The influence of corporate governance on protecting minority shareholders' rights in the Saudi stock market: a comparative study

Alkahtani, A.

THE INFLUENCE OF CORPORATE GOVERNANCE ON PROTECTING MINORITY SHAREHOLDERS' RIGHTS IN THE SAUDI STOCK MARKET: A COMPARATIVE STUDY

ABDULLAH WAHTAN ALKAHTANI

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Abstract

Despite heightened international recognition of the importance of corporate governance in reinforcing the financial stability and restoring the confidence of investors, minority shareholders (especially those from developing countries, including Saudi Arabia) still suffer some forms of expropriation at the hands of majority shareholders. There has been grave concern because most listed corporations in these countries still operate under the dominance of controlling shareholders (state's representatives and wealthy families' members) who use their influence to misappropriate the funds meant for the company to maximize their own interests to the detriment of minority shareholders.

Thus, the primary aim of this thesis was to examine the influence of corporate governance mechanisms on the protection of minority shareholders' rights in Saudi Arabia. In order to explore this issue, the internal and external mechanisms of corporate governance were compared between the UK and Saudi Arabia. The choice of the UK as a benchmark for comparison was motivated by its global reputation in terms of good corporate governance practices. Besides this, the comparison highlighted the differences and similarities between the two jurisdictions in corporate governance practices, and thus examined the possibilities of transplanting some of the UK corporate governance practices to help improve the situation in Saudi Arabia. Based on these comparisons, three key findings were highlighted: (1) corporate governance practice in the UK and Saudi Arabia reflects some elements of a global standard of good corporate governance; (2) the concentrated share ownership structure in Saudi Arabia contributes to the abuse and expropriation of the rights of minority shareholders; and (3) the Saudi security market has a legal system that is characterised by weak protection of the rights of minority shareholders.

Taken together, these findings suggest that corporate governance practices would be better for minority shareholders if its laws and regulations were modified to ensure adequate protection of the minority shareholders' rights. Importantly, adopting some of the UK corporate governance practices would steer significant changes in the way that corporations are governed in Saudi Arabia, such as encouraging the use of electronic voting and proxy by email, granting minority shareholders easy access to company's information and the use of derivative action against the abuse of board members, and also reinforcing the role and independence of the board of directors.

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Author's Declaration

I hereby declare that all the material contained in this thesis is wholly my work. The thesis has not been previously submitted in its essence to any other university, nor to any other degree or elsewhere.

Abdullah Wahtan Alkahtani

Dedication

To my mother in her grave

To my father in his grave

To my wife to whom I owe everything

To my children

Abbreviations Used

ACRSC	Saudi Appeal Committee for Resolution of Securities Conflicts
ASIC	Australian Securities and Investment Commission
BCOBS	Basel Committee on Observance of Banking Supervision
BLG	Saudi Basic Law of Governance
CCCG	UK Combined Code on Corporate Governance
CEO	Chief Executive Officer
CGRs	Saudi Corporate Governance Regulations
CL	Saudi Company Law
CMA	Saudi Capital Market Authority
CMAB	Saudi Capital Market Authority Board
CML	Saudi Capital Market Law
CRSD	Saudi Committee for Resolution of Securities Dispute
CSR	Corporate Social Responsibility
DIFC	Dubai International Finance Centre
DTR	Disclosure and Transparency Rules
FCA	UK Financial Conduct Authority
FDI	Foreign Direct Investment
FSA	UK Financial Services Authority
FSMA	UK Financial Services and Market Act
GCC	Gulf Cooperation Council Countries
GDP	Gross Domestic Product
GOSI	General Organisation for Social Insurance
IFC	International Finance Corporation
IOSCO	International Organisation of Securities Commissions
IPO	Initial Public Offering

LRs	Saudi Listing Rules
M&A	Mergers and Acquisition
MOCI	Saudi Ministry of Commerce and Industry
NCB	Italy National Commercial Bank
NWC	National Water Company
OECD	Organisation for Economic Co-operation and Development
OPEC	Organisation of Petroleum Exporting
PIF	Public Investment Fund
PPF	Public Pension Fund
PRA	UK Prudential Regulation Authority
SAGIA	Saudi Arabian General Investment Authority
SAMA	Saudi Arabian Monetary Agency
SEA	Securities Exchange Act
SEC	Saudi Supreme Economic Council
SEC	US Securities of Exchange Commission
SOA	US Sarbanes-Oxley Act
SSRC	Saudi Share Registration Company
TASI	Saudi Tadawul All Share Index
WTO	World Trade Organisation

Corporate Governance Glossary

Corporate governance	The system by which company is directed and controlled.[1] The main parties in corporate governance are management, stakeholders and directors. Corporate governance aims to strengthen transparency and accountability requirements within the corporate.
Shareholder	A person or entity that owns shares in a firm or through mutual funds.
Minority shareholder	Those who represent a class of shareholders who do not control the company and are unable to influence decision-making.
Shareholder activism	Company performance monitoring by shareholders.
Stakeholder	Any individual, group or institution that has an interest in the company.
Accountability	The responsibility of a board of directors, before shareholders and other stakeholders, for corporation performance and actions.
AGM	The annual general meeting, which is usually held at the end of each financial year, as shareholders and management can discuss the previous year, place new plans for the future, elect or dismiss directors and address other shareholder concerns.
Annual report	An audited report issued annually by listed corporations to their shareholders. It should contain full information regarding financial results and company performance of the previous fiscal year. Also, it should contain plans on future outlook.
Audit report	Evaluation of the accuracy and validity of corporate financial information and conformity with accepted accounting practices.
Board of directors	The collective group of individuals elected by the shareholders in order to monitor the company management and its performance on their behalf.
CEO	The chief executive officer.
CFO	The corporate executive responsible for the financial planning and record keeping of a corporation.
Chairman	Highest-ranking director in a firm's board of directors.
Code of best Practice	Guiding standards for ensuring good corporate governance to all publicly listed corporations.
Conflict of interest	A situation in which the objectives and aims of two different parties are incompatible.
Disclosure	Market-influencing information and the public announcement of transactions.
Fair disclosure	The release of all market material information to the public at the same time.
Transparent market	All market-influencing information and all material information are readily available to the public.
Director	A person elected by shareholders to serve on the board of directors.
Executive director	A person who is a member of a board of directors, who is also an employee of the firm.

[1]Adrian Cadbury, "Report of the Committee on the Financial Aspects of Corporate Governance" (1992). Gee and Co. Ltd, London.

Non-executive director	A person who is a member of a board of directors, but does not have a full-time management position at the company.
Fiduciary	The duties of good faith, trust, and confidence.
Financial statement	A written report that summarises the financial status of a company for a stated period of time, including an income statement and balance sheet, describing the financial resources, profits and losses.
Independent director	A director who does not have any other relationship with listed corporations.
Individual investor	A person who purchases small amounts of stocks for his or her own account.
Initial public offering (IPO)	The initial sale of shares by a corporation to the public.
Inside director	A member of a company's board and also an employee of the company.
Insider trading	Buying or selling the company shares by an insider, or upon insider information.
Internal audit	An assessment of the financial resources of the company by its own employees.
Merger	An incorporation of two or more entities or a pooling of interests into one entity.
Institutional investor	Banks, pension funds, mutual funds, and insurance funds.
Institutional ownership	Share ownership by institutional investors.
Proxy	A process that empowers shareholders to submit their votes without personally attending the annual general meeting.
Proxy statement	A document sent by listed companies to shareholders, providing material information on issues to be voted on at the annual general meeting.
Quarterly report	A report filed quarterly containing unaudited financial statements.
Right to vote	The right of shareholders to vote on matters of corporate policy at the annual general meeting.
Shareholder's derivative action	Lawsuit files by a shareholder on behalf of a company, often against an executive officer or director. Shareholder derivative action allows a shareholder to sue when management has failed to do so.
First-degree relatives	Father, mother, spouse and children.

Chapter 1

General Introduction

1.1 Background of the Research

In recent times, the issue regarding the protection of the rights of minority shareholders has become the central point of many legal, economic and political debates around the world, specifically the conflict of interests between the managers and owners, otherwise known as 'the agency conflict', which has created many problems in most publicly held corporations. The agency conflict characterises the assumptions of the agency theory and focuses on the relationship between two parties: the owners who delegate work and the managers who manage the company. The dominant view is that the shareholders usually expect that managers will act and make the best decisions in the owners' interests. In practice however, it has been shown that managers tend to express their opportunistic nature and look to maximize their own personal goals and selfish interests to the detriment of the shareholders.[2] In other words, there is no assurance that managers will fulfil the best interests of the owners, since those look to increase their own different interests and involved in relationships express their opportunistic nature.[3]

Jensen and Meckling argued in their seminal paper, that managers were squandering corporate and societal resources to benefit themselves.[4] Therefore, a form of control mechanism (corporate governance) is needed to prevent managers from shirking and misusing their fiduciary function.[5] In fact, corporate governance is seen as a system of checks and balances to prevent managers from acting on their selfish interests or making decisions that benefit themselves. The interest in the study of corporate governance can be traced to the seminal work of Berle and Means, which explored the evolution of big businesses from economic and legal perspectives.[6] Berle and Means asserted that the modern world is characterised by a changing relationship between ownership and control of business. That is, with an increase in the number of shareholders of corporations, professional managers are

[2]E.I. Mostovicz, N.K. Kakabadse and A. Kakabadse, 'Corporate governance: quo vadis?' (2011) Corporate Governance: The International Journal of Business in Society, vol 11, no 5, pp 613-626.
[3]ibid. p 614.
[4]M.C. Jensen and W.H. Meckling ,'Theory of firm – managerial behavior, agency costs and ownership structure' (1976) Journal of Financial Economics, vol 3, no 4, pp 305-60.
[5]A. Shleifer and R.W.Vishny, 'A survey of corporate governance' (1997) The Journal of Finance, vol. 52, pp 737-783.
[6]A.A. Berle and G.C. Means, *The Modern Corporation and Private Property* (New York: Harcourt, Brace & World 1932). For more insight see M. S. Mizruvhi, 'Berle and Means revisited: the governance and power of large U.S. corporations' (2004) Theory and Society, University of Michigan, pp 1-28.

gaining an influence over businesses, whereas the capacity of individual shareholders to control corporations is being diminished.[7] The implication of this, as Berle and Means argued, is that shareholders run the risk of managers utilizing the money supplied to the company to maximize their own utility rather than maximizing corporate value and the value of shares.[8]

Following Berle and Means' study, interest in the subject has continued to grow. Specifically, the last two decades have seen a renewed interest amongst scholars, practitioners and the media alike, due to the financial crisis and corporate scandals that led to the collapse of several large corporations, whose governance systems failed to prevent corruption and adequately implement risk management procedures.[9] For instance, the fall of financial institutions in Asia, Russia, the United States and some European countries during the period of 1997 has contributed largely to the establishment of corporate governance as a top concern for international financial institutions around the world.[10]

The 1987 market crash and the subsequent collapse of many corporations resulted in a more comprehensive reform of corporate governance mechanisms around the world.[11] Similarly, the financial crisis in East Asia has affected the economies of countries such as Malaysia, the Philippines, Thailand, Indonesia and South Korea. Importantly, the weakness of institutions in these economies is attributed to a lack of, or weak, corporate governance mechanisms. These corporate scandals revealed not only gaps in corporate governance,[12] but also the need for more effective corporate governance mechanisms.[13] Other countries such as the US have also witnessed various forms of corporate scandals. For instance, the massive failures in companies such as Enron and MCI Inc. (formerly WorldCom), AOL, Tyco and Arthur Andersen have led to political interest in corporate governance and specifically the passage of the Sarbanes-Oxley Act in 2002 by the US federal government, whose main aim was to restore public confidence in corporate governance.[14] According to Edwards and Burns, these

[7]A. Schneider and A. G. Scherer, 'Corporate Governance in a Risk Society' (2015), Journal of Business Ethics, vol 126, no 2, pp 309-323.
[8]ibid.
[9]M. D. Ermann and R. J. Lundman (Eds), *Corporate and governmental deviance: Problems of organisational behaviour in contemporary society* (Oxford: Oxford University Press 2002).
[10]M. Hossain, 'The Corporate Governance Reporting Exercise: The Portrait of Developing Country' (2007) International Journal of Business Research, VII (2), p 106.
[11]Standards Australia, '*AS 8000 - 2003 Good Governance Principle'* (2003) Standards Australia International, Sydney, p 4.
[12]G. Dallas and N. Bradley, 'Calibrating corporate governance practices: Corporate governance scores'in C.K. Low (eds), *Corporate Governance: An Asian-Pacific critique* (Hong Kong: Sweet & Maxwell, Asia, 2002) pp 75-101.
[13]M. Mobius, 'Corporate governance in Hong Kong' in C.K. Low (ed.), *Corporate governance: An Asia-Pacific critique* (Hong Kong: Sweet & Maxwell Asia, 2002) pp 201-223.
[14]G. Farrell, 'How Corporate Crooks Fleeced American Shareholders (and How Congress Failed to Stop Them)'*America Robbed Blind* (Wizard Academy Press 2005).

scandals have undermined confidence in the US business system and raised questions about the effectiveness of corporate governance in the US.[15]

Importantly, "in the wake of these scandals, many of these companies saw their equity values plummet dramatically and experienced a decline in the credit ratings of their debt issues, often to junk status".[16] Similar incidences have also been reported in Australia, where failings in corporations such as HIH, One.Tel have led to the passage of the CLERP 9 reforms.[17] In 2011, two companies: Sino-Forest Corporation (a Canadian-listed Chinese forestry company) and Japanese camera company (Olympus) were the victims of corporate scandals, which was attributed to a failure to follow globally recognised best practices when it comes to corporate governance.[18] According to Lin-Hi and Blumberg,

> The regular reappearance of these scandals calls attention to the apparent weaknesses in the governance structures of corporations, and ultimately raises the question of how good corporate governance can be ensured in the everyday business world, in a sustainable fashion.[19]

The evidence above suggests that corporate fraud is associated with weak corporate governance and can undermine the trust and confidence of investors in the security market, weaken the value of firms, disrupt regular operations, produce changes in key personnel and even threaten the survival of related firms.[20] The phenomenon above continues to baffle scholars and practitioners across the global. The 1990s were a landmark in the field of corporate governance and saw many laws being enacted to address the issues of corporate scandals and restore public confidence in the security market. Thus, the Cadbury Report in

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[15]F.R. Edwards and A.F. Burns, U.S. Corporate Governance: What went wrong and can it be fixed? Paper prepared for B.I.S. and Federal Reserve Bank of Chicago conference, 'Market Discipline: The Evidence across Countries and Industries' (2003).

[16]A. Agrawal and S. Chadha, 'Corporate governance and accounting scandals' (2005) Journal of Law and Economics, vol. XLVIII, p 371.

[17]J. Lee and G. Shailer, 'The effect of board-related reforms on investors' confidence' (2008) Australian Accounting Review, vol 18, no 45, pp 123-134.

[18]Top Corporate Governance Stories of 2011 http://www.forbes.com/sites/nathanielparishflannery/2011/12/28/top-corporate-governance-stories-of-2011/.

[19]N. Lin-Hi, and I. Blumberg, 'The relationship between corporate governance, global governance, and sustainable profits: lessons learned from BP. Corporate Governance' (2011) The International Journal of Business in Society, vol 11, no 5, pp 571-584.

[20]D.B. Farber, 'Restoring Trust after Fraud: Does Corporate Governance Matter?' (2005) Accounting Review 80, pp 539-561. M. Nourayi, 'Stock price responses to the SEC's enforcement actions' (1994) Journal of Accounting and Public Policy 13, pp 333-347; A. Agrawal and S. Chadha, 'Corporate governance and accounting scandals' (2005) Journal of Law and Economics, vol XLVIII; X. Yu, P. Zhang, and Y. Zheng, 'Corporate governance, political connections, and intra-industry effects: Evidence from corporate scandals in China' (2015) Financial Management, Spring , pp 49-80.

the UK[21], the OECD Principles of Corporate Governance[22], and the Sarbanes-Oxley Act of 2002[23] were born.

Both the Organisation for Economic Co-operation and Development (OECD) and the Cadbury reports are public policy instruments intended to assist governments and regulators in their efforts to evaluate and improve the legal, regulatory and institutional framework for corporate governance. The Sarbanes-Oxley Act of 2002, also known as the 'Public Company Accounting Reform and Investor Protection Act' (in the Senate) and 'Corporate and Auditing Accountability and Responsibility Act' (in the House), was enacted following the aftermath of high profile corporate scandals in the US and it is intended to improve board performance by increasing the independence of boards and by requiring them to follow more specific processes and procedures, to ensure that they act responsibly and independently.[24] These regulations reflect the significance of good corporate governance as a safeguarding tool for modern corporations to thrive in a competitive global environment. Indeed, financial crises and corporate scandals have repeatedly highlighted the need to better understand the economic, social, political and legal determinants of corporate governance in individual countries.[25] According to Charkham:

> The careful study of systems of corporate governance is important at the present time because the world of the next century will be even more competitive than it is now as the economies of the Far East gather speed… To tolerate a poor (corporate governance) system is to impose upon oneself an unnecessary competitive handicap.[26]

Corporate governance therefore, is defined from the narrow and broader perspectives. According to the narrow view, corporate governance refers to "the internal means by which corporations are operated and controlled".[27] According to the broader perspective, corporate governance involves a set of relationships between a company's management, board, its

[21]Cadbury Committee, *Report of the Committee on the Financial Aspects of Corporate Governance* (London, Gee and Co, Ltd 1992).
[22]Organisation for Economic Co-operation and Development (OECD), OECD Principles of Corporate Governance, which have endorsed by the OECD Ministers and become as a global benchmark for policy makers, investors, corporations and other stakeholders worldwide. The OECD Meeting May, 1999, Paris, OECD, 1999 and its revised version of 2004. Available at: www.oecd.org.
[23]The U.S Sarbanes-Oxley Act of 2002 was the latest legislative measures enacted to protect investors after the series of collapse of large American firms including Enron.
[24]F.R. Edwards and A.F. Burns, 'U.S. corporate governance: What went wrong and can it be fixed?' Paper prepared for B.I.S. and Federal Reserve Bank of Chicago conference, 'Market Discipline: The Evidence across Countries and Industries', Chicago, Oct. 30 Nov. 1(2003).
[25]A.M. Fleckner and K.J., 'Comparative corporate governance' (Cambridge University Press, XXXIII + 1141, 2013) Available at SSRN: http://ssrn.com/abstract=2298998.
[26]J.P. Charkham, *Keeping good company: A study of corporate governance in five countries* (Oxford: Oxford University Press 1995) 1.
[27]OECD, 'OECD Principles of Corporate Governance of 1999'.

shareholders and other stakeholders.[28] Research in corporate governance is largely rooted in the foundational arguments of the agency theory (to be described in Chapter 2), which views the modern company as a nexus of contracts between principals (risk-bearing shareholders) and agents (managers with specialised expertise).[29]

An important consideration in the study of corporate governance is the variations that characterise the system around the world. These variations are seen in terms of the focus on the link between the shareholder and the company, board structures and on the social responsibility of the firms. Over the years, views on corporate governance have been categorised into two contrasting models: the Anglo-American and the Continental European.[30] The Anglo-American model, also known as the US-UK model, the shareholder-oriented or the outsider model[31], is characterised in terms of financing strategies that involve equity, active markets for corporate control, dispersed ownership, and flexible labour markets. Whereas, the Continental European model, also known as the insider model or stakeholder-oriented model[32], is characterised in terms of financing strategies that involve long-term debt, ownership by large block-holders, weak markets for corporate control and rigid labour markets.[33] Following this categorisation, different types of corporate governance mechanisms have emerged to include those that are firm-specific (characterised by ownership structure, financing strategies, board composition, and corporate control) and those that are country-specific (characterised by the legal and cultural environment, standard accounting practices, and financial system characteristics).[34]

An important feature of these two models is that they make separate assumptions regarding the protection of minority shareholders. According to the Anglo-Saxon model, companies raise equity in the capital markets.[35] Thus, in order to protect investors and the functioning of effective capital markets, capital market transactions are regulated, for example in the US by federal laws that lay down mandatory rules,[36] which are complemented by standards issued

[28]ibid.
[29]M. Al-Suhaibani and N. Naifar, Islamic Corporate Governance: Risk-Sharing and Islamic Preferred Shares (2014) Journal of Business Ethics 124, pp 623-632. DOI 10.1007/s10551- 013-1897-6.
[30]ibid.
[31]R.V. Aguilera and G. Jackson, 'The cross-national diversity of corporate governance dimensions and determinants' (2003) Academy of Management Review,vol 28, no 3, pp 447-465.
[32]ibid.
[33]M. Al-Suhaibani and N. Naifar, 'Islamic Corporate Governance: Risk-Sharing and Islamic Preferred Shares', Journal of Business Ethics, 124, 201, p624. DOI 10.1007/s10551- 013-1897-6.
[34]ibid.
[35]P. Mantysaari, *Comparative corporate governance: Shareholder as a rule-maker* (Berlin-Heidelberg: Springer 2005).
[36]USC Section 77n (Securities Act of 1933, Section 14); 15 USC Section 78cc (a) (Securities Exchange Act of 1934, section 29(a).

by security exchanges.[37] According to the Continental European model, companies are primarily assumed to raise finance privately.[38] Thus, in order to protect minority shareholders and creditors, companies are to a large extent regulated by mandatory provisions of company law.[39] According to Mantysaari:

> The choice of one model instead of the other does not say anything about the quality of investor protection. For example, one of the fundamental purposes of company law in Europe is to protect creditors. Law, not contract, protects creditors according to the European model. In the USA, the reverse is true. Creditors who wish to protect themselves from shareholders or managers behaving opportunistically must do so by contract.[40]

