-oriented. If small businesses do not have access to funds, the fundamental purpose of venture capital institutions, which are traditionally profit-driven, will not change.

Venture capital can also specifically support struggling entrepreneurs. Such venture capital has several characteristics, including a focus on small and undercapitalised businesses, independence from larger firms, smaller amounts of funds provided, usually originating from state-owned enterprises or international organisations such as the Asian Development Bank, and lower expectations for high returns on investment.

Entrepreneurs eligible for specialised venture capital support include informal business groups such as street vendors, cottage industries, family businesses, farms, small formal businesses, cooperatives, and groups involved in research and developing new technologies. Specialised venture capital cannot fund most small entrepreneurs, while general venture capital can only fund small formal enterprises and research groups.

Venture capital is not a new financing alternative for business activities in Indonesia and other developed countries, having emerged in the United States in the 1960s and Europe in the 1970s. In Asia, venture capital started in countries such as Japan and Korea in the 1980s. Indonesia first recognised venture capital with PT Bahana Pembinaan Usaha Indonesia in 1973 (Luth & Hamidah, 2022).

Regarding operational mechanisms, Simorangkir (2023) outlines two types of venture capital management: a Single-Tier Approach, where one company manages all aspects of fundraising and investment, and a Two-Tier Approach, which involves two separate entities—one as a fund provider and the other as a fund manager. The conventional mechanism is a single-tier system, while the two-tier system delegates management to an experienced investment management company.

In the one-tier approach, the venture capital company directly manages the policy and investment functions, while in the two-tier method, the investment management company handles all investment policies and strategies. The regulatory framework for venture capital in Indonesia does not separate the two functions, and with the approval of the finance minister, one venture capital company can manage another.

2. Legal Aspects of Micro, Small, and Medium Enterprises Capital Partnership with Venture Capital Firms

The Partnership Agreement supports the development of Micro, Small, and Medium Enterprises (MSMEs) in Indonesia. Industrial growth and increased competition in local and international markets provide both challenges and opportunities for economic progress (Hisyam & Fitriyah, 2024; Soetjipto et al., 2023). MSMEs have great potential thanks to technological innovations that can create new products. Partnerships in the development of MSMEs aim to empower cooperatives, small, and medium entrepreneurs, strengthen economic structures, and gradually reduce inequality and poverty (Komarudin, 2014).

In the context of law, the idea of law as a tool to change society is discussed, referring to Roscoe Pound's book. Law is seen as a means to protect society and is an important part of legal reform in Indonesia, which must be based on the norms and values that exist in society (Komarudin, 2014)

Law No. 20 of 2008 on MSMEs, article 26, amended in article 87, paragraph 5 of Law No. 11 of 2020 on Job Creation, regulates various types of partnerships such as core plasma, subcontracting, franchising, and distribution. Each partnership model has a different focus and way of working. For example, the core plasma pattern involves a large company as a contractor fostering small businesses, while the subcontracting partnership assists small businesses in production and financing.

In Article 1, Point 13 of Law No. 20/2008, in conjunction with Article 1, Point 4 of Government Regulation No. 17/2013 on Micro, Small and Medium Enterprises, partnership is defined as mutually beneficial cooperation between MSMEs and large enterprises, with arrangements that facilitate their relationship. The government and the private sector are also involved in policy-making to create a favourable business climate, including in funding, infrastructure, and promotion.

Government Regulation No. 7 of 2021, article 117, confirms that before any collaboration takes place, a written agreement must be in place, containing the rights and obligations of each party and conflict resolution. The agreement must not create MSMEs' dependency on large companies.

An agreement is a legal form that binds both parties to carry out the agreed-upon obligations. The agreement has important elements, such as the agreement of the two parties, the objectives to be achieved, and specific terms and forms.

Venture capital as a financing instrument involves a venture capital company and a company that needs financial support. The venture capital company provides funds and assists in management, while the company receiving funds must return the capital and pay interest or profit sharing. Venture capital activity is a financing business in which each party aims to share the profit. So, the legal basis of venture capital is a maatschap, which is regulated in Article 1318 of the Civil Code, which contains an agreement by which two or more people bind themselves, intending to share the profits that occur because of it.

Venture capital companies have obligations, including providing guidance and reporting to the government. Meanwhile, the recipient of funds is obliged to return the capital and pay profit sharing according to the agreement.

Venture capital agreements are governed by Indonesian law, including the principle of freedom of contract and company law provisions. The two forms of capital participation in venture capital are direct and indirect participation, each with a specific and different method of implementation.

Direct investment is generally done through the purchase of company shares, while indirect investment is done through convertible bonds or profit-sharing patterns. Each form of investment has legal rules and regulations that must be followed (Fuady, 2002).

The application of agreements in partnerships and venture capital aims to create a mutually beneficial relationship between large companies and MSMEs, support economic development, and strengthen a fair and competitive market structure.