As far as the rights of minority shareholders are concerned, the literature in the field of corporate governance has shown that there is an ongoing conflict between majority and minority shareholders.[41] This conflict is more pronounced or observed amongst listed companies in developing countries, where dominance of controlling shareholders is still the norm. Indeed, an increase in concentrated ownership and control is seen as an advantage to controlling shareholders but at the expense of the rights of minority shareholders and creditors. Previous research has shown that countries that are characterised by a low level of legal protection of minority shareholders' rights also have a high level of concentration of ownership and control.[42] By contrast, countries with greater quality of protection of minority shareholders' rights are distinguished by separated or dispersed patterns of ownership.[43]

1.2 Minority Shareholders and their Rights

1.2.1 Minority Shareholders

Minority shareholder problem occurs due to the influence that managers and majority shareholders (or so-called the controlling shareholders) exert in the day-to-day activities of the organisation, which allows them to control the decision-making and extract private

[37]P. Mantysaari, *Comparative corporate governance: Shareholder as a rule-maker* (Berlin-Heidelberg: Springer, 2005)
[38]ibid.
[39]K.J. Hopt and W. Gesellschaftsrecht, in H.W. Festschrift für, *For the history of investor protection in Germany* (2002) pp 1015-1016; B.R. Cheffins, 'Mergers and Corporate Ownership Structure: The United States and Germany at the Tum of the 20th Century' (2003), AJCL 51, pp 499-500.
[40]P. Mantysaari, *Comparative corporate governance: Shareholder as a rule-maker* (Berlin-Heidelberg: Springer 2005) 4.
[41]R. La Porta et al., 'Law and Finance' (1998) Journal of Political Economy 106, pp 1151-52.
[42]McKinsey & Company Report, 'Giving New Life to the Corporate Governance Reform Agenda for Emerging Markets', Survey (2001) pp 1-6; J. Grant and T. Kirchmaier, 'Corporate Ownership Structure and Performance in Europe', The Centre for Economic Performance (2004) CEP Discussion Paper, no 631, p16.
[43]ibid.

benefits at the expense of minority shareholders' rights.[44] Shareholders can be major or minor, depending on the controlling interests they have in the company. Thus, it is necessary to understand the concept of 'shareholder' including 'majority' and 'minority shareholders'. The term shareholder (or stockholder) refers to people who own shares or stocks in an institution or mutual fund.[45]

In fact, they are the owner of shares in a company.[46] The Articles of Association of a firm may authorise classes of shares including ordinary shares, preference shares and other specialised types of shares.[47] According to Perakis, shareholders are the members of the company who technically hold a participation interest in its capital (equity holders), composed of relatively small units called shares.[48] Bloomsbury Business Library (BBL) defines a shareholder as 'a person who owns shares of a fund or investment trust'.[49]

The expression of minority shareholding refers to a shareholder who owns less than 50% per cent of voting rights, and thus this percentage does not enable minority shareholders to exercise influence over the company's decision making.[50] By contrast, majority shareholders are those persons or entities that hold more than 50% per cent of the shares within the firm's capital, which empowers them to control the company's affairs, and more significantly, enabling the election and dismissal of the board members, deciding directly or indirectly on the wages of the managers and dividends, deciding on incorporation, buying and selling the company's assets, increasing or decreasing the capital of the company.[51]

Kinkki (2008) suggested that controlling shareholders are able to identify decisions made by executives in a corporation.[52] Minority shareholders have limited influence on decision

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[44]Schleifer, A. and Vishny, R., 'Large shareholders and corporate control', *Journal of Political Economy, (1986),* vol. 94, pp 461-488., Jensen, M., 'Agency costs of free cash flow, corporate finance, and takeovers', *American Economic Review*, (1986), pp 323-329. Gadhoum, Y., Lang, L. and Young, L., 'Who controls US?', *European Financial Management'*, (2005), vol. 11, no. 3, pp 339-363. Lang, L. H. and Litzenberger, R., 'Dividend announcements: cash flow signalling vs. free cash flow hypothesis', *Journal of Financial Economics*, (1989), pp 181-91. Peasnell, L., Pope, P. and Young, S., 'Managerial equity ownership and the demand for outside directors', *European Managerial Management*, (2003), vol. 9, no. 2, pp 231-250.
[45]Oglesby, D.W. 'Shareholders' (2007) Concise Encyclopaedia of Investing, pp 65-66.
[46]Bob Tricker, Essential Director*: The Essential A-Z* (The Economist: Economist Books 2003) pp170-171.
[47]ibid.
[48]E. Perakis, 'Rights of Minority Shareholders', XVIth Congress of the International Academy of Comparative Law, General and Notional Reports (Brisbane, Australia 2002) p16.
[49]Bloomsbury Business Library-Business and Management Dictionary (2007) p 6764.
[50]Lee, f. 'Four Models of Minority Shareholder Protection. in. Takeover s'. European Business Law Review. 16. 4. (2005) p 803. Institute of Directors, 'Protection for Minority Shareholders', (2015), p 1. It is available at: http://www.iod.com/guidance/briefings/cgbis-directors-service-agreement.
[51]Szeutkuti. D. 'Minority shareholder protection rules ill Germany, France and in the UK-A Comparative Overview'. Thesis submitted at Central European University, (2007), p 9. Angelika Gorak, 'The Interests of Minority and Majority Shareholders in the EU', Journal of International Affairs, (2014) no. 1. It is available at: http://www.studentpulse.com/articles/1086/the-interests-of-minority-and-majority-shareholders-in-the-eu.
[52]Seppo Kinkki, 'Minority Protection and Dividend Policy in Finland' *European Financial Management'*, (2008), vol. 14, no. 3, pp 470-502.

making, but literature suggests that minority shareholders' rights can be important components of the company policy.[53] The Bloomsbury Business Library defines a majority shareholder as a stockholder with a controlling interest in a company.[54]

Minority shareholders on the other hand, are defined as shareholders who, irrespective of the amount of capital they provide, are unable to exercise a significant form of control within the company.[55] Importantly, minority shareholders are small parts of shareholders who do not dominate the company or have sufficient power to exercise their influence on the company decision-making.[56] Article (2) of the Saudi Corporate Governance Regulations (SCGRs) defines minority shareholders as 'those shareholders who represent a class of shareholders that do not control the company and hence they are unable to influence the company'.[57]

Controlling shareholders can be attributed to their controlling rights more than their cash flow rights. In reality, the controlling shareholders possibly exist in legal systems that do not have strong protection for minority shareholders from majority shareholders' oppression.[58] Majority shareholders are characterized by their motives and engagement in the company's decision making, attainment of personal goals on account of minority shareholders' rights, thereby neglecting justice and fairness.[59]

It is important to note that directors and controlling shareholders, who own a controlling interest or exercise control over the company, are subject to a fiduciary duty towards minority shareholders.[60] As is well-known that the fiduciary duty always relies on the trust between the trustee and the beneficiary, and therefore it guarantees protection to minority shareholders whilst also deterring controlling shareholders from conducting self-dealing transactions or abuse of their power.[61] To restore the balance in the relationship between minority shareholders and majority shareholders, the fiduciary duty should expand all responsibilities of directors and controlling shareholders to involve such implications resulting from failure

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[53]ibid.
[54]Bloomsbury Business Library-Business and Management Dictionary (2007) p 6764.
[55]Netherlands Comparative Law Association. 'Rights of Minority Shareholders in the Netherlands'. Available at: http://www.ejcl.org/64/art64-12.html.
[56]Article (2) Saudi Arabian Corporate Governance Regulations issued by the Board of Capital Market Authority Resolution No 1/212/2006 dated 21/10/1427 AH corresponding to 12/11/2006.
[57]Ibid art (2).
[58]La Porta, R., Lopez-de-Silanez, F., Schleifer, A. and Vishny, R., 'Law and finance', *Journal of Political Economy*, (1998), 106, pp 1113-1155.
[59]For more insight about important minority stockholders in companies see: http://www.lawteacher.net/free-law-essays/business-law/important-minority-stockholders-in-companies-business-law-essay.php.
[60]Levy, R. E. 'Freeze-out Transactions the Pure Way: Reconciling Judicial Asymmetry between Tender Offers and Negotiated Mergers', West Virginia Law Review 106 (2004) p 320.
[61]ibid.

of the company, merger and acquisition, selling the company's assets in price below the market value. In all cases, directors and controlling shareholders must be responsible for the duty of care, good faith, duty of disclosure and also they should fulfil the best interest of the corporation.[62]

1.2.2 Rights of Minority Shareholders and their Protection Issues

Before discussing what the rights of minority shareholders are, it is necessary to justify the reason why minority shareholders should receive protection and what the ultimate goal of this protection should be. Several reasons have been given to justify why minority shareholders should receive protection. First, weak protection of minority shareholders increases the average cost of capital for a company, putting it at a competitive disadvantage with foreign companies.[63] Secondly, the confidence of minority investors is enhanced when the legal system provides mechanisms for minority shareholders to bring lawsuits when they have reasonable grounds to believe that their rights have been violated.[64] Thirdly, with the common aim of improving market credibility, the choice and ultimate design of different provisions to protect minority shareholders necessarily depends on the overall regulatory framework and the national legal system.[65]

Minority shareholders should be confident that their funds will be invested in a safe area and protected from the abuse and misconduct of management and controlling shareholders. A legal protection of minority shareholders is considered the best tool to encourage investment in the stock market. Lazarides suggested that there is a solid relationship between strong law and the protection of minority shareholders' rights: 'better protection comes from better legal protection, stronger structure of the internal control mechanisms and more efficient capital markets and market for corporate control'.[66]

In recent years, a number of studies[67] have revealed an inverse relationship between the protection of rights of minority shareholders and a higher valuation of corporate assets with more developed and valuable capital markets. Following this, scholars in the past decade

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[62]ibid.
[63]The Netherlands Comparative Law Association, 'Rights of Minority Shareholders in the Netherlands'. Available at: http://www.ejcl.org/64/art64-12.html.
[64]OECD Principles of Corporate Governance Draft for Public Comment – November 2014. Available at: http://www.oecd.org/daf/ca/OECD-Principles-CG-2014-Draft.pdf.
[65]ibid.
[66]Jonida Rustemaj, 'The New Legal Regime on Minority Shareholder Protection in Albania' (2012) European Journal of Business and Economics, vol 6, p 40.
[67]Cooter, R.D., '*Innovation, Information and the Poverty of Nations'* (2005) FLA. ST. U. L. REV, vol 33. p 373; Glaeser, E. et al. 'Coase versus the Coasians' (2001) 116:3 QUARTERLY J. OF ECON 853-899.

reached a consensus suggesting that minority shareholders deserve legal protection, not only for equitable reasons but for efficiency considerations as well.[68]

The OECD principles of corporate governance set out the rights and equitable treatment of shareholders and key ownership functions. The principle states that:

> The corporate governance framework should protect and facilitate the exercise of shareholders' rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.[69]

The OECD principles further outline the basic rights of shareholders to include the right to: '1) secure methods of ownership registration; 2) convey or transfer shares; 3) obtain relevant and material information on the corporation at a timely and regular basis; 4) participate and vote in general shareholder meetings; 5) elect and remove members of the board; and 6) share in the profits of the corporation'.[70] These rights are detailed below:

1. Shareholders should be sufficiently informed about, and have the right to approve or participate in, decisions concerning fundamental corporate changes, such as: i) amendments to the statutes, or articles of incorporation or similar governing documents of the company; ii) the authorisation of additional shares; and iii) extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company.
2. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings
3. Shareholders should have the opportunity to ask questions to the board, including questions relating to the annual external audit, to place items on the agenda of general meetings, and to propose resolutions, subject to reasonable limitations.
4. Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members should be facilitated. Shareholders should

[68]Salama, B.M., and Prado, 'V.M. Legal protection of minority shareholders of listed corporations in Brazil: brief history, legal structure and empirical evidence' (2011) Journal of Civil Law Studies, *v*ol 4, no 1, pp 147-185.
[69]OECD Principles of Corporate Governance Draft for Public Comment – November 2014. Available at: http://www.oecd.org/daf/ca/OECD-Principles-CG-2014-Draft.pdf.
[70]OECD Principles of Corporate Governance of 2004.

be able to make their views known, including through votes at annual shareholder meetings on the remuneration of board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval.

5. Shareholders should be able to vote in person or in absentia and equal effect should be given to votes, whether cast in person or in absentia.[71]

According to the OECD principle, all shareholders of the same series of a class should be treated equally. In terms of minority shareholders, the principle states that: 'minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress. Abusive self-dealing should be prohibited'[72].

Different countries have their own legislations that provide protections for minority shareholders. For example, the Canada Business Corporations Act provides several protections for minority shareholders. These include: the right to apply to the court for a remedy where a shareholder believes that the affairs of a company have been conducted in an oppressive or unfairly prejudicial manner; a shareholder can apply to the court for leave to bring an action on behalf of a company to remedy a wrong to the company (otherwise known as derivative action); a shareholder has the right to require a company to buy its shares for fair value where that shareholder dissents from a shareholder vote, approving certain fundamental corporate changes.[73] In Brazil, the Corporation Law provides a legal framework for protecting minority shareholders in listed corporations. It sets out five essential rights of minorities to include: (1) the right to receive dividends; (2) the right to participate in the sale of the corporation's assets upon liquidation; (3) the right to supervise the corporation's bodies; (4) the right of first refusal that arises upon the subscription of shares, founders shares convertible into shares, debentures convertible into shares and subscription bonuses; and (5) the right to withdraw from the corporation in specific instances set forth under the Corporations Law.[74]

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[71]ibid.
[72]ibid.
[73]Mohtadi, P. and Fox, S., 'Control and Minority Protection: Canada: International Joint Ventures' (2010) pp503-4161. Available at: www.practicallaw.com/9 .
[74]Salama, B.M. and Prado, V.M., 'Legal protection of minority shareholders of listed corporations in Brazil: brief history, legal structure and empirical evidence' (2011) Journal of Civil Law Studies, vol 4, no1, pp 147-185.

As the above review reveals, different countries seem to have specific legislation in place that provides protection for minority shareholders. In terms of analysis of Saudi context, the OECD principles of corporate governance will be used. Specifically, the analysis will focus on all five out of six OECD principles of corporate governance[75], which are specifically related to protection of rights of minority shareholders:

1) Ensuring the basis for an effective corporate governance framework

2) Rights of shareholders and key ownership functions

3) Equitable treatment of shareholders

4) Disclosure and transparency

5) Responsibilities of the board

1.3 The Dilemma of Minority Shareholders

Previous studies have shown that most companies in the world are dominated by controlling family members, which tentatively suggests that the conflict of interests between the minority and majority shareholders is inevitable.[76] The major concern is that controlling shareholders may use the company's profits to benefit themselves instead of returning the revenues to minority shareholders or outside shareholders.[77] In the celebrated English case of *Burland* v *Earle,* Lord Davey affirmed that most abuse of power takes place when "...the majority shareholders are endeavouring directly or indirectly to appropriate to themselves money, property or advantages which belong to the company or in which other shareholders are entitled to participate".[78]

According to Dari 'it is a well settled legal position that the rule of majority will prevail if the decision of the majority is in accordance with the provisions of the company law'.[79] For instance, in a famous case of Foss v Harbottle, the court refused to interfere in the management of the company at the instance when the minority shareholders were dissatisfied with the conduct of the company's affairs by its board of directors. The courts further

[75]OECD Principles of Corporate Governance (OECD), (2004). Available at: http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf.
[76]M. Santiago-Castro, 'Corporate Governance and Expropriation of Minority shareholders' rights: Evidence from Latin America', PhD Thesis, University of Texas-Pan American, UTPA (2005). Sarbanes- Oxley Act 2002, U.S. Congress.
[77]M.C. Jensen and W.H. Meckling, Theory of firm – managerial behavior, agency costs and ownership structure (1976) Journal of Financial Economics, vol 3, no 4, pp 305-360.
[78]Per Lord Davey: *Burland v Earle* (1902) AC 83.
[79]S. S. Dari, 'Majority rule and minority protection under companies Act 1956 with special reference to Foss vs. Harbottle' (2014) IJR, vol 1, no 9, p 1400.

clarified that if the company directors are supported by the majority shareholders in what they do, the minority shareholders, in general, can do nothing about it.[80] There are different ways in which rights of minorities can be violated, and these include investing in inefficient projects, awarding failed contracts by board members (as well as directors, who can direct cash and loans for their private benefits or to their relatives and friends, instead of returning and dividing it among the minority shareholders). Another example is directors or controlling shareholders selling the company's assets, or its production, to another firm they own at a price below the market value. In addition, the expropriation of the rights of minority shareholders may occur when the controlling shareholders appoint unqualified family members to sit on the company's management or the board of directors.

The weakness of judicial systems is a crucial factor that reinforces directors and controlling shareholders to oppress and abuse the rights of minority shareholders. For instance, the case of *Atwool v Merryweather* revealed that preventing minority shareholders from exercising their right against directors and controlling shareholders will always give the latter the opportunity to engage in transactions, which will always divert the firm's profits to their own interests. In the above case, the problem emerged when the two directors *Merryweather and Whitworth* conducted a secret deal by selling mines to the corporation. As a result, the court affirmed that "…the whole contract is a complete fraud".[81]

The evidence above suggests that issues regarding the protection of rights of minority shareholders in the security markets have been a subject of controversy and scholarly debate.[82] For instance, Bebchuk argued that a major issue facing minority shareholders is that they are unable to challenge the company directors.[83] He proffered a solution based on giving minority shareholders the power to change the company's charter and challenge the directors.[84] It has been argued that strengthening of shareholder's rights is a crucial element in reforming and stabilising the financial institutions. Therefore, shareholders should be empowered to use their shares to participate in the decision-making processes of the company.[85]

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[80]ibid.
[81]*Atwool v Merryweather* (1867) LR 5 EQ 464.
[82] L.A. Bebchuk, 'The Myth of Shareholder Franchise' (2007) Harvard Law School: Virginia Law Review, vol 93, pp 1-40; M. Lipton and W. Savitt, 'The Many Myths of Lucian Bebchuk' (2007) Virginia Law Review, vol 93, pp733-743; M.M. Siems, 'Shareholder protection around the world' (2007) Centre for Business Research, University of Cambridge Working Paper No. 359.
[83]L.A. Bebchuk, 'The Myth of Shareholder Franchise' (2007) Harvard Law School: Virginia Law Review, vol 93, pp 1-40.
[84]ibid.
[85]J. Velasco, 'Taking Shareholder Rights Seriously' (2007) University of California, Davis, vol 41, pp 605-681.

The failure of Enron Company has increased debate in US literature concerning corporate governance and has influenced legislation aimed at providing adequate protection of shareholders against the abuse of directors and controlling shareholders.[86] In the EU, the European Parliament has also endorsed and enacted the so-called *A Directive on Shareholder Rights,* which supported the position of shareholders in listed corporations, for instance, giving shareholders the right to use new media at the general meeting.[87]

Similarly, the OECD Principles of Corporate Governance affirmed that '…the corporate governance framework should protect and facilitate the exercise of shareholders' rights'.[88] These principles, which are used by some countries and international organisations, such as the IMF and the World Bank, are seen as a *panacea par excellence* for good corporate governance systems and strengthening the protection of rights of the minority shareholders. In Saudi Arabia, applying corporate governance principles in the listed corporations has increased dramatically, particularly in the wake of the economic crisis of 2006. Specifically, this awful financial crisis hit the Saudi stock market and made the price index plummet by approximately 13,000 points within one month (65% of its maximum level).[89] This resulted in heavy losses to many Saudi people, especially the minority shareholders, who are yet to recover their losses or obtain fair compensation following the collapse.

The collapse of the Saudi stock market in 2006 has been attributed to poor monitoring and supervision of the market, the weakness of transparency and disclosure requirements and the lack of adequate legal and judicial protection tools. Importantly, the core issue facing minority shareholders in the Saudi stock market is that the listed corporations have not complied fully with the provisions of the corporate governance rules.[90] Indeed, the Saudi stock market is suffering from an insufficient legal framework, a weak judicial enforcement

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[86]Enron Corporation was headquartered in Houston, US, and operated one of the biggest natural gas transmission networks in North America. It is deemed as the largest marketer of energy in the United States. The company reached the figure (7) on the Fortune 500 list in 2000 as *"Most Innovative"* in the United States listing for many years. Its bankruptcy occurred in December 2001 and became the largest breakdown in United States history. The name of Enron Corporation became synonymous with corporate greed and corruption over the world, and its collapse cost investors and employees more than $70 billion in lost capitalisation and retirement bonuses. Twenty-two Enron directors and partners were convicted of criminal charges for their roles in Enron's collapse. Arthur Andersen was found guilty of fraud; other Andersen partners were also personally convicted of crimes committed during their work at Enron Company. Whereas several Enron directors received probation, others received lengthy imprisonment terms, including CFO Andrew Fastow; accounting Chief Richard Causey; CEO of the trading unit, David Delainey; and Treasurer Ben Glisan. In addition, former Chairman Ken Lay and CEO Jeff Skilling were found guilty in May 2006. Skilling, guilty of nineteen counts of security and wire fraud, was sentenced over twenty-four years in federal prison and began serving his term in December 2006. Ken Lay died suddenly in July 2006 before sentencing, but lately in November 2006 Lay's conviction was voided. In 2006, the U.S Judiciary Authority declared plans to chase Lay's properties in civil court in an attempt to recover some of Enron's losses. For more insight visit: https://www.tshaonline.org/handbook/online/articles/doe08.

[87]The European Parliament and the Council on the exercise of certain rights of shareholders in listed companies (2005) /0265 (COD), Brussels, 1 June 2007.

[88]The OECD Principles of Corporate Governance of 2004, Principle No2.

[89]A.A. Al-Twaijry, 'Saudi Stock Market Historical View and Crisis Effect: Graphical and Statistical Analysis' (2007) Journal of Human Sciences, vol 34, pp 1-2.

[90]K. I. Falgi, 'Corporate Governance in Saudi Arabia: A stakeholder Perspective' (2009) PhD Thesis, University of Dundee, UK, p 295.

and the lack of accountability.[91] Previous studies have also shown that trading upon insider information is a common factor in the Saudi stock market and this threatens the market integrity.[92] In addition, the weakness of available information issued by the Capital Market Authority (CMA) or listed corporations, constitutes a great obstacle amongst shareholders and investors and it also reduces cash flow to the Saudi securities market.[93] In fact, the drawbacks above contributed largely to heightened fears among shareholders, as well as lack of confidence in the stock market.

1.4 Concept of Control and Controlling Shareholders

One key question facing practitioners and scholars of corporate governance is: Which shareholders should be classified as minority shareholders? For instance, in corporations that are widely diffused with absence or limited control, it might be that every shareholder is considered a minority shareholder. The listing rules of the London Stock Exchange used the term 'controlling shareholder' to describe one who determines the votes of 30% or more of the shares of the company.[94] According to Leech, the way of the distribution of the shares among different shareholders determines the power of each, particularly the controlling shareholder.[95] A large minority shareholder has control if the remaining shares are so widely distributed among a mass of small shareholders, that it is very likely that they will be able to determine the outcome of a vote.

Previous research has shown that controlling shareholders would be able to take advantage of the controlling power to infringe the rights of dispersed minority investors.[96] La Porta et al argued that the most important problem had been changed from one of agency, to how to constrain the majority shareholder from exploiting the interests of the minority shareholders.[97] In another study that examined the ownership structure of large companies in 27 countries around the world, La Porta et al concluded that, except in those countries whose legal protection of minority shareholders was already developed, such as the UK and the US,

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[91]ibid.
[92]M. Al-Abbas, 'Information in the Stock Market between Disclosure and Black Market' *Aleqtisadiah Newspaper* (10 November 2006). Available at: http://www.aleqt.com/2006/11/10/article-6944.html [Arabic edition]
[93]N.A. Azizan and Y.S. Mohamed, 'Predictability of the Saudi Arabian market'(2010) International Journal of Business Research, vol 10, no 2, p 108.
[94]London Stock Exchange, 'The Listing Rules' (The Yellow Book) (London, The Stock Exchange, 1993).
[95]D. Leech, 'Shareholder Voting Power and Ownership Control of Companies' (2002). Available at: http://www2.warwick.ac.uk/fac/soc/economics/research/workingpapers/2008/twerp564a.pdf.
[96]M. Pagano and A. Roell, 'The Choice of Stock Ownership Structure: Agency Costs, Monitoring, and the Decision to Go Public'(1998) 113 The Quarterly Journal of Economics, p 187; A. Shleifer and R.W. Vishny, 'A Survey of Corporate Governance' (1997) The Journal of Finance , vol 52, no 2, p 737.
[97]R. La Porta et al., 'Law and Finance' (1998) Journal of Political Economy 106, pp 1151-52.

in general there was a pyramidal ownership structure.[98] La Porta et al defined controlling shareholders as those who directly and indirectly hold 20% of voting rights in the firm. However, it should be noted that using percentages to conceptualise control has been previously challenged by Cubin and Leech.[99]

Cubin and Leech proposed taxonomy of different types of control: location of control and degree of control. In terms of location, they reasoned that control could either be inside or outside the management and they went further to divide external control into large individual shareholders and institutional shareholders. The degree of control however, is dependent on the location of control. They argued that internal controllers are expected to have a higher degree of control than other shareholders outside the internal management. Importantly, they posit that the degree of control is assessed based on the voting power exercised by a group of controlling shareholders. They went ahead to define a controlling shareholder as one who has a specified high degree of control and is able to control the direction of the firm.[100]

It has been shown that firms or companies that are stakeholder-oriented tend to adopt the insider model of corporate control as it recognises that the greatest control in a firm is held by those who were closest to its actual workings.[101] By contrast, those firms whose corporate governance is shareholder-oriented tend to adopt the outsider model of corporate control as it recognises the distance between the management of a firm and its owners.[102] This view is consistent with Berle and Means' assertions: that because of 'ownership dispersion, shareholders as a group are powerless because no individual among them could be said to have any appreciable voting power or control'.[103] Importantly, they argued that '…even a relatively large shareholder has little incentive to monitor the performance of the management, to take an interest in the direction of the firm or even to vote their shares because their ownership stake – small in percentage terms - gives them only a small entitlement to the returns accruing to their investment in those activities'.[104]

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[98]R. La Porta et al., 'Corporate Ownership around the World' (1999) The Journal of Finance, vol 54, no 2, pp 471-511.
[99]J. Cubbin and D. Leech, 'The effect of shareholding dispersion on the degree of control in British companies: Theory and Measurement' (1983) The Economic Journal, vol 93, no 370, pp 351-369.
[100]ibid.
[101]Department of the Treasury, 'Directors' Duties and Corporate Governance: facilitating innovation and protecting investors', Corporate Law Economic Reform Program Proposals for Reform, (1997), Paper No.3, Canberra: AGPS.
[102]ibid.
[103]M.S. Mizruchi, 'Berle and Means revisited: the governance and power of large U.S. corporations' (2001) Department of Sociology, University of Michigan, p 2. This paper was presented at the conference on Shareholder-Value, Capitalism and Globalisation, Bad Homburg, Germany, May 2001; D. Leech, 'Shareholder Voting Power and Ownership Control of Companies' (2002) pp 1-2. Available at: http://www2.warwick.ac.uk/fac/soc/economics/research/workingpapers/2008/twerp564a.pdf.
[104]D. Leech, 'Shareholder Voting Power and Ownership Control of Companies' (2002) pp 1-2. Available at: http://www2.warwick.ac.uk/fac/soc/economics/research/workingpapers/2008/twerp564a.pdf.

Fama and Jensen explained the concept of control from the perspective of corporate decision-making processes that include four steps: initiation, implementation, ramification and monitoring.[105] The managers have the power to initiate and implement, which they referred to as 'decision management', whereas the shareholders have the power to ratify and monitor decisions, which they referred to as 'decision control'.[106] They defined the concept of control as the power of an individual or group who is/are able to control the entire decision-making processes considerably within the corporation (initiation, ratification, implementation and monitoring).[107] Whereas the board of directors have the power to decide the direction of the firm, the control of the firm on the other hand, is the ability to select the board members, or influence the decision-making processes within the firm.[108]

Based on the above review, it appears that there is no general consensus amongst scholars regarding the meaning of control. Whereas some argued that control is determined based on specified threshold of voting powers, others however, assumed that control is determined by a substantial degree of control or influence over the management. In fact, the concept of control could be said to be relative, given variations in the dispersion of shareholders in different countries. For example, in the UK, where ownership of listed companies is widely dispersed, a shareholder with not less than 75% of the voting shares in a company is able to control the company.[109]

However, the reverse might be the case in a country where ownership is concentrated. A shareholder may have to hold at least 30% of the voting rights in the company to be able to influence the decision-making as is the case with Germany.[110] In the US, the Delaware Corporation Law interprets the concept of 'control' by stating that a shareholder who holds at least 20% of the stock can exercise control over the company.[111] Furthermore, in the UK, the controlling shareholders can be defined as 'shadow directors', which means a person who owns the power to direct and instruct the directors of the firm.[112] (Though, a shadow director may not be classified as a controlling shareholder, but in practice, among those who are

[105]E. F. Fama and M. C. Jensen, 'Separation of Ownership and Control' (1983) Journal of Law and Economics, vol 26, no 2, pp 301-325.
[106]ibid.
[107]ibid.
[108]E. F. Fama and M. C. Jensen, 'Separation of Ownership and Control' (1983) Journal of Law and Economics, vol 26 no 2, pp 301-325.
[109]Part (13) Chapter (1) Paragraph (283) of the UK Company Act of 2006.
[110]German Securities Acquisition and Takeover Act of 2001, Paragraph 29 *[Wertpapierewerbs-und Ubernahmegesetz].* German Stock Corporation Act of 2009, Paragraphs 15-22 *[Aktiengesetz].*
[111]Delaware General Corporation Law, Paragraph 203 (c) (4).
[112]Paragraph (c) (6) UK Companies Act 1985; Part (10) Chapter (9) Paragraph (251) UK Company Act of 2006.

shadow directors, some evidence suggest that many of them are shareholders holding a controlling block in their firms, and that they also own the same kind of influence on the board).[113]

In Saudi Arabia, the data on the ownership structure of listed firms is limited. However, it appears that the ownership structure of listed corporations is highly concentrated. According to the report of the World Bank, roughly 1/3 of the market's total capital is owned by the government and another 1/3 is owned by founding families.[114] Through the Corporate Governance Regulations, it is obvious that shareholders who hold not less than 5% of the equity share capital are entitled to participate and challenge the board agendas.[115] In the section that follows, the concentration of ownership and control in Saudi Arabia is provided, highlighting similarities and differences on the above definitions of control.

1.4.1 Concentration of Ownership and Control in Saudi Arabia

In Saudi Arabia, the volume of the concentrated ownership represents about 70% of shareholdings structure in the securities market.[116] Specifically, most listed corporations in the Saudi securities market are still working under the control of a relatively small network of prevalent Saudi families and business leaders.[117] In fact, the dominance of ownership concentration in the Saudi market can be attributed to a number of factors, which are mainly political and legal. Saudi Arabia as a country is characterised by absolute monarchy, and indeed, the nature of the political system has a large impact on the life of trade and the economy.[118]

According to the political perspective, the less democratic a State is, the weaker its minority shareholder protection and the more likely it is to have concentrated patterns of ownership.[119] From the perspective of the political economic theory, Gourevitch and Shinn argued that investor confidence is a function of political transparency and firm-level transparency.[120]

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[113]R. R. Penningtong, *Directors' Personal Liability* (BSP Professional Books 1987) 28.
[114]The World Bank, 'Report on the Observance of Standards and Codes (ROSC): Corporate governance country assessment Saudi Arabia, (2009) 1.
[115]Article (5-b-f) Corporate Governance Regulations of 2004.
[116]W. Al-Ajlan, 'Ownership Patterns and the Saudi Market' (2004) Advances in Financial Economics 9, pp 161-184; A.M. A. Eljelly, 'Ownership and Firm Performance: The Experience of Saudi Arabia's Emerging Economy' (2009) International Business & Economics Research Journal, vol 8, no 8, p 12.
[117]M. Al-Ghamdi, 'Family Ownership, Corporate Governance and Performance: Evidence from Saudi Arabia' (2015) International Journal of Economics and Finance, vol 7, no 2, p 85.
[118]P. Gourevitch and J. Shinn, *Political Power and Corporate Control: the New Global Politics of Corporate Governance* (Princeton University Press, Princeton 2007) pp 80-81. It is quoted from F. Almajid, *A Conceptual Framework of Reforming the Corporate Governance of Saudi Publicly Held Companies: Comparative and Analytical Study from a Legal Perspective* (School of Law, University of Manchester 2008) 208.
[119]ibid.
[120]ibid.

Indeed, it is not a surprise to see a high concentration of shares in the hands of few powerful individuals, particularly in the developing countries. These individuals, especially small wealthy families, own a large percentage of stocks, not just in one company, but in several listed corporations in the stock market. Such a tendency is a ubiquitous phenomenon in the Saudi stock market, characterised by high ownership of shares by wealthy families, who thus control the market in ways that are detrimental to the minority shareholders. Previous research has earlier shown that concentrated ownership structure empowers the controlling shareholders to expropriate minority shareholders' rights.[121]

The high concentration of ownership in Saudi Arabia is also explained from a legal point of view. According to the laws matter theory, the legal origin of a country has a strong influence in shaping the ownership structure of companies as well as the design of shareholder protection.[122] According to this theory, countries with a background in common law offer good shareholder protection compared to those with civil law.[123] In their major study *Law and Finance*, La Porta et al concluded that the environments favourable to shareholders are provided by common law countries, characterised by a dispersed ownership structure.[124] Specifically, the theory stresses an index regarding shareholder protection. In order to comply with certain *ex-ante* determined criteria, points are assigned to the legal system of a country.[125] The criteria used for the judgement of the shareholder protection are outlined below. Thus, if the legal system fails to comply with these criteria, zero points are assigned. Scoring more points means better shareholder protection.[126] According to Cools, these criteria serve as a standard reference in comparative corporate and financial law[127] and they include:

- One share – one vote
- Proxy by mail allowed
- Shares not blocked before meeting
- Cumulative voting/proportional representation
- Oppressed minority

[121]R. La Porta et al., 'Investor protection and corporate governance' (2000) Journal of Financial Economics, vol 58, pp 3-27.
[122]R. La Porta et al., 'Law and Finance' (1998) Journal of Political Economy, vol 106, pp 1151-1152.
[123]T. Nenova, 'The value of corporate voting rights and control: A cross-country analysis' (2003) Journal of Financial Economics vol 68, pp 325-351.
[124]R. La Porta et al., 'Law and Finance' (1998) Journal of Political Economy, vol 106, pp 1151-1152.
[125]U.C. Braendle, Shareholder Protection in the USA and Germany, 'Law and Finance' Revisited (2005) German Law Journal, vol 7, no 3.
[126]ibid. p 261.
[127]S. Cools, 'the Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers' (2004) *Harvard Law and Economics*. Discussion Paper No. 490.

- Pre-emptive right to new issues
- The percentage of share capital to call an extraordinary shareholder meeting has to be less or equal to 10% of the votes.[128]

The analysis below reveals that ownership structure in Saudi Arabia is concentrated in the hands of the State and rich wealthy individuals. There are three main types of corporations that are recognised in terms of their ownership structure. These include: (1) State-controlled companies, (2) family-controlled companies and (3) publicly-owned companies. However, for the sake of analysis, only State-controlled and family-controlled corporations will be considered in this thesis. This is necessary in order to understand how ownership of shares is largely controlled by the State and in particular, wealthy families who hold huge shares in listed firms.

1.4.1.1 State-Controlled Corporations

According to the OECD, the State-owned enterprises (SOEs) constitute an integral feature of almost all economies in the Middle East and North African (MENA) region.[129] The rationale behind this can be seen from the post-World War II development economists, who argued that the State needs to take a leading role in capital accumulation and infrastructural investment as only the government can provide sufficient scale and capital to compete internationally and 'catch up' with advanced countries.[130] Following the introduction of the Capital Market Authority (CMA) in 2003, the involvement of State corporations in the Saudi Stock market has been very significant, and indeed, influential.[131] This is reflected in huge investment in three large national funds, managed by its various agencies, which include:[132] the Public Investment Fund (PIF), General Organisation for Social Insurance and the Public Pensions Fund. For example, the Public Investment Fund, as part of the Ministry of Finance, has the mandate to invest in commercial projects that are wholly owned or partially State-owned, either alone or in partnership with other government agencies.[133]

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[128]ibid.
[129]OECD, 'State-Owned Enterprises in the Middle East and North Africa: Engines of Development and Competitiveness?' (2013) OECD Publishing. It is available at: http://dx.doi.org/10.1787/9789264202979-en.
[130]ibid.
[131]F. M.Almajid, 'A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective', A PhD Thesis, (The Faculty of Humanities, University of Manchester, 2008) 212.
[132]ibid.
[133]A. Amico, 'Priorities for improving governance and performance of state-owned enterprises in the Middle East and North Africa', in OECD, *Towards New Arrangements for State Ownership in the Middle East and North Africa*, (OECD Publishing 2012). Available at: http://dx.doi.org/10.1787/9789264169111-3-en.

The official statistics revealed that the State owns 8.8 billion shares with a market capitalisation of 584.7 billion riyals.[134] As in 2013, the statistics showed that the total stock market capitalisation reached SR1.75 trillion ($467.43 billion), increasing by 25.17% compared to the year 2012.[135] By implication, this suggests that the Saudi government is perhaps the largest shareholder, with an ownership of almost 44% of shares.[136] In the State corporations, the chairman and CEO of companies are appointed by the government. The government is also responsible for the hiring and firing of senior management, differing from countries where such responsibility is vested on shareholders or committees aligned with the board. Importantly, the strong engagement of the Saudi government in the stock market suggests that it is not only a major shareholder through its investments, but that it also has a strong managerial position. In other words, it performs two separate roles with unrestricted powers.[137] Indeed, if the government controls the ownership structure of a company, then very little is left for other shareholders, regardless of their size, or to other board members who are not appointed by the government. Furthermore, board members not elected by the government cannot challenge managerial decisions made by the government representatives, especially if such decisions have a negative impact on the company. This in essence seems to work against the guidelines provided by the OECD on corporate governance of State-owned enterprises. The guidelines provide that: 'the boards of State-owned enterprises should have the necessary authority, competencies and objectivity to carry out their function of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions'.[138]

There are benefits to shareholders due to States' presence in the boardrooms. For instance, State-owned companies are well managed, financed, resourced, and above all, the most profitable in the Saudi Stock market and most of these companies provide utilities such as electricity, whilst some invest in the petrochemical industry. Indeed, shareholders' confidence in those companies is high because they believe that it is much safer to invest in companies where the government has a high stake and controlling power than in other companies. Examples of companies that fall into this category are the Saudi Arabia Basic Industries Corporation (SABIC) in the petroleum sector, where the government owns 70% of

[134]F. M.Almajid, 'A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective, A PhD Thesis (The Faculty of Humanities, University of Manchester 2008) 212.
[135]Arab news, 'Saudi share market capitalization reached SR1.75 trillion' (29 April 2015). Available at: http://www.arabnews.com/news/502176,
[136]Tadawul. 'Statistical Report – First Nine Months 2008, in, Saudi Stock Exchange, Riyadh Bank, p 25.
[137]*Alriyadh Newspaper* (Edition 14527, 02.04.2008).
[138]OECD, 'OECD Guidelines on Corporate Governance of State-owned Enterprises' (ISBN 92-64-00942-6 – © OECD 2005).

its shares and the Saudi Telecom Company (STC).[139] As the largest listed company in the Saudi Arabia Stock Exchange (Tadawul), SABIC came into being in 1976 through a royal decree and was developed and staffed by a small number of young administrators and engineers who had been recruited selectively by the country's then Crown Prince and later King Fahd.[140] SABIC became the main agent of heavy industrialisation in Saudi Arabia, taking the responsibility for petrochemicals, as well as steel and fertiliser projects, away from the General Organisation of Petroleum and Minerals.[141] Furthermore, investors are more likely to invest in State-controlled companies because the risk of the latter going bankrupt is low.[142] Besides, the State invests in companies rated highly on credibility and transparency and such companies are likely to diversify their investments, which in turn reassures shareholders or investors. Indeed, a recent study by Yu revealed that a higher level of State ownership is superior to a dispersed ownership structure, due to the benefits of government support and political connections.[143]

1.4.1.2 Family-Controlled Corporations

Family firms represent the backbone for businesses throughout the world. According to Cadbury, the economic and social importance of family enterprises has recently been widely recognised.[144] From the global perspective, they are the dominant form of business organisation and represent the backbone of the global economy.[145] Indeed, as Stamm and Lubinski argued, the collapse of family firms could have an impact on the national economy.[146] Family businesses thrive mainly in countries whose legal systems are founded based on civil law. According to La Porta et al, one key feature of countries with the insider system, which most developing countries are liable to is that its rich families are inclined to own substantial shareholdings in different companies listed in the stock market.[147] This description defines the situation in the Saudi Kingdom, whereby rich families (because of their size) play a crucial role in the economy and invest in so many large companies. Indeed,

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[139]F. M.Almajid, 'A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective', A PhD Thesis (The Faculty of Humanities, University of Manchester 2008)214.
[140]OECD, 'State-Owned Enterprises in the Middle East and North Africa: Engines of Development and Competitiveness?' (OECD Publishing 2013). Available at: http://dx.doi.org/10.1787/9789264202979-en.
[141]ibid.
[142]M. Burkart and S. Lee, 'The One Share - One Vote Debate: A Theoretical Perspective' (SSRN) p 34; Awwad (n 557) 151-52.
[143]M. Yu, 'State ownership and firm performance: Empirical evidence from Chinese listed companies' (2013) China Journal of Accounting Research 6, pp 75–87.
[144]A. Cadbury, 'Family firms and their governance: Creating tomorrow's company from todays' (2000) Egon Zehnder International pp 2-35.
[145]J.C. Casillas et al, 'Internationalization of family businesses: A theoretical model based on international entrepreneurship perspective' (2010) Global Management Journal, vol 2, no 2, pp 16-33. Available at: http://globalmj.eu/
[146]I. Stamm and C. Lubinski, 'Crossroads of family business research and firm demography—A critical assessment of family business survival rates' (2011) Journal of Family Business Strategy 2, pp 117-127. doi:10.1016/j.jfbs.2011.07.002.
[147]R. La Porta et al., 'Law and Finance' (1998) Journal of Political Economy 106, pp 1151-52.

Saudi family firms dominate most of the firms that operate in the Saudi economy.[148] With close ties with the members of the royal families through partnerships and joint ventures, their influence in the stock market is further strengthened.[149] Besides, many companies listed in the stock market were originally controlled by Saudi families, who as a result wield strong control in the boardrooms and high managerial positions.

For instance, companies such as banks, petrochemicals, agriculture, energy, cement, telecoms and transport have a heavy presence of Saudi families. Specifically, two Saudi families control 2 out of 11 local banks in Saudi Arabia.[150] In 4 other banks, a high proportion of the ownership (about 15% of shares) is held by rich Saudi families.[151] The majority of companies listed in the stock market are mainly owned by a single family. For example, the Al-Drees, Al-Othaim, Al-Zamil, Al-Babtain, Al-Abdullatif, Al-Hokair companies and several others have ownership that exceeds 40% of total shareholdings.[152]

The evidence above reflects the size of family ownership in the listed companies in Saudi Arabia, which in turn explains how widely family-controlled firms make up companies listed in the stock market. Indeed, with the amount of shares controlled by these families, they are able to increase their wealth and wield influence over other companies. Interestingly, board composition in most of these companies is occupied and controlled by family members, such as the Al Rajhi Bank, which has members of the same family on the board including the firm's CEO.