The expiration of the partnership agreement with the Indonesian government prompted efforts to promote venture capital funding by establishing Regional Venture Capital Companies (PMVDs) in 27 provinces by the end of 1998. All PMVDs are affiliated with PT Bahana Artha Ventura (BAV), which holds the most significant stake and is a PT Bahana Pembinaan Usaha Indonesia subsidiary. However, while PMVDs have supported small and medium-sized enterprises (MSMEs), they have not fully addressed the issues that led to business failure in partner enterprises (Sunaryo, 2008). Key issues include unclear long-term business direction, low working capital, unprofessional management, lack of skilled labour, unclear market prospects, inadequate marketing efforts, and high production costs leading to limited products.

Constraints And Solutions To Legal Regulations In Venture Capital Partnerships For Small And Medium Enterprises

1. Constraints On Partnerships Between Venture Capital Firms And MSMEs in Indonesia

Venture capital in Indonesia provides financing and management assistance to the companies it works with. According to Fuady (2002), venture capital's characteristics include investors' involvement in the company's management, the temporary nature of the investment, the objective of obtaining high profits despite high risks, and medium—or long-term investment. Venture capital is also conducted without collateral, in the form of equity participation, and is generally aimed at small or new companies with growth potential.

High risk is a hallmark of the venture capital business, which tends to favour investments in ventures that promise high returns, such as new technologies. However, it is important to note that not all investments in the capital market or property sector constitute venture capital. Bank lending can follow the concept of venture capital, but venture capital institutions in Indonesia have not fully implemented pure venture capital principles as abroad.

The institutional structure of venture capital in Indonesia is separate from management, and the legal entity does not distinguish between the two (Li & Zahra, 2012). This causes venture capital companies in Indonesia to rely on capital from shareholders. The economic situation and beliefs in Indonesia are different from those in other countries, so the approach to venture capital is also different (G. D. Bruton et al., 2013). The focus in Indonesia is more on creating small and medium-sized businesses rather than high-tech companies that are usually more desirable in other countries (G. Bruton et al., 2017).

The goal of venture capital in Indonesia is to finance small and medium-sized enterprises to expand and, in doing so, more equitably support economic growth. Indonesia's Venture capital operates similarly to banking, providing the same terms as bank loans. This has resulted in the suboptimal role of venture capital in supporting MSMEs, especially start-ups in the creative economy sector. Funding by venture capital is often similar to bank financing activities, creating a mismatch.

Therefore, there is a need for regulatory reform to support the growth of the venture capital industry and better reflect the actual characteristics of venture capital. This is expected to increase funding support for start-ups and MSMEs and address mismatches in fund management. Policy changes and co-operation between OJK and stakeholders in the economic sector are required to support the growth of the venture capital industry in Indonesia. This includes co-operation with relevant ministries and supporting changes that the House of Representatives proposed.

Some ideas for updating venture capital financing institutions include developing suitable funding sources for venture capital businesses. Funding should be based more on equity rather than loans. Opening up fund management through venture funds is also important to attract professional investors. In addition, the venture capital industry needs to expand its activities to provide working capital for MSMEs and mentoring services while still focusing on equity participation.

Due to the lack of an adequate stock exchange for SMEs, changes in the divestment process are also necessary. Research into the possibility of a second stock exchange needs to be conducted to aid the divestment process. In addition, increasing venture capital capacity by strengthening capital requirements for venture capital establishment is necessary for the venture capital industry to grow and contribute more to the Indonesian economy.

2. Legal Solutions in the Partnership of Venture Capital Firms and MSMEs

Legal reform of venture capital financing institutions in Indonesia requires cooperation between OJK, the government, and the legislature. Support needed includes tax incentives for Venture Capital Companies that divest, the provision of government funds to assist MSMEs, and the role of KADIN as a liaison between investors and entrepreneurs. Currently, no programme effectively connects the two.

Venture Capital Companies should also actively educate the public about venture capital, including how to develop a good business plan. Many innovative and creative products on campuses and research institutions have not been financed due to a lack of ability to present these ideas. This challenge is important so that more business plan proposals are submitted, and from the existing proposals, it is believed that one or two plans will emerge that can provide significant benefits.

CONCLUSION

The author concludes several things about venture capital partnerships' role and legal aspects with Micro, Small, and Medium Enterprises (MSMEs). Venture capital is not only focused on profit, but also has a mission to help entrepreneurs who need support. Venture capital supports small companies not affiliated with large companies and usually does not expect high financial returns. Small businesses that can get venture capital assistance include home industries, agriculture, and cooperatives. Venture capital was introduced in Indonesia in 1973 through PT Bahana Pembinaan Usaha Indonesia. There are two approaches to venture capital management: One-Tier, where one company manages the funds directly, and Two-Tier, which involves separate funding and management companies. In Indonesia, the law does not distinguish between venture capital and management, providing flexibility in management. A venture capital agreement is an agreement for investment between a Venture Capital Company and a Business Partner Company, which follows Law No. 40 of 2007. Venture capital provides support in the form of equity participation, not loans, and is more likely to be focused on small and emerging companies with great potential. The risks are pretty high, especially in technology, but venture capital in Indonesia differs from other countries by focusing more on MSMEs. Legal changes are needed to increase the role of venture capital. OJK, as the regulator, should work closely with ministries and other stakeholders to support the development of venture capital and ensure the availability of funds for the creative sector and MSMEs, with political support from the Parliament.

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