1.4.1.3 Public-Controlled Corporations

The review of State and family-controlled corporations above suggests that in the Kingdom of Saudi Arabia, corporate sectors are dominated by few State-owned enterprises and family-held private businesses. Furthermore, the board of directors in those corporations are mostly government officials and/or members of the royal family. For instance, the SABIC has a royal family member as Chairman of the board. The two private sector representatives and the rest are government officials.[153] The Saudi Aramco reports to its owner (the Saudi Arabian Government) through the Supreme Council for Petroleum and Minerals Affairs,

[148]Saudi Arabian General Investment Authority (SAGIA). Available at: https://www.sagia.gov.sa/.
[149]M. Field, 'The Merchants: The Big Business Families of Saudi Arabia and the Gulf States' (The Overlook Press, New York, 1985),.
[150]Al Rajhi family owns about 44% of Al Rajhi Bank and Al-Subai"e and Al Rajhi hold about 36% of Albilad Bank shares. Available at: Tadawul website.http://www.tadawul.com.sa.
[151]Al-Rashid family hold about 22.2% of shares of Bank Al-Jazira. Al-Olayan family owns almost 20.60% of shares of Hollandi Bank, and about 17% of SAAB Bank either. Available at: Tadawul website.http://www.tadawul.com.sa.
[152]Tadawul website. http://www.tadawul.com.sa.
[153]Ownership Structures in MENA Countries: Listed Companies, State-Owned, Family Enterprises and Some Policy Implications. Available at: http://www.oecd.org/mena/investment/35402110.pdf.

chaired by the custodian of the two holy mosques. The Supreme Council for Petroleum and Minerals Affairs sets the company's policy and objectives and its members are drawn from the government and the private sector.[154] According to Almajid, the introduction of the CMA to the stock market has encouraged public participation in stock trading, which occurs in response to many IPOs launched, following a takeover by the CMA in regulating the stock market.[155] However, compared to other MENA countries, the channels in which individuals can invest their wealth in Saudi Arabia are limited.[156] Importantly, those who cannot invest in the real estate market tend to revert to the stock market as a viable resource for wealth. Specifically, this applies to the years 2004 and 2005, when the market share index increased dramatically with 120% of annual growth in 2005.[157]

According to Almajid,

> Tempted by the spectacular increases in the share values of many companies, Saudis of all classes entered the stock market almost blindly and without sufficient experience, in the hope of quickly making large financial gains. To do this, they initially bought shares in all companies, regardless of financial stance or reputation.[158]

Evidence suggests that such investors were only speculators, who did not pay much attention to the companies in which they invested, how they were managed, what plans they had, or whether they were profitable in the first place.[159] In fact, it is examples such as this that led a high profile German banker, Carl Fuerstenberg to say that "Shareholders are stupid and impertinent: stupid, because they buy shares, and impertinent, because they demand a return".[160]

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[154]ibid.
[155]F. M.Almajid, 'A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective', A PhD Thesis, (The Faculty of Humanities, University of Manchester, 2008).
[156]ibid.
[157]ibid.
[158]Ibid. p.19.
[159] ibid
[160]T. Baums and K. Scott, 'Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany' (2005), 53 AM. J. COMP. L. 31.

1.5 Research Objectives and Questions

The previous section provided an overview of corporate governance including the events that led to the establishment of corporate governance legislations (Chapter 1.1), protection of minority shareholders (Chapter 1.2), ownership structure and control in Saudi Arabia (Chapter 1.4.1) and dilemma of minority shareholders (Chapter 1.3). Based on the reviewed literature, a number of research questions are put forward to guide the analysis provided in the rest of this thesis. Specifically, evidence from the literature suggests that corporate fraud is associated with weak corporate governance and can undermine the trust and confidence of investors in the stock market.[161] This in turn, suggests that effective corporate governance can perhaps enhance the protection of the rights of minority shareholders. Previous research has also shown that countries that are characterised by a low level of legal protection of rights of minority shareholders also have a high level of concentration of ownership and control, and vice versa. According to the OECD principles of corporate governance, 'minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress. Abusive self-dealing should be prohibited'.[162]

Indeed, as noted in the OECD document, the confidence of minority investors is enhanced when the legal system provides mechanisms for minority shareholders to bring lawsuits when they have reasonable grounds to believe that their rights have been violated. Although the principles are not binding, they are seen as a reference point to guide policy makers as they examine and develop their own economic, social, legal and cultural circumstances. Similarly, the OECD principle also state that 'effective corporate governance requires a sound legal, regulatory and institutional framework that market participants can rely on when they establish their private contractual relations'.[163]

In other words, for effective corporate governance to safeguard the rights of minority shareholders, a sound and effective legal system needs to be in place. However, the extent that the OECD principles can be applied effectively in the Saudi stock market operations, however, remains to be determined. Indeed, previous research suggests that the practice of

[161]D.B. Farber, 'Restoring Trust after Fraud: Does Corporate Governance Matter?' (2005) Accounting Review 80, pp 539-561.
[162]OECD, OECD Principles of Corporate Governance of 2004.
[163]ibid.

corporate governance is growing rapidly and increasingly in developing countries.[164] This in turn, suggests that developing countries are closing the gap they have, in terms of corporate governance with developed countries.[165]

According to the OECD reports on MENA countries, 'State-owned enterprises (SOEs) are an important feature of the economic landscape in the MENA region and yet, their contribution to the local economies has not been subjected to a systematic investigation'.[166] Furthermore, a study that looked at the ownership structures in MENA countries showed that as far as the board of directors of some of the largest companies in the MENA region is concerned, they are mostly government officials and/or royal family members.[167] Specifically, the study found that the Saudi corporate sectors are dominated by few State-owned enterprises and family-held private businesses.[168] Corporate governance is seen as the critical enabling factor for the development of family-owned businesses.[169]

Therefore, it is necessary to understand how corporate governance mechanisms influence the protection of minority shareholders in Saudi Arabian listed firms. Specifically, the thesis seeks to: 1) compare corporate governance mechanisms in Saudi Arabia and the UK and their influence on protecting the rights of minority shareholders; 2) it also examines whether Saudi Arabian and UK firms differ in share ownership structures; and 3) how these differences can explain how minority shareholders are treated in those countries. The board of directors are seen as a hallmark of effective corporate governance, which acts as a bridge between the company and the owners.[170] Therefore, it is necessary to understand: 4) the role of the board of directors in Saudi Arabia and the UK and their impact on the protection of minority shareholders. The four objectives lead to the following research questions:

(a) How does the current practice of corporate governance in the Saudi stock market reflect an adequate protection of minority shareholders' rights?
(b) What are the major differences and similarities between Saudi Arabia and the UK concerning the protection of minority shareholders' rights?

[164]A. Ananchotikul and B. Eichengreen, 'Corporate Governance Reform in Emerging Markets: How Much, Why, and with What Effects?'(2009) Journal of Japanese International Economies, vol 23, no 2, pp 149-176.
[165]I. Aytekin, M. Miles, and S. Esen, 'Corporate governance: A comparative study of practices in Turkey and Canada' (2013) IUP Journal of Corporate Governance, vol 12, no 2, p 8.
[166]OECD, 'State-Owned Enterprises in the Middle East and North Africa: Engines of Development and Competitiveness?' (OECD Publishing 2013). Available at: http://dx.doi.org/10.1787/9789264202979-en.
[167]'Ownership Structures in MENA Countries: Listed Companies, State-Owned, Family Enterprises and Some Policy Implications'. Available at: http://www.oecd.org/mena/investment/35402110.pdf.
[168]ibid.
[169]Corporate governance is the key GCC Family Business Groups need to unlock full potential. Available at: https://www.pedersenandpartners.com/news/2014/17062014-0912/corporate-governance-key-gcc-family-business-groups-need-unlock-full.
[170]ibid.

Taking the above questions into account, the thesis predicts that:

Proposition 1: A strong corporate governance culture and shareholder protection mechanisms would safeguard the rights of minority shareholders.

Furthermore, the thesis seeks to explore: 5) how the Saudi Arabia and UK legal systems mediate the relationship between corporate governance and protection of rights of minority shareholders. In other words,

(c) What is the role of Saudi Arabian laws and regulations in protecting the rights of minority shareholder?

Taking question (c) into account, the following predictions are made:

Proposition 2: When a strong legal system exists, a greater level of minority shareholders protection is expected by the listed firms.

Proposition 3: When a weak legal system exists, a lower level of minority shareholders protection is expected by the listed firms.

Specifically, a legal system is considered to be strong when there are adequate enforcement mechanisms to deal with violators of security market laws and regulations. By contrast, a weak legal system exists when there is an absence of or inadequate enforcement mechanisms to deal with violators of provisions of security market laws and regulations. All the above key questions will be covered through Chapters 2 to 5 of this thesis. These chapters will focus on a review of definitions and theories of corporate governance, the development of corporate governance in Saudi Arabia, a review of relevant legal structures to corporate governance and protection of minority shareholders rights in the Saudi stock market and mechanisms of protecting minority shareholders in the UK and Saudi Arabia.

1.6 Importance of the Research

Modern corporations need sound legal solutions to resolve their challenges. Thus, good corporate governance practice has become a fundamental prerequisite for long-term success and growth of corporations. It offers a better chance to access external capital and different economic resources and attract foreign cash flow, whilst also increasing investors' confidence. This view was supported by the 3rd meeting of the Eurasian Corporate

Governance Roundtable, which emphasised that 'the continuing need for attracting the equity capital to finance corporate growth is one of the key incentives to enhance shareholders treatment and corporate governance practice in general'.[171]

However, the major problem facing the development of corporate governance, particularly in developing countries including Saudi Arabia, is the dearth of research available to explain the significance of corporate governance regulations in supporting and improving the investment climate, as well as the confidence of investors in the stock market. Moreover, minority shareholders are considered a significant tool in any stock market and thus providing sufficient protection for them will enhance the reputation of the stock market in general and increase the confidence that investors have in this market. To my knowledge, this research is the first to examine the influence of corporate governance on the protection of minority shareholders' rights in Saudi Arabia. In fact, this research is the first academic initiative in the field of analysing the corporate governance laws and regulations in the Saudi stock market, taking into account the impact of the recent regulations on improving the confidence of investors in the Saudi stock market and reinforcing the financial stability in Saudi Arabia. This novel research also compares the characteristics and drawbacks of the Saudi Arabian and the UK corporate governance systems, which in turn, can serve as a tool for reforming the Saudi stock market and perhaps the market in the Arabic Gulf States.

1.7 Research Methodology

In legal studies, it is broadly known that the use of a comparative study plays a fundamental role in developing and improving the reformation of laws and legislations in any country. According to Mantysaari, choosing the jurisdictions to be compared is vital because the work of a comparative lawyer is only meaningful if the choice of jurisdiction is meaningful.[172] A comparative study is a significant tool used to facilitate legislative reforms and has also been shown to offer solutions for legal amendments.[173] According to Zweigert and Kotz, comparative law not only aims to criticise existing rules but also to make law in general more efficient and indicative of the best ways to enhance the effectiveness of existing rules, as well as formulating entirely new ones.[174] Aguilera and Jackson define comparative corporate governance as the study of relationships between parties with a stake in the firm and how

[171]OECD, '3rd Meeting of the Eurasian Corporate Governance Roundtable', *Shareholders Rights, Equitable Treatment and the Role of the State* (April 2002).
[172]P. Mantysaari, 'Comparative corporate governance: Shareholder as a rule-maker' (Berlin-Heidelberg: Springer 2005) 10.
[173]J. Hill, 'Comparative Law, Law Reform and Legal Theory' (1989) Oxford Journal of Legal Studies, issue 9, p 102; H. Xanthaki, 'Legal transplants in legislation: Defusing the Trap' (2008) International and Comparative Law Quarterly, pp 659, 660.
[174]K. Zweigert and H. Kotz, *An Introduction to Comparative Law*. (Oxford University Press, Oxford 1998) 34.

their influence on strategic corporate decision-making is shaped by institutions in different countries.[175] Specifically, it deals with the diversity across countries and over time and focuses on explaining similarities and differences among cases in a systematic fashion.[176]

By using a comparative approach, the regulator can use other legal systems styles and tackle common problems.[177]According to Maine: 'it would, however, be universally admitted by competent jurists, that, if not the only function, the chief function of Comparative Jurisprudence is to facilitate legislation and the practical improvement of law'.[178] Hill concluded in his study by affirming that comparative law can demonstrate the relationship between law, political and moral values clearly, more than the study of a single legal system. Besides this, a comparative method can help to 'demonstrate the extent to which the form and substance of any legal system are not 'natural', but result from the implementation of moral and political values'.[179]

Scholars who adopt this method have sought to address a number of distinct questions, such as: How is corporate governance practised in different countries? Why are corporate governance practices similar or different across countries? Is it possible to identify international best practices of corporate governance, or do clear economic, social, and political trade-offs exist between different corporate governance systems? To what extent may practices be borrowed or adapted across international contexts?[180] The comparative method has been adapted in previous studies of corporate governance.[181]

Corporate governance systems vary across countries around the world, reflecting variations in cultural, legal, social and economic environments in which companies operate, although, there is some element of convergence between countries.[182] With this in mind, the present thesis seeks to compare the influence of corporate governance in protecting the rights of

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[175]R.V. Aguilera and G. Jackson, 'Comparative and international corporate governance', The Academy of Management Annals, (2010), vol 4, no 1, pp. 485-556, DOI: 10.1080/19416520.2010.495525.
[176]ibid.
[177]ibid.
[178]Villagt Comnaoatus in Ou East and Wta 2nd edn (1872) 4. This reference is cited from Jonathan Hill, 'Comparative Law, Law Reform and Legal Theory' (1989) Oxford Journal of Legal Studies, vol 9, p 102.
[179]Jonathan Hill, 'Comparative Law, Law Reform and Legal Theory' (1989), Oxford Journal of Legal Studies, vol 9, pp 113-115.
[180]ibid.
[181]O. Bordean and Z.C. Pop, 'A Comparative Study of Corporate Governance Issues: The Case of Germany and Romania' (2012) IUP Journal of Corporate Governance, pp 20-35; G.F. Maassen, 'An international comparison of corporate governance models: A study on the formal independence and convergence of one-tier and two-tier corporate boards of directors in the United States of America, the United Kingdom and the Netherlands' (3rd ed., Netherlands 2002); Spencer Stuart. J. Schneider and S.Y. Chan, 'A Comparison of Corporate Governance Systems in Four Countries', *BRC Working Papers, Hong Kong Baptist University* (2011); R.V. Aguilera and G. Jackson, 'Comparative and international corporate governance. The Academy of Management Annals' (2010), 4:1, pp. 485-556, DOI: 10.1080/19416520.2010.495525.
[182]J. Schneider and S.Y. Chan, 'A comparison of corporate governance systems in four countries'. (2001) Hong Kong: Business Research Centre.

minority shareholders in Saudi and UK listed firms. There are several rationales for choosing the UK as a benchmark to measure the influence of corporate governance on minority shareholder's protection in Saudi Arabia.

Firstly, the UK is among the few countries with good corporate governance practices in the world. Indeed, as Maseko suggests, 'adopting international best practices in financial reporting and disclosure is crucial for ensuring transparency and thus effective corporate governance in all markets'.[183] La Porta et al, Nenova and Yu asserted that the rights of minority shareholders in the UK are well-protected by a well-developed legal system, menegarial labour market and active takeover market.[184] Grant and Kirchmair confirmed that the UK system provides stronger protection of shareholders' rights. Thus, it might act as drivers of widely-held companies' structures.[185]

Secondly, despite the fact that Saudi Arabia is an independent country with political and legal sovereignty, it has adopted a number of Western legal concepts into the Saudi legal system, especially in commercial, financial and administrative laws.[186] According to Berkowitz et al., for practical implementation, legal policies and rules can perhaps be borrowed from a jurisdiction with a similar legal heritage so that domestic legal agents will be familiar with the imported laws.[187] In keeping with this assertion, it is necessary to understand how the UK corporate governance model can be used as a reformative approach for Saudi Arabian corporate governance practice. Indeed, as Schneider and Chan suggest, this understanding is helpful for policy makers to evaluate the advantages and disadvantages of implementing a particular philosophy in their corporation laws and adopting a particular board model.[188]

Thirdly, it is important to acknowledge that the reader does not understand or read the Arabic language. Therefore, if the researcher wants to explain Saudi law to the English speakers so much would be lost in translation and many concepts that English speakers would take for

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[183]N. Maseko, 'A review of factors shaping corporate governance practices in different countries'. DBA Working Papers (March, 2015) .5.
[184]R. La Porta et al., 'Investor Protection and Corporate Valuation (2002) Journal of Finance, vol LV11, no 3, pp 1147-1170. T. Nenova, 'The value of corporate voting rights and control: A cross-country analysis' (2003) Journal of Financial Economics, vol. 68, pp 325-351. Yu, M., 'State ownership and firm performance: Empirical evidence from Chinese listed companies' (2013) China Journal of Accounting Research 6, pp 75–87.
[185]Jeremy Grant and Thomas Kirchmaier., 'Corporate Ownership Structure and Performance in Europe' (2004) CEP Discussion Paper No 631, Center for Economic Performance, p 16.
[186]Fahad, M. Almajid., 'A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective', A PhD Thesis, (The Faculty of Humanities, University of Manchester, 2008) 208.
[187]D. Berkowitz, K. Pistor, and J. Richard, 'Economic development, legality and the transplant effect' (2003) European Economic Review 165.
[188]J. Schneider and S.Y. Chan, 'A Comparison of Corporate Governance Systems in Four Countries'. BRC Working Papers (Hong Kong Baptist University 2001).

granted would not be translatable from Arabic to English. Consequently, in order to avoid this risk of mistranslation and misunderstanding, this research has included a brief review and analysis of corporate governance mechanisms and the relevant shareholders' laws and regulations under the UK legal system. This approach is necessary in that it will offer a foundation for a comparative understanding of laws and certain technical terms that are common to both jurisdictions. In addition, although the review of UK law is brief, it provides a theoretical basis for comparing mechanisms of shareholders' protection including relevant legal structures in both the UK and Saudi Arabia.

Furthermore, the structures of Saudi firms reflect concentrated ownership, which is in the hands of rich families and the State. By contrast, ownership structure in the UK is entirely different. It is characterised by separation between ownership and management. In terms of the board system, both the UK and Saudi Arabia share a similar board structure. Both jurisdictions adopt a one-tier board, otherwise known as the unitary system, which is different to a two-tier board system, common in some European countries (such as Germany). The two-tier board system assigns the monitoring and executive functions of the company to two independent boards: the supervisory board and the management board.[189] The unitary system on the other hand, combines the two functions and assigns all the duties to one board.

Although the comparative approach has been adopted in many studies of corporate governance, it is not without limitations. For instance, Ungureanu argued that no model of governance is perfect and even better than the other.[190] Their existence over time shows that each one is effective in its own way and corporate governance structure specific to a country is difficult to transfer to another country. According to Hill, one of the disadvantages of comparative law is the use of the data in order to substantiate a precedent thesis.[191] This problem can be exacerbated by the fact that the legal tool, which the comparative method provides, is usually diverse and flexible.[192] Thus, it has been suggested that choosing the comparative style is to a large extent dependent on the end of the comparative method.[193]

Similarly, concerns have also been raised regarding the benefits of legal transplantation, which Kyselova defined as the movement of law from one legal tradition to another, by a

[189]OECD Principles of Corporate Governance of 2004, Principle no VI-D-3.
[190]M. Ungureanu, 'Models and practices of corporate governance worldwide'. *CES Working Papers* (2012) 625-635.
[191]J. Hill, 'Comparative Law, Law Reform and Legal Theory' (1989) Oxford Journal of Legal Studies vol 9, p 107.
[192]ibid.
[193]F. F. Stone, 'The End to be Served by Comparative Law' (1951) 25 Tuhnu Law Review, pp 325-333.

conscious process of law-making or legal reform.[194] Some scholars argue for the necessity of a legal transplant, in that it will help to improve local laws and regulations. For instance, Watson assumed that 'transplanting is, in fact, the most fertile source of development. Most changes in most systems are the result of borrowing'.[195] Indeed, as Mousourakis states, 'at a time when our world society is increasingly mobile and legal life is internationalized, the role of comparative law is gaining importance'.[196]

There are diverse views amongst scholars regarding the term 'legal transplantation'. One view believes that legal transplantation is often mentioned to absorptive process of foreign law, including the legal concepts, norms, principles, systems and article, and the legal idea.[197] According to Erlandsen, legal transplantation is a transition of a legal system from one country to another country, or from one family to another family.[198] Legal transplantation is a mutual process, involving implantation of the law and explanation of the law.[199] Explanation of the law means that legal articles, rules and principles are migrated from country to another country, but implantation of the law means that legal norms and principles are output to other nations.[200] It has been argued that legal transplantation chiefly relies on the needs of the construction of domestic legislations. Therefore, a lack of legal culture and legislative experience may contribute to the introduction of a foreign legal system to improve the domestic laws and regulations.[201] For millennia, laws and regulations around the world have improved through legal transplantation.[202]

Nonetheless, others have challenged this assumption. For instance, Ewald and Legrand argued that transplantation of law is not possible at all because every law is culturally determined.[203] Legrand went further to state that 'no form of words purporting to be a "rule" can be completely devoid of semantic content, for no rule can be without meaning'.[204] As a corollary, since the meaning of law in different cultures can never be the same 'meaning

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[194]T. Kyselova, 'The concept of legal transplant: Literature review draft' (2008). Available at: http://www.academia.edu/3371274/The_Concept_of_Legal_Transplant_Literature_Review_DRAFT.
[195]A. Waston, 'Legal transplants: An approach to comparative law' (2nd ed, 1993).
[196]G. Mousourakis, 'Transplanting legal models across culturally diverse societies: A comparative law perspective' (2010) Osaka University Law Review, vol 57, pp 88.
[197]Jianzhong Dai., 'On Several Problems in Legal Transplantation' (2009) Journal of Politics and Law, vol 2, no 3, p 107.
[198]Alan Wosen. 'On legal transplantation, Study of Comparative Law' (1989) (1): 54. Cited from Jianzhong Dai, 'On Several Problems in Legal Transplantation' (2009) Journal of Politics and Law, vol 2, no 3, p 107.
[199]Jianzhong Dai., 'On Several Problems in Legal Transplantation'(2009) Journal of Politics and Law, vol 2, no 3, p 107.
[200]ibid.
[201]ibid.
[202]Ellen Goodman, 'The Origins of the Western Legal Tradition' (Federation Press, Sydney 1995)131-36.
[203]William Ewald , 'What was it Like to Try a Rat? (1889) 143 University of Pennsylvania Law Review; Pierre Legrand, 'Comparative Legal Studies and Commitment to Theory'(1995) 58 Modern Law Review, p 262.
[204]Pierre Legrand, 'Comparative Legal Studies and Commitment to Theory' (1995) 58 Modern Law Review, p 262.

cannot survive the journey'[205] and transplantation as such, is impossible. This is because, as it crosses borders, the original rule undergoes a change that affects it *qua* rule.[206] Others have also argued that even when the borrowed rule remains unaltered, its impact in the new socio-cultural setting may be entirely different.[207]

Despite the above criticisms, the success of legal transplantation has been observed in several developing countries. Previous studies have mentioned that legal implantation is a significant approach that enriches legal culture and improves the domestic laws.[208] As a result, many examples have revealed that some countries have made significant modifications of their laws by means of legal transplantation. For example, the Chinese constitutional framework published in 1908 was completely influenced by the spirit of the Japanese Constitution.[209] Similarly, the Draft Law of Chinese Civil Procedure, the Chinese draft Criminal Law and the Chinese penalty system were borrowed principles and systems from civil law and British principles.[210]

The interaction among trading nations and international agencies in the early 1990s increased legal harmonisation globally. The financial crisis that hit East Asia in 1997 was because of the weakness of laws and corporate governance rules. Consequently, global legal elites asserted that financial stability in developing countries requires Western legal structures.[211] For instance, in Japan, when the regulators decided to be an industrial State and become world force, they did not wait decades to extract financial and commercial regulations from internal practices, but they decided to introduce and borrow Western commercial law rules.[212] In developing East Asian countries, legal transplantation has been affected by 'the law and development' movement. The early literature suggested that due to causal links between the 'rule of law' and industrial development, one cannot proceed without the other.[213] Importantly, developing countries were induced to reproduce the new institutional features of Western countries, such as legal education, judicial independence and particularly the

[205]ibid.
[206]G. Mousourakis, 'Transplanting legal models across culturally diverse societies: A comparative law perspective' (2010) Osaka University Law Review, vol 57, pp 97.
[207] ibid
[208]T. Kyselova, 'The concept of legal transplant: Literature review draft' (2008).
[209]Greenton, Gordon, Osakui, 'Comparative legal traditions' (Chinese Political and Law University Press 1993) 12-90.
[210]Jianzhong Dai., 'On Several Problems in Legal Transplantation' (2009) Journal of Politics and Law, vol 2, no 3, p 109.
[211]World Bank, 'Entering the 21st Century: World Development Report 1999/2000' (Oxford University Press, Oxford, 1999) 23; Ugo Mattei, 'A Theory of Imperial Law: A Study on US Hegemony and the Latin Resistance' (2003) 3 Global Jurist Frontiers (1). Available at: www.bepress.com/gj/frontiers.
[212]Masaji Chiba, 'Japan', in Pho-Ling Tan (ed.) *Asian Legal Systems* (Butterworths, Sydney 1997) 99-108; Ugo Mattei, 'Three Patterns of Law: Taxonomy and Change in the World's Legal Systems' (1997) 45 American Journal of Comparative Law (5)12-40.
[213]David Trubek, 'Reconstructing Max Weber's Sociology of Law' (1985) 37 Stanford Law Review, pp 919, 920–26; Sally Ewing, 'Formal Justice and the Spirit of Capitalism: Max Weber's Sociology of Law' (1987) 21 Law Society Review (3) 487, 487–500; Brian Tamanaha, 'The Lessons of Law-and-Development Studies' (1995) 89 American Journal of International Law 470.

enactment of rights-based financial and commercial laws. It has been argued that there were no 'free' or 'natural' markets and those developing countries should tackle their dependency on globally dominant, economic classes. Consequently, legal harmonisation should be tightly controlled due to it favouring stronger countries.[214]

This research shows that legal transplantation cannot be copied by another legal system or applied mechanically because transplantation of foreign law is a complicated process. However, the benefits can only be derived by focusing on its methods and techniques. Therefore, comparing the UK corporate governance model allows for a conclusion to be drawn, regarding the possibility of legal reforms in Saudi Arabia, especially as it relates to minority shareholders. In order to explore this issue, the current research will begin with an in-depth and critical review of literature in order to understand as much as possible of the previous findings related to the issue of minority shareholders' protection. This revision will focus mainly on secondary resources. The approach will allow for an understanding of the underlying principles, concepts and rules regarding the protection of rights of minority shareholders and the application of corporate governance, whether at domestic or international levels.

In addition, in order not to limit emphasis on secondary resources alone, the present research will utilize primary resources. Thus, the following primary resources in Saudi Arabia will be examined: Company Law (CL), Capital Market law (CML), Listing Rules (LRs), Case Laws, and Corporate Governance Regulations (CGRs), as well as administrative bodies and judicial authorities. This analysis will also take into consideration the unique characteristics and disadvantages existing in the UK systems and compare them with the mechanisms of protecting minority shareholders' rights in Saudi Arabian system.

1.8 Overview of Thesis

It has been suggested that the Saudi legal system does not provide sufficient protection for minority shareholders.[215] Specifically, company law contributes largely to reinforcing the control of majority shareholders who exercise their influence over the company's affairs.[216] Also, the law does not allow the minority shareholders to bring legal action against the board

[214]MwangalaKamuwanga, 'The Teaching of International Trade and Investment Law in a "Law and Development" Context': A View from Zambia' (1987) 5 Third World Legal Studies 131.
[215]M. H. Almadani, 'The Reform of Minority Shareholder Protection in Saudi Arabia and Dubai in Private Companies', PhD Thesis (The University of Leeds, School of Law 2011) p109.
[216]Article (77-78) Saudi Company Law of 1965.

members without approval of the controlling shareholders, who are mainly in control of the board of directors.[217] With this in mind, it becomes necessary to understand corporate governance mechanisms in Saudi Arabia in relation to minority shareholder protection. Therefore, the primary aim of this thesis is to critically examine the influence of corporate governance in protecting the rights of minority shareholders in Saudi Arabia. In order to explore this issue, a comparative approach will be employed to examine the corporate governance mechanisms and the legal protection of minority shareholders in Saudi Arabia, in comparison with the UK.

Chapter 2 provides a critical review of theories of corporate governance in order to identify the most important factors for corporate governance analysis in Saudi Arabia and specifically, to understand whether one or a combination of theories is most suitable for the analysis of corporate governance within the Saudi context. Specifically, definitions of 'corporate governance' from different scholarly perspectives are considered. In terms of theory, the agency, stakeholders, stewardship, resource dependent and myopic-model theories of corporate governance will be critically analysed, including their relevance to Saudi Arabian corporate governance practice. The rationale is to find out whether one or a combination of theories fit nicely to understanding corporate governance behaviour in Saudi Arabia.

Chapter 3 will focus on the development of a corporate governance framework in Saudi Arabia. Importantly, the chapter will provide an overview of development of corporate governance, especially examining the external structures of corporate governance (such as the Capital Market Authority) in Saudi Arabia and their role in protecting minority shareholders' rights. In keeping with the objective of the thesis, comparison will also be made between the UK Financial Conduct Authority (FCA) and Saudi Capital Market Authority, highlighting differences, similarities and possibilities of legal transplantation from the UK to Saudi Arabia. The shortcomings directed to the CMA, and the security market in general, will also be explored in this chapter.

In Chapter 4, a brief historical overview of the Saudi legal system is provided. Specifically, the chapter examines the Islamic legal system and its perspective on corporate governance. The Saudi statutory laws, such as the basic law of governance, company law and capital market law will be examined. Furthermore, Saudi stock market regulations such as the Saudi

[217] ibid.

Corporate Governance Regulations and listing rules will be examined. The rationale is to understand the existing judicial and legal provisions for protecting the rights of minority shareholders in Saudi Arabia. The legal and judicial enforcement authorities in Saudi Arabia stock market will also be provided in this chapter, including their shortcomings.

Chapter 5 will provide an analysis of internal structures or mechanisms of protecting minority shareholders in the UK and Saudi Arabia. Specifically, it compares share ownership structure, shareholders' protection mechanisms, the board system and duties, the board committees, shareholders institutions and minority shareholders' rights in both the UK and Saudi Arabia. The rationale for this comparison is to highlight the points of difference and similarity between the two jurisdictions and also to examine the possibilities of adopting some of the UK corporate governance mechanisms in the Saudi context. Finally, the thesis is concluded in Chapter 6 highlighting the main findings and recommendations, the contribution of the thesis to the literature and possible suggestions for future research.

Chapter 2

Corporate Governance: Definitions and Theories

2.1 Introduction

A critical review of the existing literature on corporate governance is provided in this chapter. Specifically, Chapter 2 seeks to achieve the following objectives. First, it provides a definition of corporate governance from different scholarly and organisational perspectives. Second, it reviews relevant theories associated with corporate governance. The rationale is to form a baseline of comparison between the global and international studies and the Saudi context. Finally, the chapter is summarised, highlighting the key issues discussed and the transition to the next chapter.

2.2 Definition of Corporate Governance

There has been diversity among views regarding the meaning of 'corporate governance'. Perhaps because different scholars investigate firms from different viewpoints, they are bound to differ in their views of corporate governance.[218] According to Schneider and Scherer, corporate governance refers to a mechanism aimed at minimizing the risk borne by shareholders, who are regarded as the owners of a firm.[219] Al-Suhaibani and Naifar on the other hand, define corporate governance as the factors that affect firm processes (including, among others, financing strategies).[220] Other scholars have also shed light on the meaning of corporate governance. Dignam and Lowry view corporate governance as a set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled, and its purpose is to influence (directly or indirectly) the behaviour of the organisation towards its stakeholders.[221] Corporate governance has also been conceptualised as 'the system by which companies are directed and controlled'.[222]

This definition offered by Sir Adrian Cadbury further stated that:

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[218]S. Turnbull, 'Corporate Governance: Its Scope, Concerns and Theories' (1997) Wiley Blackwell, vol 5, no 4 pp 184-185.
[219]A. Schneider and A.G. Scherer, *Corporate Governance in a Risk Society* (Springer, 2015) 310-320.
[220]M. Al-Suhaibani and N. Naifar, 'Islamic Corporate Governance: Risk-Sharing and Islamic Preferred Shares' (2014) Journal of Business Ethics 124, 623–632. DOI 10.1007/s10551- 013-1897-6.
[221]A. Dignam and J. Lowry, 'Corporate governance 1: corporate governance and corporate theory', *Company Law, Core Text Series* (Oxford University Press, New York, NY, 2006) 350-70.
[222]Cadbury Committee, *Report of the Committee on the Financial Aspects of Corporate Governance* (1992) London, Gee, p 2.5.

> Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.[223]

Donaldson defined corporate governance as 'the structure whereby managers at the organisational apex are controlled through the board of directors, its associated structures, executive incentive, and other schemes of monitoring and bonding'.[224] According to the International Financial Corporation (IFC), corporate governance represents the relationship between different interest groups including: management, the board of directors, controlling shareholders, minority shareholders and other stakeholders.[225] The OECD Principles of Corporate Governance recognised as the global standard of "good corporate governance" that:

> Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.[226]

The principle further states that good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders, as well facilitating effective monitoring. However, the principles are not binding. Instead they are seen as a reference point to guide policy makers as they examine and develop their own economic, social, legal and cultural circumstances. The principles seek to identify objectives and make various suggestions on how to achieve them. Indeed, good governance provides better transparency in corporate structures and operations, and reduces

[223]Cadbury Committee, *Report of the Committee on the Financial Aspects of Corporate Governance,* (1992) London, Gee, p 2.5.
[224]L. Donaldson, 'The ethereal hand: organizational economics and management theory' (1990) Academy of Management Review 15, p 376.
[225]International Finance Corporation, *Corporate Governance,* online: A World Bank Group. Available at: http://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/Corporate+Governance.
[226]OECD, 'OECD Principles of Corporate Governance of 1999'.

the opportunities for political interference in the interactions amongst government, management and stakeholders.[227]

Importantly, the definition of corporate governance can be viewed from at least two major perspectives: the narrow definition and the broad definition. The narrow definition of corporate governance is restricted to the issues of shareholders' protection, management control and other issues associated with the *agency theory problem.*[228] According to this perspective, corporate governance is seen as an instrument that handles the problems that arise due to the separation of ownership and control in large corporations.[229] Supporters of this view define corporate governance as a set of mechanisms that aim to create a balance between interests of shareholders and management.[230] According to this perspective, corporate governance should concentrate on structures and mechanisms that prevent a conflict of interests between shareholders and managers, as well as guarantee the rights of shareholders.

On the contrary, the broad perspective of defining corporate governance is concerned with the so-called *stakeholders' theory.*[231] According to this school of thought, corporate governance should focus on regulating the relationship between a corporation and the wide range of other stakeholders, such as shareholders, customers, employees, creditors, bondholders, suppliers and society in general.[232] It is clear from this standpoint that corporate governance is recognised as a set of laws, rules, regulations and acceptable business practices that govern the relationship among the owners (principals), managers (agents) and stakeholders in general.[233] This wider perspective is consistent with the views of Shleifer and Vishny who suggested that:

> Corporate governance ensures fairness, transparency, accountability, sustainable financial performance, increased shareholder confidence, access to external finance and foreign investment, fair treatment of the stakeholders in a

[227]Working Group 5 'Hawkamah Institute for Corporate Governance: Task Force on Corporate Governance of State-Owned Enterprises'.
[228]W. K. Olayiwola, 'Practice and Standard of Corporate Governance in the Nigerian Banking Industry' (2010) International Journal of Economics and Finance, vol 2, no 4, p178.
[229]B. Tricker and R. I. Tricker, *Corporate Governance: Principles, Policies and Practices* (Oxford University Press 2012) p 29.
[230]M.H. Cheema, E. Johansson and Q.N. Mir, 'International Corporate Governance Comparison: Pakistan and Sweden', Masters Thesis (Lund University 2009) 6.
[231]P. T. Lin, B. Li and D. Bu, 'The relationship between corporate governance and community engagement: Evidence from the Australian mining companies' (2015) Elsevier Ltd, vol 34, pp 28-30.
[232]J. Tirole, 'Corporate Governance' (2001) The Econometric Society, vol 69, no 1, pp 1-5.
[233]M. Becht, P. Bolton and A. Roell, 'Corporate Governance and Control', ECGI Working Paper Series in Finance, (2002) 12.

company, maximization of shareholders' value and the enhanced reputation of a company, nation and economy.[234]

Freeman defined corporate governance as 'any group or individual who can affect or is affected by the achievement of the organisation's objectives'.[235] Hence, the company has to take into consideration the interests of other people who are associated with the company, such as customers, employees, creditors, suppliers and even the society at large.[236] According to the broad perspective, it can be said that corporate governance systems should do the best to serve the relationship between the company and its stakeholders, as well as to ensure that the executive management is monitored properly and acts in the interest of stakeholders.

Indeed, the above definitions reveal diversities in the concept of corporate governance. According to Alzahrani, these diversities are due to differences in the subject matter (business, economics, investment), the countries where it is practised, the type of trade policy followed, the practitioner and the researcher. For instance, in Saudi Arabia the terminology 'corporate governance' is a relatively new phenomenon and a recent addition to the Saudi legal system.[237] Thus, applying any of the above definitions to situations in Saudi Arabia has to be treated with caution. This is because the definition of corporate governance in Saudi Arabia and the concepts it covers are unclear.[238] It is important to note that Saudi Arabia was the second State in the Gulf Cooperation Countries after Oman, to adopt the concept of corporate governance.[239] As a consequence, the Saudi Capital Market Authority (to be described later) enacted a code in 2006, otherwise known as the Corporate Governance Regulations, analogued to other international corporate and capital market standards. This code was transplanted into the Saudi corporate and capital market system but it does not contain a comprehensive definition of corporate governance. Indeed, with the lack of familiarity with the terminology itself, due to its novelty, there is a need for more clarification of the full meaning of the concept and for each person, including the shareholders, to be aware of its solemnity.

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[234]A. Shleifer and R.W. Vishny, 'A Survey of Corporate Governance' (1997) Journal of Finance 52, p 737-783.
[235]R. E. Freeman, *Strategic Management: A Stakeholder Approach* (Cambridge University Press 2010) 46; P. Arora and R. Dharwadkar, 'Corporate Governance and Corporate Social Responsibility (CSR): The Moderating Roles of Attainment Discrepancy and Organization Slack' (2011) Corporate Governance: An International Review, vol 19, no 2, pp 136-152.
[236]J.L. Dean, 'Directing public companies-Company law and the stakeholder society' (Brunel University London 2000); R. E. Freeman and J. McVea, 'A Stakeholder Approach to Strategic Management', Darden Business School Working Paper (2001) No. 01-02, pp 1-32.
[237]F. S. Al Kahtani, 'Current practices of Saudi corporate governance: A case for reform' (Brunel University London 2013).
[238] ibid
[239] Y. A. Alzahrani, 'The corporate governance in Saudi listed companies' (2013) International Journal of Humanities and Management Sciences, vol 1, no 4.

With the above in mind, the definitions in the Cadbury report[240] and the OECD principles of corporate governance[241] will serve as working definitions in this thesis. These definitions have a ubiquitous application in the field and discourse of corporate governance. Unarguably, the Cadbury report was the first corporate governance report that was well received, both domestically (in the UK) and internationally. It has an admirable criterion and is seen as the set of paramount UK corporate governance regulations that offers valuable suggestions and recommendations to deal with corporate governance issues, including the rights of shareholders, duties and responsibilities of the board of directors, as well as board's sub-committees. Furthermore, the OECD principles of corporate governance represent a global standard of corporate governance and are seen as a 'panacea' for good and sound corporate governance. Importantly, the principles focus on sustaining the rights of shareholders including minority shareholders, disclosure and transparency requirements, the action of stakeholders, equitable treatment of shareholders and responsibilities of the board of directors. Indeed, the World Bank has a procedure in place that encourages transparent gathering of country information in relation to corporate governance practices. Thus, information gathered is used to develop corporate governance regulations and practices in each country by improving work plans, academic conferences and the levels of practical support required by each country.[242]

In keeping with the above, the framework of Saudi corporate governance is assumed to be built on recommendation of the 1992 UK Cadbury report as well as the OECD principles of corporate governance. Specifically, the CGC recommends the adoption of a single or unitary board system, which consists of executive and non-executive directors (NEDs), who are primarily accountable to shareholders through a voluntary 'comply or explain' compliance and disclosure regime.[243] Similarly, the Saudi code covers the principles outlined by the OECD, for example, the rights of shareholders, disclosure and transparency requirements and responsibilities of the board of directors.[244] Despite these similarities, there exist some contextual differences, such as a strong hierarchical social structure, importance of kinship

[240]Cadbury Committee, 'Report of the Committee on the Financial Aspects of Corporate Governance' (1992) London, Gee, p 2.5.
[241]OECD, 'OECD Principles of Corporate Governance (2004), OECD. Available at: http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf.
[242]F. S. Al Kahtani, 'Current practices of Saudi corporate governance: A case for reform' (Brunel University London 2013).
[243] W. Albassam, 'Corporate governance, voluntary disclosure and financial performance: ban empirical analysis of Saudi listed firms using a mixed-methods research design'. (University of Glasgow, 2014) 38.
[244]Y. A. Alzahrani, 'The corporate governance in Saudi listed companies' (2013) International Journal of Humanities and Management Sciences, vol 1, no 4.

and personal relationships, religion[245] and concentrated ownership structure (State and family), which may hinder effective implementation of corporate governance mechanisms in Saudi Arabia.

2.3 Theories of Corporate Governance

Corporate governance relates to different fields, namely economics, finance, law, management, politics and organisational behaviour.[246] As a result, it is unnecessary to rely or focus on one theory (such as the agency theory) as a basis of analysis and interpreting corporate governance practices and behaviour.[247] Specifically, Zattoni et al suggested that research on corporate governance must shift emphasis from agency theory and consider other theoretical frameworks.[248] Over the years, numerous theories have dominated the interpretation of data acquired from the fields of economics, law, finance and organisational behaviour in relation to corporate governance behaviour. Prominent among these theories are the agency (shareholder) theory, the stakeholder theory, the stewardship theory, the resource dependence theory and the myopic market model. In the section that follows, a critical review of these theories is provided in order to broaden understanding of the concept, as well as form a baseline of comparison to the corporate governance practices in Saudi Arabia.

2.3.1 Agency Theory

The agency theory is regarded as the dominant model of corporate governance that is based on a shareholder-oriented approach. The underlying premise of this theory emerged following the problems that arose from changing relations between ownership and control of businesses.[249] For instance, shareholders ran the risk of managers utilizing the money supplied to the company to maximize their own utility, rather than maximizing corporate value and the value of shares. As a result, a form of control mechanism (corporate governance) is needed to prevent managers from shirking and misusing their fiduciary function. According to this theory, maximizing the interests of the shareholders must form a top priority of the firm, with the benefits of the employees subordinate to that of the

[245]R. Haniffa and M. Hudaib, 'Locating audit expectations gap within a cultural context: The case of Saudi Arabia' (2007) Journal of International Accounting, Auditing and Taxation, vol 16, pp 179–206.
[246]L. Bebchuk and M. Weisbach, 'The State of Corporate Governance Research' (2010) The Review of Financial Studies, vol 23, no 3, pp 939-961.
[247] N. Sharma, 'Theoretical Framework for Corporate Disclosure Research' (2013) Asian Journal of Finance & Accounting, vol 5, no 1, pp 183-196.
[248]A. Zattoni, T. Douglas, and W. Judge, 'Developing Corporate Governance Theory through Qualitative Research' (2013) Corporate Governance: An International Review, vol 21, no 2, pp 119-122.
[249]A. Schneider and A. G. Scherer, *Corporate Governance in a Risk Society* (Springer, 2015) 310-320.

shareholders.[250] In other words, the primary responsibility of the firm is to protect the interests of the shareholders because they are unarguably perceived as the owners of the company, while those of the employees should be considered a secondary responsibility. In fact, the theory views employees as insignificant in corporate governance and places great emphasis on shareholders. Moral responsibilities to act in someone else's interest are considered a second priority.[251] The implication of this definition, as Kim and Kim argued, is that the interests of other organisational stakeholders (employees, customers and community) are likely to be compromised.[252] Notably, countries that had a tradition of common law, such as Australia, the UK, the US, Canada and New Zealand developed corporate governance structures that focussed on shareholders' returns or interests. Therefore, the role of corporate governance is to ensure that corporations achieve the objectives set by their owners.[253]

The assumptions of the agency theory suggest that the interests of shareholders and managers are likely to be different and their behaviours characterised by self-interested opportunism.[254] In the US and Great Britain, the regimes of Regan and Thatcher encouraged the adoption of a shareholder approach, as a corporate governance principle which saw many corporations emphasising the maximization of shareholder value.[255] Importantly, a boom in the US stock market and economy impressed corporate executives in major economies such as Germany, Italy, France, Korea and Japan to adopt a shareholder approach as a principle of corporate governance.[256]

An important consideration in terms of the assumptions of the theory, is the principal agent conflicts that arose due to the separation of ownership and management functions,[257] which according to Ugurlu may lead to managers pursuing their own interests at the expense of the principals', or create information asymmetry, thus leading to agency costs.[258] In their seminal

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[250]D.J. Kim and D. Kim, 'The impact of corporate governance on employment relations in South Korea: the shareholder versus stakeholder perspectives' (2015) The International Journal of Human Resource Management, vol 26, no 3, pp 338-360, DOI:10.1080/09585192.2014.919953.

[251]S. Thomsen and M. Conyon, 'Corporate Governance: Mechanisms and Systems' (London: McGraw Hill, 2012).

[252]D.J. Kim and D. Kim, 'The impact of corporate governance on employment relations in South Korea: the shareholder versus stakeholder perspectives' (2015) The International Journal of Human Resource Management 26:3, 338-360, DOI:10.1080/09585192.2014.919953.

[253]B.M. Mulili and P. Wong, 'Corporate governance practices in developing countries: the case for Kenya' (2011) International Journal of Business Administration, vol 2, no 1, pp 14-27.

[254]N. Chambers et al., 'Towards a framework for enhancing the performance of NHS boards: a synthesis of the evidence about board governance, board effectiveness and board development' (2013) Health Services and Delivery Research, vol 1, no 6.

[255]D.J. Kim and D. Kim, 'The impact of corporate governance on employment relations in South Korea: the shareholder versus stakeholder perspectives' (2015) The International Journal of Human Resource Management 26:3, 338-360, DOI:10.1080/09585192.2014.919953.

[256]W. Lazonick and M. O'Sullivan, 'Maximizing shareholder value: a new ideology for corporate governance' (2000) Economy and Society 29:1, 13-35, DOI: 10.1080/030851400360541.

[257]M. Mustapha and A. Ahmad, 'Agency theory and managerial ownership: Evidence from Malaysia' (2011) Managerial Auditing Journal 26, pp 419-436.

[258]M. Ugurlu, 'Agency costs and corporate control devices in the Turkish manufacturing industry' (2000) Journal of Economic Studies, vol 27, no 6, pp 566-599; J. Farrer and I.M. Ramsay, 'Director share ownership and corporate performance: Evidence from Australia corporate governance' (1998) An International Review, vol 6, no 4, pp 233-248.

study, Berle and Means provided a crucial explanation of the contractual relationships between owners (principles) and managers (agents). Importantly, they argued that as countries became industrialised and expanded their markets, the ownership and control of enterprises became separated.[259] The dominant view is that the shareholders usually expect that the managers will act and make the best decisions in the owners' interests. Nonetheless, the managers may not necessarily make decisions in the best interests of the shareholders. The conflict of interests between these two parties can be attributed to two main sources: owners (shareholders) are interested in gaining high profits and increasing cash flows, whereas the management is interested in high salaries and allowances.[260] Jensen and Meckling proposed a convergent of interest model to address the agency conflict that arose due to separation of ownership and control.[261] The model predicted a zero agency cost when those who owned the company also managed the company.[262]

Specifically, managers can be given incentives to share some of the shareholders' risk, for example by being remunerated with stock options or bonuses for excellent firm performance.[263] In other words, by encouraging managers to own the company's shares, the interests of the internal and external shareholders are aligned.[264] Mustapha and Ahmad investigated the effect of managerial ownership in relation to agency theory in the Malaysian business environment. Data from 235 companies indicated that managerial ownership in various segments has an inverse relationship with total monitoring costs, as predicted in the agency theory.[265] The findings contradicted previous meta-analysis conducted by Deutsch.[266] Deutsch found little empirical support regarding the impact of board composition, especially with the proportion of outside directors, on critical decisions (such as CEO compensation, risk and control that involved a potential conflict of interest between managers and shareholders).[267]

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[259]M.S. Mizruchi, 'Berle and Means revisited: the governance and power of large U.S. corporations' (2001) Department of Sociology, University of Michigan, p 2. This paper was presented at the conference on Shareholder-Value, Capitalism and Globalization, Bad Homburg, Germany, May 2001.
[260]ibid
[261]M.C. Jensen and W.H. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) Journal of Financial Economics, vol 3, no 4, pp 305-360.
[262]J. Farrer and I.M. Ramsay, 'Director share ownership and corporate performance: Evidence from Australia corporate governance' (1998) An International Review, vol 6, no 4, pp 233-248.
[263]S. Thomsen and M. Conyon, *Corporate Governance: Mechanisms and Systems* (London: McGraw Hill, 2012).
[264]M. Mustapha and A. C. Ahmad, 'Agency theory and managerial ownership: Evidence from Malaysia' (2011) Managerial Auditing Journal 26.
[265]ibid.
[266]Y. Deutsch, 'The impact of board composition on firms critical decisions: A meta-analytic review'. (2005) Journal of Management, vol 31, no 3, pp 424-444.
[267]N. Chambers et al., 'Towards a framework for enhancing the performance of NHS boards: a synthesis of the evidence about board governance, board effectiveness and board development' (2013) Health Services and Delivery Research, vol 1, no 6.

Agency theory suggests a reduction in the number of executive board members, which according to some scholars could enhance the board's independence[268] and thus, help shareholders hold board members to account.[269] Importantly, the theory suggests that establishment of sound corporate governance should help reduce monitoring and bonding costs, which in turn, leads to net improvement in governance practices, voluntary disclosure and financial performance.[270] Indeed, this recommendation is reflected in corporate governance codes of many countries including the 2006 Saudi Corporate Governance Regulations and the 1992 UK Cadbury report. In summary, the theory acknowledges the establishment of board sub-committees, such as audit, nomination and remuneration committees, which are seen as vital instruments to monitor managerial behaviour.[271]

The theory however, has been heavily criticised for its strict emphasis on shareholders, whilst ignoring the impact of other stakeholders. As Lazonick and O'Sullivan argued, viewing shareholders as the sole residual claimants was an increasingly tenuous description of the actual relationships among a corporation's various stakeholders.[272] Given the influence of these stakeholders in the management of business enterprises, as well as heightening competition and increasing complexity surrounding organisations domestically and globally, it became harder for companies to reach their business goals without satisfying these stakeholders.[273] Indeed, as Schneider and Scherer argued, agency theory does not considers the risks accruing from changing economic and political conditions of business firms operating in a global environment, or the resulting legitimacy problems of business firms adequately.[274]

In keeping with the assumptions of agency theory, the Saudi government has embarked on a number of measures aimed at reforming its corporate governance culture. Specifically, the enactment of the SCGRs in 2006 is seen as a major milestone in the history of the Saudi capital market.[275] In line with other corporate governance codes and regulations, the SCGRs seek to mitigate agency conflict between principles (owners) and agents (managers) through

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[268]Y. Al-Janadi, A. Rahman, and N. Omar, 'Corporate Governance Mechanisms and Voluntary Disclosure in Saudi Arabia' (2013) Research Journal of Finance and Accounting, vol 4, no 4, pp 25-35.
[269]L. Bebchuk and M. Weisbach, 'The State of Corporate Governance Research' (2010) The Review of Financial Studies, vol 23, no 3, pp 939-961.
[270] M. Siddiqui et al., 'Internal Corporate Governance Mechanisms and Agency Cost: Evidence from Large KSE Listed Firms' (2013) European Journal of Business and Management, vol 5, no 23, pp 103-109.
[271]M. Allegrini and G. Greco, 'Corporate Boards, Audit Committees and Voluntary Disclosure: Evidence from Italian Listed Companies' (2013) Journal of Management and Governance, vol 17, no 1, pp 187-216.
[272]ibid.
[273]D.J. Kim and D. Kim, 'The impact of corporate governance on employment relations in South Korea: the shareholder versus stakeholder perspectives' (2015) The International Journal of Human Resource Management 26:3, 338-360, DOI:10.1080/09585192.2014.919953.
[274]A. Schneider and A. G. Scherer, *Corporate Governance in a Risk Society* (Springer 2015) 310-320.
[275]C. Robertson et al., 'A Cross-National Analysis of Perceptions of Corporate Governance Principles' (2013) International Business Review, vol 22, no 1, pp 315-325.

improving transparency, accountability and responsibility of boards of directors of several corporations.[276] However, these mechanisms seem to work in theory rather than in practice, due to a high concentration of ownership in the hands of the State and powerful, rich Saudi families. It is important to note that diverse shareholder ownership, and resulting separation of ownership and control suggested by the proponents of agency theory, is only applicable in Western countries. In fact, this type of ownership structure, which highlights stewardship and monitoring aspects of non-executive directors' functions, is absent in Saudi Arabia. Importantly, with a high concentration of ownership, which characterises the Saudi situation, the rights of minority shareholders could be adversely affected[277]; thus creating a conflict of interest between minority shareholders and controlling shareholders (State and family owners). The above analysis revealed the importance of applying agency theory to understanding corporate governance behaviour in Saudi Arabia.

2.3.2 The Stakeholder Theory

This theory is considered the most fundamental challenge to the agency theory and emerged in response to the criticism of the agency theory that exclusively focusing on shareholders' interests has not held the key to good corporate performance and effective accountability.[278] Importantly, there was a growing realisation that a company is not just a production system, but that it is comprised of several other diverse and often interrelated systems, all of which require equal attention and strategic thinking.[279] The theory was developed by Freeman[280] and popularized by Blair.[281] Freeman defines stakeholders as 'any group or individual who can affect, or is affected by, the achievement of a firm's purpose'.[282] Stakeholders can include employees, customers, suppliers, creditors and even the wider community and competitors.[283] The stakeholder theory emphasizes social responsibility and takes the interests of shareholders, and all parties involved, into account.[284] In other words, the importance of democratic participation in corporate decision-making should form a top

[276]A. Alshehri and J. Solomon, 'The Evolution of Corporate Governance in Saudi Arabia', Conference Paper, British Accounting and Finance Association (BAFA, Brighton, UK, 2012)
[277] N. Baydoun et al., 'Corporate Governance in Five Arabian Gulf Countries' (2013) Managerial Auditing Journal, vol 28, no 1, pp 7-22.
[278]ibid.
[279] S. Pande and V.A. Ansari, 'A theoretical framework for corporate governance' (2014) Indian Journal of Corporate Governance, vol 7, no 1, pp 56-72.
[280]R. E. Freeman, *Strategic management: A stakeholder approach* (Boston: Pitman, 1984).
[281]M.M. Blair, *Ownership and control: rethinking corporate governance for the twenty-first century* (Washington DC: Brookings Institution, 1995).
[282]R.E. Freeman, *Strategic management: A stakeholder approach* (Boston: Pitman, 1984) 25.
[283]Corplaw Admin, 'Shareholder and stakeholder theories of corporate governance'(2013). Available at: http://www.corplaw.ie/blog/bid/317212/Shareholder-Stakeholder-Theories-Of-Corporate-Governance
[284] D.J. Kim and D. Kim, The impact of corporate governance on employment relations in South Korea: the shareholder versus stakeholder perspectives (2015) The International Journal of Human Resource Management 26:3, pp 338-360, DOI:10.1080/09585192.2014.919953.

priority of the firm[285] and the maximization of social wealth, rather than mere maximization of shareholders' welfare (seen as the objective of management).[286]

According to this theory, corporate governance problems arise when corporate objectives are narrowly defined. Therefore, in order to resolve the problem, the purpose of the firm should be broadly defined rather than the mere maximization of shareholder welfare. That is, the firm's objective should be geared towards serving broader societal interests, beyond economic value creation for shareholders. In fact, the stakeholder theory represents an important element of corporate social responsibility (CSR) and demands that interests of all stakeholders be considered, even if it reduces company profitability.[287] Previous research has shown that countries that followed civil law (such as France, Germany, Italy and the Netherlands) developed corporate governance frameworks that focused on stakeholders.[288] Importantly, the objective of corporate governance focus is on balancing the interests of a variety of key stakeholders such as employees, managers, customers, creditors, suppliers and the entire wider community.

An important consequence of the difference between the stakeholder and shareholder theory is that they are fundamentally distinct when it comes to the firm's profit. Under the shareholder theory, non-shareholders can be viewed as means to the ends of profitability; under the stakeholder theory, the interests of many non-shareholders are also viewed as ends.[289] Another difference between the two models lies in the purpose of the firm. According to the shareholder theory, the objective of the firm is to maximize shareholders' value. The stakeholder theory, on the other hand, assumes that the purpose of the firm is to commercially serve the interests of society.

Evidence in support of the stakeholder theory has been demonstrated in a study of 214 Korean firms.[290] The study contrasted the stakeholder and shareholder perspectives of corporate governance on employment relation outcomes in Korean firms. The results revealed that a stakeholder corporate governance orientation (as compared to the shareholder

[285]P.Y.Gomez and H. Korine, *Entrepreneurs and democracy: A political theory of corporate governance* (Cambridge, UK: Cambridge University Press, 2008)
[286]M. M. Blair and M. J. Roe, *Employees and corporate governance* (Washington, DC: Brookings Institution Press, 1999).
[287]J.F. Smith, 'The shareholders vs stakeholders debate' (2003). Available at: http://sloanreview.mit.edu/article/the-shareholders-vs-stakeholders-debate/.
[288]B.M. Mulili and P. Wong, 'Corporate governance practices in developing countries: the case for Kenya' (2011) International Journal of Business Administration, vol 2, no 1, pp 14-27.
[289]ibid.
[290]D. J. Kim and D. Kim, The impact of corporate governance on employment relations in South Korea: the shareholder versus stakeholder perspectives (2015) The International Journal of Human Resource Management 26:3, pp 338-360, DOI:10.1080/09585192.2014.919953.

orientation) had positive relationships with education/training expenses, average employee tenure and industrial relations (IR) climate, but negative associations with the number of strikes (contrasted with the stakeholder and shareholder perspectives of corporate governance in investigating the impact of corporate governance on employment). The findings led the authors to suggest that stakeholder orientations of firms have more beneficial effects for employees and more consensual relations with labour unions than shareholder orientations did.

A recent study that analysed the annual reports of a sample of 222 listed companies suggests that firms providing more CSR information have better corporate governance ratings, are larger, belong to higher profile industries and are more highly leveraged.[291] In another study, Guosong found that 'stakeholder-oriented governance mechanisms, including reduced institutional ownership, increased insider ownership, enlarged board representativeness, increased board interlocks, fixed compensation for CEOs and directors, and certain takeover controls like dual class shares and poison pills, were positively associated with media firms' performance'.[292] From the perspective of stakeholder opportunism, not only can the management of a company exercise opportunism, but rather all stakeholders of a company can (and will to some extent) have options to behave opportunistically and at the same time bear the risk of being victims of the opportunism of other stakeholders.[293] Using a stakeholder approach, Kansal and Joshi conducted a study to understand the perceptions of shareholders and brokers regarding corporate social responsibility (CSR) initiatives by Indian companies. Results from the respondents in both categories of stakeholder groups agreed that CSR-oriented companies enjoy higher levels of investor confidence, which is reflected in higher stock prices and leads to enhanced reputation and corporate goodwill.[294] On the basis of these finding, the authors suggest that Indian companies are in fact implementing CSR initiatives and that stakeholders have a considerable interest in such initiatives.[295]

Hillman et al studied 250 firms and more than 3000 directors and found no association between the presence of stakeholder directors on the board and organisational

[291]M.C. Chan et al., 'Corporate governance equality and CSR disclosures' (2014) Journal of Business Ethics, vol 125, no 1, pp 59-73.
[292] S. Guosong, 'Toward a stakeholder model of corporate governance: Evidence from U.S. media companies' (2010) Humanities and Social Sciences, vol 70(8-A) pp 278.
[293]A.V. Werder,'Corporate governance and stakeholder opportunism' (2011) Organization Science, Special Issue: New Perspectives in organizational science, vol 22, no 5, pp 1345-1358.
[294]M. Kansal and M. Joshi, 'Perceptions of investors and stockbrokers on corporate social responsibility: A stakeholder perspective from India' (2014) Knowledge and Process Management, Special Issue: Measuring Corporate Social Responsibility (CSR): The central role of stakeholder, vol 21, no 3, pp 167-176.
[295]ibid.

performance.[296] Ayuso et al found evidence that CSR responsibility on the board is positively associated with indicators for dealing with primary and secondary stakeholders.[297] They further explored the effects of stakeholder engagement on firm financial performance and their results showed that whereas board responsibility for CSR had a positive effect on firm financial performance in firms in the United States, Australia, and Hong Kong, for companies in the United Kingdom, Canada and South Africa, a positive impact of stakeholder engagement on firm profitability could be observed.[298]

Despite its emphasis on CSR, the stakeholder theory has been criticised for providing no formula for adjudicating among the stakeholders' disparate interests.[299] Also, concerns have been raised regarding diversity of and lack of clarity about stakeholder expectations, complexity of trade-offs (if stakeholder interests are to be taken account of) and the need for a simple focus of the bottom line for managers.[300] Indeed, as Chambers et al argued

> Despite the fact that stakeholder governance models are deeply embedded in some countries in Europe, notably Germany, and in Japan, and that claims for these countries' industrial and social success are often based on this model, the empirical evidence for stakeholder theory is weak. The theory is further criticised for encouraging risk-averse, inoffensive but bland and lowest common denominator decision-making.[301]

There is evidence to suggest that Saudi corporate governance practice reflects some elements of the stakeholder theory. For instance, Article 1a of the CGRs made provisions in relation to protection of stakeholders' rights and social responsibility.[302] By implication, firms operating in Saudi Arabia are expected to pursue the interests of other stakeholders (employees, local communities and governments) in addition to advancing the interests of shareholders. Besides, the Islamic sacred obligation of *zakat* (alms-giving) is thought to reflect the concept

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[296]A.J. Hillman et al., 'Board composition and stakeholder performance: do stakeholder directors make a difference?' (2001) Bus Soc 40:295–314. Available at: http://dx.doi.org/10.1177/000765030104000304.

[297] S. Ayuso et al., 'Maximizing stakeholders' interests: An empirical analysis of the Stakeholder Approach to Corporate Governance' (2014) Business & Society, vol 53, no 3, pp 414–439.

[298]ibid.

[299]J.F. Smith, 'The Shareholders vs Stakeholders Debate' (2003). Available at: http://sloanreview.mit.edu/article/the-shareholders-vs-stakeholders-debate/.

[300]J. Argenti, 'Stakeholders: the case against Long Range Planning' 30 (1997) 442–5. Available at: http://dx.doi.org/10.1016/S0024-6301(97)00004-6 in N. Chambers et al., 'Towards a framework for enhancing the performance of NHS boards: a synthesis of the evidence about board governance, board effectiveness and board development' (2013) Health Services and Delivery Research, vol 1, no 6, p 22.

[301]N. Chambers et al., Towards a framework for enhancing the performance of NHS boards: a synthesis of the evidence about board governance, board effectiveness and board development (2013) Health Services and Delivery Research, vol 1, no 6, p 22.

[302]Art (1-a) Saudi Corporate Governance Regulations 2006 that issued by the Resolution of Board of Capital Market Authority No. 1/212/2006 dated 21/10/1427AH (corresponding to 12/11/2006).

of CSR advocated in stakeholder theory. In fact, the Islamic perspective of corporate governance requires firms to make donations, which can be equalised with *zakat*. These donations can come in the form of building and maintaining mosques, schools, charitable trusts, hospitals, providing relief supports and programmes to Muslims worldwide.[303] The rationale is that by engaging in such acts, their CSR as a key instrument of corporate governance is raised, thus increasing the trust and confidence of the masses including minority investors.

Importantly, firms such as the Saudi Zain Company, the Kingdom Holdings and the Saudi Research and Marketing Group are among the few listed firms that demonstrate CSR principles in their business activities. Also, the Saudi Arabian Oil Company (popularly known as Saudi Aramco and reputed to be the biggest company in Saudi Arabia) has a profile of a multinational corporation and is fully owned by the Saudi government. According to information available on the company's website, Saudi Aramco has sought to undertake activities that add real value for the people of Saudi Arabia, from building roads, railroads, schools and hospitals, to establishing wildlife sanctuaries and growing a knowledge economy.[304] This reflects elements of corporate social responsibility as advocated by stakeholder theory. Perhaps these firms may have adopted this valuable principle due to the demands for CSR in the CGC, even though they may lack precise direction.[305]

However, it is important to note that the application of stakeholder theory in Saudi Arabia seem to work in theory rather than in practice. This is because, as discussed later in Chapter 5 of this thesis, compliance with the provisions of the CGRs is voluntary rather than obligatory (a 'comply or explain' principle) in Saudi environments where concentration of ownership is a ubiquitous phenomenon. As a result, a review of boards' annual reports and websites showed that a significant number of Saudi listed firms (such as Saudi Ceramics Company, Al-Babtain Power and Telecommunication Company) still do not acknowledge CSR. Perhaps lack of an explanation by the CGRs and ignorance of the boards of listed corporation, as to this valuable principle, may further explain low or poor engagement of some listed firms in corporate social responsibility.[306]

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[303]T. Kochuyt, 'God, Gifts and Poor People: on Charity in Islam' (2009) Social Compass, vol 56, no 1, pp 98.
[304]http://www.saudiaramco.com/en/home/news-media/publications/corporate-reports/Citizenship2014.html.
[305]F. S. Al Kahtani, 'Current practices of Saudi corporate governance: A case for reform' (Brunel University, London, 2013)
[306] ibid

Taken together, the concept of corporate governance from a broader perspective may still not be fully developed and accepted in Saudi Arabia due to poor awareness and appreciation of good corporate governance among key corporate stakeholders. Therefore, it may be premature to assess the full impact of the stakeholder theory in the Saudi corporate environment.

2.3.3 The Stewardship Theory

Stewardship theory was developed by Davis, Schoorman, and Donaldson in response to the agency theory pessimistic assumption that managers are always self-interested and self-serving, rational maximizes.[307] Instead of regarding managers as opportunists, the theory assumes that the goals of managers and shareholders are aligned (with the former being intrinsically motivated to act in the best interests of the organisation and to focus on intangible rewards, such as opportunities for personal growth and achievement).[308] In other words, both the managers and shareholders have interests in maximising the long-term stewardship of the company and are therefore already well-aligned.[309] According to this theory, combing the roles of a chairman and chief executive is necessary in that it will help to protect a key aspect of high performance: the strength and authority of executive leadership. Implicit in stewardship theory is the understanding that the owners (principals) are prepared to take risks on how managers will run their business and provide a return on their investment, indicating a level of trust that is absent in agency theory.[310]

Chambers et al outlined the implications of stewardship theory for an understanding of board governance.[311] First, managers on the whole direct their efforts to the well-being of the organisation that they are serving.[312] Secondly, managers and owner representatives (outsider directors, non-executive directors, lay members or governors) on boards work together to develop strategy and to monitor performance.[313] And thirdly, the value of directors lies in using their knowledge to advise their executive colleagues on the board.[314] According to Schneider and Scherer, one advantage of the stewardship theory lies in its emphasis on the

[307]J.H. Davis et al.,'Toward a stewardship theory of management' (1997) Academy of Management Review 22, pp 20-47. Available at: http://dx.doi.org/10.2307/259223.
[308]A. Schneider and A.G. Scherer, 'Corporate Governance in a Risk Society' (2015) Journal of Business Ethics 126, pp 309–323. DOI 10.1007/s10551-013-1943-4; N. Chambers et al., 'Towards a framework for enhancing the performance of NHS boards: a synthesis of the evidence about board governance, board effectiveness and board development' (2013) Health Services and Delivery Research, vol 1, no 6.
[309]ibid.
[310]N. Chambers et al., 'Towards a framework for enhancing the performance of NHS boards: a synthesis of the evidence about board governance, board effectiveness and board development' (2013) Health Services and Delivery Research, vol 1, no 6, p 19.
[311]ibid.
[312]ibid.
[313]ibid.
[314]ibid.

integrity of managerial decision-making.[315] However, the stewardship theory seems to be unsuited to respond to the challenges that corporations are confronted with in the risk society. Other critiques of stewardship theory have raised concerns that its applications can lay organisations open to risks of governance failure and strategic drift.[316] There is also a problem with groupthink[317], or what Hambrick and Mason call "upper echelons" - dominated thinking, in which there is not enough independent challenge on the board.[318] Stewardship theory has also been challenged for its lack of details about board activities and for not describing how directors make decisions.[319]

A critical look at Saudi corporate governance practice reveals a sharp contrast to the assumptions of stewardship theory. For instance, Articles 12c and 12e of CGC emphasized the need to appoint independent non-executive members of the board who should enjoy complete independence.[320] Similarly, Article 12d of the same code also emphasizes the separation of the functions of the chairman and CEO of the company.[321] The rationale is to provide accountability of management of the corporation through supervision and monitoring. Indeed, the above provisions contrast with the stewardship theory assumptions, which view managers as trustworthy individuals, with no need of direct supervision or monitoring of their performance. In fact, applying such a view within the Saudi context can have an adverse impact on voluntary corporate disclosure and financial performance, and in turn encourage the excesses of controlling shareholders. However, considering the high concentrated ownership structure that characterises the Saudi corporate environment, one may argue that appointment of relatives and friends as directors and CEOs may likely fit the perspective of stewardship theory because these individuals are likely to be perceived as trustworthy. Thus, the application of stewardship theory becomes even more relevant in the context of Saudi Arabia.

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[315]A. Schneider and A.G. Scherer, 'Corporate Governance in a Risk Society' (2015) Journal of Business Ethics 126, pp 309–323. DOI 10.1007/s10551-013-1943-4.

[316] N. Chambers et al., 'Towards a framework for enhancing the performance of NHS boards: a synthesis of the evidence about board governance, board effectiveness and board development' (2013) Health Services and Delivery Research, vol 1, no 6.

[317]G. Nicholson and G.Kiel, 'Can directors impact performance? A case-based test of three theories of corporate governance.' (2007) Corporate Governance 15, pp 585–608. Available at http://dx.doi.org/10.1111/j.1467-8683.2007.00590.x.

[318]D.C. Hambrick and P.A. Mason, 'Upper echelons: the organization as a reflection of its top managers' (1984) Academy Management Review 9, pp 193–206. Available at: http://dx.doi.org/10.2307/258434; N. Chambers et al., 'Towards a framework for enhancing the performance of NHS boards: a synthesis of the evidence about board governance, board effectiveness and board development' (2013) Health Services and Delivery Research, vol 1, no 6.

[319]O. Bordean et al., 'A multi-theory approach of the strategic role of boards', Studies in Business and Economics (2012) vol 7, no 2, pp 43-51.

[320]Art (12-c) and (12-e) Saudi CGRs 2006.

[321]Ibid art (12-d).

2.3.4 The Resource Dependence Theory

The resource dependency theory is a strategic contingency theory that originated from economics and sociology.[322] Popularized by Pfeffer, the theory emphasized the distribution of power in the firm and focused on the board as a human capital resource, seeing it as the primary task of the board members to use their powers, knowledge and skills internally, to advise the management of the firm.[323] According to Pfeffer and Salancik, the board of directors can bring four benefits to the firm, including advice, access to information, legitimacy and preferential access to resources.[324] Furthermore, 'boards, and especially outside board members, can bridge the gap between the firm and its environment and serve as a mechanism for attracting resources and thereby add to the value creation of the firm'.[325] From a resource-based view, it can be argued that the unique combination of the expertise, the wider experience of the board (boards' human and relational capital) and the quality of top management, will contribute positively to the strategic decision-making and ultimately to the successful performance of the firm.[326]

Chambers et al summarise the implications of resource dependence theory for the understanding of corporate governance as follows. 'First, the organisations depend on others for survival. Secondly, board members add value because of their background, skills and contacts. Thirdly, the main role of the board is leveraging and managing external relationships. Fourthly, board members may belong to a network of other powerful people who exercise control over the direction of public life in a series of board interlocks'.[327]

In the Saudi context for instance, the composition and appointment of board members seem to contradict the assumptions of resource dependency theory. Importantly, the Saudi government and Saudi wealthy families are basic shareholders in many listed corporations. As a consequence, most Saudi corporate boards are dominated by members, who are selected by the State or rich families. Specifically, the concentration of ownership and control in the hands of owners and controlling shareholders still influence the operation and activities in the

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[322]N. Chambers et al., 'Towards a framework for enhancing the performance of NHS boards: a synthesis of the evidence about board governance, board effectiveness and board development' (2013) Health Services and Delivery Research, vol 1, no 6.

[323]J. Pfeffer, J, 'Size and composition of corporate boards of directors: The organization and its environment' (1972) Administrative Science Quarterly, pp 218-228; M. Neville, 'The role of boards in small and medium sized firms' (2011) Corporate Governance: The international Journal of Business in Society, vol 11, no 5, pp 527 – 540.

[324]J. Pfeffer and G.R. Salancik, *The external control of organizations: a resource dependence perspective* (Stanford, CA: Stanford Business Books, 2003).

[325]Neville, 'The role of boards in small and medium sized firms' (2011) Corporate Governance: The International Journal of Business in Society, vol 11, no 5, p 528.

[326]O. Bordean et al., 'A multi-theory approach of the strategic role of boards' (2012) Studies in Business and Economics, vol 7, no 2, pp 43-51.

[327]N. Chambers et al., 'Towards a framework for enhancing the performance of NHS boards: a synthesis of the evidence about board governance, board effectiveness and board development' (2013) Health Services and Delivery Research, vol 1, no 6, pp 19.

Saudi capital market, especially in relation to the appointment of chairmen and members of boards of directors. In fact, appointing members of the board by controlling shareholders is still a common practice in the Saudi securities market.[328] These appointments are characterised by favouritism and nepotism and do not follow the legal procedures set out in corporate governance regulations. In fact, individuals who are politically well-connected may be appointed as directors or CEOs without due regard for their ability to perform those roles.[329] Indeed, the board of directors are seen as a hallmark of effective corporate governance, which acts as a bridge between the company and the owners.[330] Therefore, disregarding the skills and background of the board members during appointment raises doubt as to whether the board members will add to the value creation of the firm, as the resource dependency theory postulates.

Taken together, the resource dependency theory focuses on how uncertainty caused by external environmental factors and dependence on outside organisations can be minimised.[331] The theory has received support in the literature, as revealed in a study by Hilman, Withers and Collins, which showed that the contention that firms are constrained by, and can affect their environments, is well-accepted.[332] Indeed, as Davis and Cobb suggest, resource dependence theory will continue to provide insight as long as power plays a part in the conduct of organisational life.[333] In a recent meta-analysis of 157 tests of resource dependency theory, Drees and Heugens confirmed its main predictions: 'organizations respond to resource dependencies by forming interorganizational arrangements like interlocks, alliances, joint ventures, in-sourcing arrangements, and mergers and acquisitions. In turn, these arrangements make them more autonomous and more legitimate'.[334]

However, the theory's over focus on external factors has been challenged by many.[335] Chambers et al argued that reliance on external factors underplays the views of the board

[328]ibid
[329]Boytsun et al., 'Social norms, social cohesion, and corporate governance' (2011), Corporate Governance: An International Review, vol 19, no 1, pp 41-60.
[330]ibid.
[331]ibid.
[332]A.J. Hillman et al., 'Resource dependence theory: A review' (2009) Journal of Management 35, pp 1404–27. Available at: http://dx.doi.org/10.1177/0149206309343469.
[333]G.F. Davis and J.A. Cobb, *Resource dependence theory: Past and future.' Stanford's organization theory renaissance, 1970-2000'* (Bingley, NY: Emerald Group, 2010) 21-42
[334] J.M. Drees and P.P.M.A.R. Heugens, 'Synthesizing and Extending Resource Dependence Theory: A Meta-Analysis' (2013) Journal of Management 39, pp 1666-1698.
[335]G.P. Hodgkinson and P. Sparrow, *The competent organization: a psychological analysis of the strategic management process* (Buckingham: Open University Press, 2002).

role, in determining its own future through strategising and in exercising oversight of internal management actions and performance.[336]

2.3.5 The Myopic Market Model

The myopic market model shares the same premise with the agency theory, which states that the purpose of the firm is to serve the sole interests of the shareholders. However, it evolved as a challenge to the agency theory because of what Hayes and Abernathy termed 'competitive myopia',[337] due to its consequent preoccupation with short-term market value (such as returns, profit and stock price) and other performance measures induced by inefficient market forces.[338] According to the myopic market model, failures in corporate governance arise because the current institutional arrangement encourages managers to focus on short-term performance, while diverging from the maximization of long-term wealth for shareholders and competitiveness of the firm.[339] The theory suggests that corporate governance reform should create an enabling environment whereby shareholders (particularly large and/or institutional shareholders) and managers are encouraged to share long-term performance horizons.[340] Other solutions recommended by the theory to improve corporate governance include (a) increasing shareholder's loyalty and voice, (b) reducing shareholders' exist, (c) encouraging 'relationship investing' to lock financial institutions into long-term positions, as well as restrictions on the takeover process and on voting rights for short-term shareholders, and finally (d) empowering other groups such as employees and suppliers that have long-term relationships with the firm.[341]

Evaluation of the myopic market model in the Saudi context showed that Saudi corporate governance regulations (SCGRs) have sought to create an enabling environment whereby shareholders, including minority shareholders and managers, are encouraged to share long-term performance horizons. Specifically, the SCGRs clearly stipulate that shareholders should be empowered to exercise their rights, especially their right to attend the general meeting and vote on fundamental issues, the right to oversee the board's activities and the

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[336] N. Chambers et al., 'Towards a framework for enhancing the performance of NHS boards: a synthesis of the evidence about board governance, board effectiveness and board development' (2013) Health Services and Delivery Research, vol 1, no 6.

[337] R.H. Hayes and W.J. Abernathy, 'Managing our way to economic decline' (1980) Harvard Business Review 58, pp 67-77.

[338] X. Sun et al., 'Theories of corporate governance: A critical perspective'. Available at: http://www.business.otago.ac.nz/mgmt/ANZAM2004/CD/Papers/abstract258.htm.

[339] M.M. Blair, *Ownership and control: rethinking corporate governance for the twenty-first century* (Washington DC: Brookings Institution, 1995).

[340] S. Letza et al., 'Shareholding versus stakeholding: A critical review of corporate governance' (2004) Corporate Governance, vol 12, no .3, pp 242-262.

[341] K. Keasey et al., 'Introduction: The corporate governance problem-competing diagnoses and solutions' in K. Keasey, S. Thompson & M. Wright (eds) *Corporate governance: economic and financial issue* (Oxford: Oxford University Press, 1997) pp 6-7.

right to obtain sufficient information.[342] It is clear that by allowing shareholders to exercise these rights, they will contribute in meeting the long-term performance horizon of the company. However, empowering their right to vote on fundamental issues seems to contrast with the assumptions of the theory, which suggests restricting voting rights on short-term shareholders. Even though the theory fails to clarify what it means by short-term shareholders, there is a clear indication that this might refer to minority shareholders within the Saudi context.

An important consideration in terms of the differences between the corporate governance theories is that they make conflicting assumptions regarding the problems and solutions of corporate governance. According to the agency theory, corporate governance problems emerge due to separation of ownership and management function. Thus, strengthening the incentive system and removing restrictions on markets would help address the agency conflict that characterizes failures in corporate governance. According to the stakeholder theory, lack of stakeholders' involvement is seen as an underlying cause of failure in corporate governance. A broad definition of corporate objectives geared towards serving broader societal interests beyond economic value creation for shareholders, is seen as a panacea for corporate governance problems. A pessimistic assumption that managers are always self-interested and self-serving rational maximizes underlies the cause of corporate governance failures, according to the stewardship perspective. To address this, the goals of managers and shareholders should be aligned to maximize the long-term stewardship of the company. From the perspective of the myopic market model, corporate governance failure arises due to inefficient market forces. Thus, increasing shareholder loyalty and voice, reducing shareholders' exits and encouraging relationship investing, are seen as remedies for corporate governance failures. Indeed, the differences in perspectives reveal a real gap between the theoretical models and corporate governance.

Previous research has also revealed differences between the agency and stewardship theories in relation to ownership and management of family firms. For instance, a study of 56 Italian family businesses by Giovannini (2010) showed that the agency theory had a strong explanatory power in some firms, but in others, stewardship theory prevails.[343] Based on these findings, the author concluded that a one-size-fits-all remedy does not exist, even in

[342]Art (3) Saudi CGRs 2006.
[343]R. Giovannini, 'Corporate governance, family ownership and performance' (2010) Journal of Management & Governance 14, pp 145–166.

firms where ownership structure and size are similar.[344] Furthermore, Westhead and Howorth (2006) studied over 200 UK-based family firms and their results showed that management, rather than the ownership structure, of a family firm was generally associated with selected firm-performance indicators and nonfinancial (stewardship-oriented) company objectives.[345]

Despite these differences however, some of the theories share common assumptions. For example, both the agency theory and myopic market model share the assumption that the goal of the firm should focus on maximisation of shareholders' wealth. Other theories (such as the stakeholder and the stewardship theory) recognise the contribution of various stakeholders in meeting the objectives of the corporation. It is important to note that despite the plethora of case studies of corporate governance of many countries, there is no single theory that captures the corporate governance system in Saudi Arabia uniquely, especially regarding how corporate governance may be explicitly protected under the current Saudi regulatory regime. In fact, each of these theories seems to offer a parsimonious explanation of corporate governance issues in Saudi Arabia. Therefore, a combination of the assumptions of these theories could shed light on the understanding of corporate governance practices in Saudi Arabia. Besides, some scholars have previously argued that no model of governance is perfect and even better than the other.[346] In fact, their existence over time shows that each one is effective in its own way and corporate governance structure specific to a country is difficult to transfer to another country.

2.4 Chapter Summary

This chapter has reviewed the definition of corporate governance from various perspectives. As the review shows, these variations reflect differences in scholars' backgrounds, country experiences, trade policy and standards. However, despite these conflicting views, the definitions by the UK Cadbury report of 1992 and the OECD principles of corporate governance were considered as working definitions for the rest of this thesis. This direction was taken due to the lack of comprehensive definition of corporate governance by Saudi CGRs. Besides, both the Cadbury report and the OECD principles have an admirable criterion, and the latter has been chosen by several countries across the world as a global standard when it comes to good corporate governance. The chapter also reviewed critically

[344]ibid.
[345]P. Westhead and C. Howorth, 'Ownership and management issues associated with family firm performance and company objectives' (2006) Family Business Review 19, pp 301–316.
[346]M. Ungureanu, *Models and practices of corporate governance worldwide* (CES Working Papers, 2012) pp 625-635.

different theoretical underpinnings to the understanding of corporate governance. Specifically, agency theory alongside stakeholder, stewardship, resource dependency and myopic market theories were considered. This has helped in understanding corporate governance issues and in particular, interpreting the findings from the rest of this thesis. Importantly, how and whether one or a combination of these theories fits best to the Saudi situation was also considered. The analysis suggests that none of the theories fully account for corporate governance behaviour in Saudi Arabia, instead understanding of corporate governance in Saudi Arabia lies on the combination of the assumptions, of each of these theories. In keeping with the objectives of this thesis, the next chapter (Chapter 3) will focus on the development of a corporate governance framework in Saudi Arabia.

Chapter 3

Development of a Corporate Governance Framework in Saudi Arabia

3.1 Introduction

The present chapter provides a general description as well as evaluation of corporate governance framework in the Kingdom of Saudi Arabia. Specifically, it provides background information to the development of security markets in Saudi Arabia, whilst also highlighting the role of external structures of corporate governance (the Ministry of Commerce and Industry, the Capital Market Authority and the Saudi Stock Exchange). Since the study focuses on the protection of minority shareholders' rights, the chapter devotes great attention to the analysis of the Capital Market Authority in Saudi Arabia including its history, formation and roles in protecting the rights of minority shareholders. The major drawbacks directed to the Capital Market Authority, as well as stock market operations, in Saudi Arabia are also provided. The rationale is to understand those issues that may perhaps impede effective corporate governance practices in Saudi Arabia.

3.2 Saudi Corporate Governance: An Overview

The growth of the stock market in Saudi Arabia has passed through two main phases. The first phase virtually lasted from the year 1932 until the year 2002. The second phase began in the year 2003. During those periods, the Saudi stock market witnessed a series of dramatic events, especially the financial crisis that occurred in 2006 (which led to a big leap in the march of the development of the stock market in Saudi Arabia). The history of joint stock companies in Saudi Arabia dates back to the early 1932, when the first joint stock company, the Arab Company for Cars, was established in 1934. Two decades later, an Arabian Cement Company was set up in 1954, followed by the commissioning of three electric companies. In 1953, the Mahfouz and Kaki Company incorporated into one entity to become the first local bank, which later came to be known as the National Commercial Bank (NCB).[347] In order to keep pace with the demands of the development, the Saudi government established the second local bank in 1957, otherwise known as the Riyadh Bank. The bank was established

[347]M. A. Ramady, *The Saudi Arabian Economy: Policies, Achievements, and Challenges* (King Fahad University, Saudi Arabia, 2000) 115.

to carry out banking services and had an initial capital of SAR 50 million ($13.3 million) distributed to 50,000 shares.[348]

The actual emergence of the stock market in Saudi Arabia can be traced to the early 1970s, when the number of joint stock companies increased significantly. In 1975, there was a qualitative leap in the Saudi economy, when the Saudi government decided to merge the electricity companies in the central, Eastern and Southern regions as one consolidated company. This decision led to the issuance of additional shares to shareholders without charge.[349] In order to boost the private sector, the Saudi government established six major government lending institutions, namely the Saudi Agricultural Bank, the Saudi Credit Bank, the Public Investment Fund, the Industrial Development Fund and others.[350]

The late 1970s witnessed considerable changes in the Saudi stock market, when the government nationalized foreign banks operating in the Saudi economy. Following this nationalization programme, the government urged the banks to sell their shares to members of the public in the form of public offers. Privatization agendas have also had a huge impact in creating a regulated market for the Saudi stock trading.[351] The ministry of commerce and industry have also contributed to the development of stock trading in Saudi Arabia through the allocation of some of its shares, in order to expand the basis of investment in the stock market. This increased investors' interest in stock trading at that period. Furthermore, the 1980s saw the introduction of mutual funds in the Saudi Arabian stock market, which led to the establishment of the National Commercial Bank (NCB).[352] Although these mutual funds helped to increase investment culture amongst Saudi investors, the stock market still remained small and unattractive. As a result, some of the activities in the Saudi stock market, such as sale and purchase of shares, were conducted by unlicensed stockbrokers. However, due to the lack of sound legislations to regulate the activities of these stockbrokers, the Saudi market continued trading under these unlicensed agents until the beginning of the year 1980, when increases in oil prices led to improvement in the stock market, which in turn led to increases in trading volumes and high market prices. Following this, the Saudi government began to see the need to reform and regulate the stock market activities.

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[348]ibid
[349]M.R. Abdullah, *The Financial Market* (Al-Imam Mohammed Bin Saud Islamic University, 2006)
[350]M. A. Ramady, *The Saudi Arabian Economy: Policies, Achievements, and Challenges* (King Fahad University, Saudi Arabia, 2010) 115.
[351] ibid; M. A. Ramady, *The Saudi Arabian Economy: Policies, Achievements, and Challenges* (King Fahad University, Saudi Arabia 2010) 323-329.
[352]Aleqtisadiah, 'The History of the Mutual Funds: Its Goals, Features and Performance', cited in B. Al-Anazi, *Investor Protection and the Civil Liability for Defective Disclosures in the Saudi Securities Market: A Legal Analysis (*School of Law, University of Wollongong, 2012) 39.

The initial step that the government took was to suspend the activities of the unlicensed stockbrokers and then set up an agency, otherwise known as the Saudi Arabian Monetary Agency (SAMA), to regulate the stock trading. According to this new trend, the dealings in stocks had become limited to the commercial banks. The SAMA has the exclusive jurisdiction to monitor the shares in order to protect them from reverse speculations and also to regulate the market, making it more organised and stable financially.[353] Importantly, the Saudi government has shown a serious desire to involve the private sector to engage in supporting and sustaining this development. The efforts of the Saudi government have also culminated in the incorporation of the stock market as an emerging market under the supervision of the International Finance Corporation (IFC). This step is in response to international recognition of the importance of the Saudi stock market, which was seen as playing a leading role amongst the lists of emerging markets listed in the IFC's database. In 1984, the Saudi government took a decision to establish the Saudi Share Registration Company (SSRC), which was operated by the local banks under the supervision of the SAMA in order to manage the records of shareholders in joint stock companies.

In addition, the SSRC has a responsibility to carry out all of its supported operations, including the settlements, transfer and registration of property and other transactions that are implemented via the automated system. To support the investment in the stock market, the Electronic Securities and Information System was adopted in 1990 to provide an automated information system (AIS) for the dealers in the stock market. At first, the Saudi stock market was restricted only to the Saudi shareholders. However, between the periods of 1994 and 1999, a radical change was introduced in the Saudi stock market, which saw the citizens of the Gulf Cooperation Council Countries (GCC) allowed owning shares and participation in the Saudi stock market.[354] In 1999, the stock market headed towards allowing the foreign investors to invest their funds, particularly in the banks' mutual funds. This was done to enhance and promote the foreign cash flowing into the Saudi economy.[355] The encouragement of the foreign investment led to the establishment of the Saudi Arabian General Investment Authority (SAGIA) in 2000, to oversee the investment affairs in the

[353]Saudi Arabian Monetary Agency (SAMA) was established in the Era of King Abdulaziz under two royal decrees issued on 25/7/1371H (20/4/1952). For more insight see http://www.sama.gov.sa.
[354]M. A. Ramady, *The Saudi Arabian Economy: Policies, Achievements, and Challenges* (King Fahad University, Saudi Arabia, 2010) 169.
[355]ibid pp 475.

State, including foreign investment.[356] In 2001, the Saudi government abolished the ESIS and replaced it with the so-called *Tadawul,* which is deemed as the official name of the Saudi Arabian stock exchange. It is monitored by the Capital Market Authority (CMA) and the capitalization weighted index (all share index) and is named after Tadawul, hence Tadawul All Share Index (TASI).[357] In fact, following the establishment of the TASI, using the internet in share trading operations accelerated the trading process, speed transactions and boosted the volume of the stock market.

Furthermore, the Saudi market confidence was increased by the rising oil prices during 2005 and beyond. As a result, the TASI increased significantly from 2518 to reach 16.713 point and the market capitalization climbed from SR281 billion ($75 billion) to RS2.44 trillion ($651.5 billion). With the launching of the Tadawul All Share Index, the market expanded to involve about 128 traded companies in 2009.[358] Other developments in the Saudi stock exchange were related to the emergence of the bond market, where bonds become tradable on the Tadawul in 2009. The increase in the issuance of the bonds was associated with the companies' desire to invest in the bond market.[359] The volume of corporate bonds issued between 2006 and mid-2009 was estimated at about SR30 billion ($8 billion).[360]

The SAGIA set out a specific target, which was to see the Saudi Arabian economy emerging as one of the top 10 countries in the World Bank's. Consequently, this strategy had led to sparkling success, as the Saudi economy reached 13 out of 183 countries in 2009.[361] The Governor of the SAGIA confirmed this by saying:

> We are right on track and were just ranked 13th in the World Banks' 2009 "Doing Business" report up from 16th place in 2009, 27th in 2007, 38th in 2006, and 67th in 2005. We have a very comprehensive list of what needs to be done to reach our goal and in 2009 there has been a very tight schedule as to when each step has to be completed. This involves cooperation with each and every Saudi agency and ministry-as well as the private sector- on procedural. Among

[356]The Saudi Arabian General Investment Authority (SAGIA) has been established under the Council of Ministers Resolution No. 2 (1421/1/5 H corresponding to 2000/10/2 G). For more insight see http://www.sagia.gov.sa.
[357]For more insight http://www.tadawul.com.sa.
[358]Saudi Arabia Report (Oxford Business Group 2009) 70.
[359]ibid pp 72.
[360]ibid.
[361]Saudi Arabia Report (Oxford Business Group 2009) 31.

> others, there are some 300 indicators in total to be considered that apply to the whole corporate life and competitiveness.[362]

The Saudi Company Law (SCL) of 1965 is considered the principal body for regulating companies. In practice, however, there were clearly shortcomings in a number of aspects, particularly with legislations and regulations concerning the stock exchange. In order to address these problems and keep pace with the rapid developments of the Saudi stock market, the Saudi government issued a bundle of reformative legislations in recent years, such as the Capital Market Law (CML), the listing rules and the Corporate Governance Regulations. It is important to note that the most prominent factor in the reformation of the Saudi stock market was the stock bubble and the collapse of the stock market, which occurred in 2006.

As previously mentioned, the Ministry of Commerce and Industry (MOCI) has a mandate to supervise and monitor the share trading and all commercial activities in Saudi Arabia. Before the emergence of the Saudi stock market, the CL of 1965 had given the MOCI the statutory rights to oversee and govern the stock activities. Consequently, the MOCI enjoyed a bundle of jurisdictions (such as legal and judicial). Gradually, the share trading started becoming more complex, especially with the increasing number of joint stock companies and the initial public offerings (IPO). These developments and many others suggest that the MOCI cannot perform all the duties and responsibilities alone, hence the need for change.[363]

In order to improve the performance of the MOCI, the Saudi Central Bank, otherwise known as the Saudi Arabian Monetary Agency (SAMA) was brought in to relieve the MOCI of some of its duties and responsibilities (regulating and overseeing the share trading), in particular the Saudi banks. It can be said that the MOCI and the SAMA have shared responsibility of monitoring and controlling share trading. The MOCI is responsible for regulating the stock market, whereas the market operation and stock activities, such as buying or selling of shares, security advertising and others is controlled and overseen by the SAMA.[364] In reality, the shared responsibilities between these two bodies may inevitably lead to conflict of jurisdiction. In order to avoid these conflicts, the Saudi government established two high ranking committees, which were called the Ministerial Committee[365] and the Supervisory

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[362]Amr Abdullah Al-Dabbagh, the Former Governor of the Saudi Arabian General Investment Authority (SAGIA). This interview has made by the Saudi Arabia Report (Oxford Business Group 2009) 34.

[363]H. Azzam, *The Emerging Arab Capital Markets: Investment Opportunities in Relatively Underplayed Markets* (Kegan Paul International, London, 1997) 141-42.

[364]F. M. Almajid, *A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: a Comparative and Analytical Study from a Legal Perspective* (School of Law, University of Manchester, 2011) 198.

[365]The Ministerial Committee was established by a Royal Decree No.12308, dated 11/07/1403 H (24.04.1983), and included members of the Minister of Finance, the MOCI and the Governor of SAMA.

Committee[366], to review the activities of the MOCI and SAMA and give them fundamental recommendations and suggestions regarding their performance. In spite of the Saudi government's efforts to encourage the work of the share trading however, the Saudi stock market has not reached the expected aspirations.

The fall of financial institutions in Asia, Russia, the US and some European countries during the period of 1997 has contributed largely to the establishment of corporate governance as a top concern for international financial institutions around the world (Hossain, 2007). Specifically, the 1987 market crash and corporate scandals (such as Enron WorldCom) that hit the global economy in 2002 and beyond have accelerated the need for new principles and regulations to address the status quo. The Saudi Arabian government was concerned about these crises surfacing in its economy. Hence, it began to launch a series of reforms aimed at restoring trust and confidence in its financial system, thus protecting its financial and economic institutions from the hazards of a global financial crisis.

It is important to note that the development of the stock market in Saudi Arabia coincided with the establishment of the Saudi Capital Market Authority in 2003, which saw a legal landmark in the regulation of share trading in the Saudi stock market. As mentioned above, the stock market was subject to the directives of the MOCI and the SAMA, which led to duplication of functions between the two bodies. Thus, the Saudi stock market is characterised by what is known as a duplication of the regulatory structure. However, an independent body (the CMA) was set up with a bundle of jurisdictions. The main purpose of the CMA is to issue the essential regulations, rules and instructions in accordance with the provisions of Saudi Capital Market Law (CML). Consequently, the legal function of the CMA can be shortened to the following points[367]:

(1) Regulate and develop the stock exchange, securities transactions and reduce the stock market risk. (2) Regulate and monitor the issuance and trading in securities. (3) Regulate and monitor the works and activities that are subject to the control and supervision of the CMA. (4) Protect citizens and investors from unfair and unsound practices, or practices including fraud, deceit and manipulation. (5) Act to achieve efficiency, transparency and fairness in security transactions. (6) Regulate and monitor the full disclosure of information related to

[366]The Supervisory Committee was set up by the Executive Rules, comprised members representing the Ministry of Finance, MOCI and SAMA.
[367]Art (5) Capital Market Law 2003, which issued pursuant to Royal Decree No (M/30) dated 4/6/1424H - 31/7/2003.

securities and their issuers. (7) Regulate proxy and purchase requests and public offers of shares.

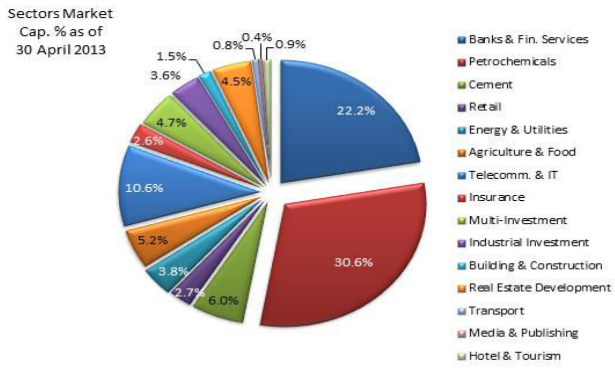


Figure 1: Tadawul market overview 2012 [368]

Today, the Saudi stock market is the biggest market in the Middle East and North Africa (MENA) region. It has a market capitalization of $373.42 billion and daily trade of $2.05 billion, as at the end of 2012. In the Gulf Cooperative Countries (GCC) region, for instance, the Saudi Stock Market represents about 90% of the volume of investment.[369] Furthermore, there were about 5 million investors registered at the Tadawul depository over 30 licensed brokerage companies.[370] The Saudi stock market is classified as one of the best emerging markets, which involves about 160 listed firms covering several sectors, such as cement, petrochemicals, banks, food, agricultural, industrials, energy, construction and other industries.[371]

As previously mentioned investors lost confidence in the Saudi securities market, particularly in the wake of the financial crisis in 2006. Indeed, the lack of transparency and insufficient information provided by the CMA has largely contributed to the failure of the market in 2006. Saudi securities market is deemed as one of the biggest and fastest growing markets in the MENA region. However, it is still characterized by some irregularities, especially in relation to issue of transparency and disclosure. Furthermore, it has also been stressed that most shareholders in the Saudi securities market have limited knowledge about the activities

[368]These Statistics and other information regarding the volume of the Saudi Arabian Market have been taken from the Tadawul Website. For more insight: http://www.tadawul.com.sa.
[369]SAMBA Report Series, 'The Saudi Stock Market: Structural Issues, Recent Performance and Outlook' (2009) 3-5.
[370]For more insight see the interviews with Saudi Stock Exchange (Tadawul), which made by World Federation of Exchanges (WFE). Available at: http://www.world-exchanges.org.
[371]ibid

and operations of the stock market, thus they are not fully empowered to participate effectively in stock market operations and transactions. To lessen major problems facing the Saudi stock market, the Capital Market Authority has issued a new strategic plan in 2015. The new strategy plan 2015-2019 aimed at developing the stock market and protecting shareholders' rights. The strategic plan is going to implement during four years and including strategic objectives and initiatives which has been broken down into four plans, namely:[372] (1) foster capital market development, (2) promote investor protection, (3) improve the regulatory environment, and (4) enhance CMA's organizational excellence.

3.3 The Capital Market Authority (CMA)

As the findings from the preceding section reveal, the Saudi stock market regulation has witnessed a number of crucial historical developments since its inception in 1957. Through the last decade, several attempts have been launched by the Saudi government with a view to improving local investment in the Saudi economy. Importantly, the major revolution in the Saudi Arabian economy started following the enactment of Capital Market Law in 2003 by the Saudi Arabian government, which made provisions for the establishment of the Capital Market Authority. In fact, the introduction of the CMA to the stock market was considered a paradigm shift in Saudi Arabia and a major legal landmark in the business and economic activities of the Kingdom. Specifically, it is considered the most important external corporate governance reform in Saudi Arabia.[373] The financial scandals that hit the global economy, which led to collapse of several international giant corporations over the world, such as Enron Company, WorldCom and so on also had a negative impact on the global economic activities, including that of Saudi Arabia. These financial scandals and frauds have forced many countries to launch a bundle of legal reforms in order to restore the trust and confidence of investors in their local markets and institutions.

Indeed, the regulatory and supervisory authority in any market plays a fundamental role in protecting the market, and investors alike, from manipulation and fraud. Therefore, providing an overview of the history and role of the Capital Market Authority is necessary in understanding its capability to protect the rights of minority shareholders at the hands of controlling shareholders. In keeping with the above, the sections below will examine the

[372]Capital Market Authority Strategic Plan (2015-2019). Strategy and Research Division - Strategy and Program Management, pp.1-47. For more insight see: http://www.cma.org.sa/en/Pages/home.aspx.

[373]K. Hussainey and A. Al-Nodel, 'Corporate governance online reporting by Saudi listed companies' (2008) Corporate Governance in Less Developed and Emerging Economies, vol 8, pp 39-64; A. Al-Matari et al., 'Corporate governance and performance of Saudi Arabia listed companies' (2012) British Journal of Arts and Social Sciences, vol 9, no 1, pp 1-30.

internal structure and legal nature of the CMA and its role in regulating and monitoring the stock market. According to Capital Market Law, the CMA is considered as the sole entity responsible for monitoring the stock market and supervising its activities.[374] As a consequence, it plays a crucial role in building confidence among investors in the stock market and ensuring that the statutory protection of all shareholders, including minority shareholders is guaranteed.

3.3.1 The Internal Structure of the Capital Market Authority

The Saudi government represented by the Saudi Arabian Monetary Agency commenced drafting of the Capital Market Law in May 1998.[375] The aim of enacting the CML and its relevant rules was to govern the stock market's activities. Consequently, the CML was issued in 2003 and become the main source of the Saudi Stock Market regulations. The CML is comprised of 10 chapters, divided into 67 articles as follows:

1) Definitions
2) The Capital Market Authority
3) The Stock Exchange
4) The Securities Depositary Centre
5) Brokers' Regulation
6) Investment Funds and Collective Investment Schemes
7) Disclosure
8) Manipulation and Insider Trading
9) Regulation of Proxy Solicitations, Restricted Purchase and Restricted Offer for Shares
10) Sanctions and Penalties for Violations

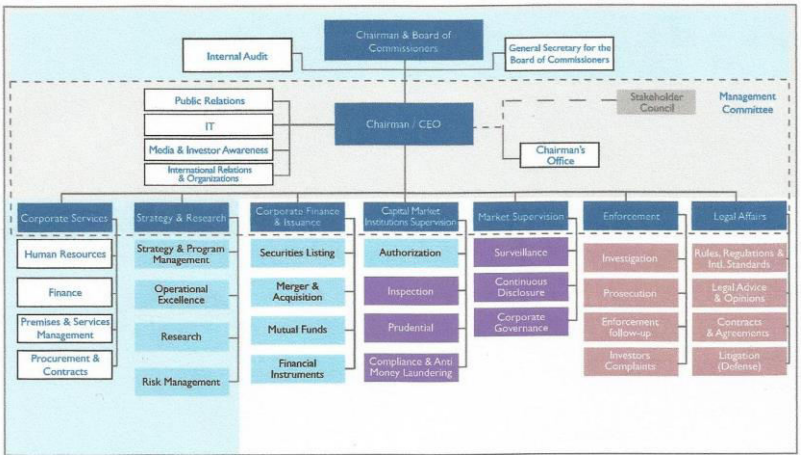
The Capital Market Authority has appeared within the articles of the CML as one of the most significant initiatives that has been presented by the Saudi government in order to enhance the confidence within its market and economy. In reality, there is no doubt that this paradigm shift in the emergence of the Saudi stock market, by creating the CMA, has had a positive impact, especially in relation to the protection of minority shareholders' rights. The internal

[374] Art (20-a) Saudi CML.

[375] The Draft of the CML placed by SAMA with the assistance of Professors James D. Cox and Joseph W. Beach from School of Law, Duke University in USA. James D. Cox is a Professor of Law, specializes in the areas of corporate and securities law. Cox joined the Duke Law faculty in 1979 after teaching at the law schools of Boston University, the University of San Francisco, the University of California, Hastings College of the Law, and Stanford. He got B.S. from Arizona State University and law degrees at the University of California, Hastings College of the Law (J.D.) and Harvard Law School (LL.M.). More insight: http://law.duke.edu. Professor Joseph W. Beach received his J.D., magna cum laude, from Duke University School of Law, where he was a member of the Order of the Coif. He received his B.A., cum laude, from Davidson College, and an M.A. in International Relations from Duke University Graduate School. He is admitted to practice in North Carolina. More insight: http://www.cadwalader.com.

regulatory structure of the Capital Market Authority plays a crucial role in controlling the market behaviours. Given the importance of the CMA in developing the market and protecting the rights of dealers and traders, studying its internal structure will aid the understanding of how the CML regulations are enforced by the CMA.

Table 1: Organisational Structure of the CMA[376]



In the section that follows, the main duties and the formation of the Capital Market Authority is provided.

3.3.2 The Main Duties and the Formation of the Capital Market Authority

According to Article (7) of the Capital Market Law, the CMA should have a board, known as the 'Board of Capital Market Authority', consisting of five members. The board members are appointed by the Royal Order on a full-time basis. The period of membership on the board is five years, which can be renewed once. All the members should be citizens of Saudi Arabia and their salaries, rewards and privileges should be specified by the Royal Order. The members of the board of the CMA should be highly qualified with a wealth of experiences and familiarity in economics, business and law. In order to ensure fairness and independence of the CMA, the CML clearly states that the members of the board and employees of the CMA are not allowed to engage in any form of commercial or economic activities, have a private interest in any project intended for profit, borrow or lend any funds, or to acquire,

[376]For more information see Annual Report 2012. Available at: http://www.cma.org.sa.

own or issue any security.[377] In addition to that, the CML has stipulated that as the CMA is considered the regulator body of the stock market, its members and employees should disclose to the authority the securities they possess in their name, including that of their relatives, and furthermore should declare any change thereafter, within three days of becoming aware of such change.[378]

It is clear from the above that the CMA was established to fulfil the first OECD principle of corporate governance: 'ensuring the basis for effective corporate governance framework'.[379] Specifically, the principle states that 'the corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities'.[380]

It is important to note that the CMA has implemented three major corporate governance initiatives in order to improve the standard of corporate governance in Saudi Arabia. These initiatives have been implemented in three phases.[381] The first phase was completed following the publication of the CGRs. The second phase, which is currently in progress, deals with creating awareness among market participants on the corporate governance and how to apply its regulations. The third phase will focus on the revision of the CGRs and perhaps make parts or the entire CGRs are mandatory. It is also important to note that the CGRs are currently implemented on a 'comply or explain' basis.[382] Importantly, as will be discussed in Chapter 4 of this thesis, the description and evaluation of the CGRs will shed light on how legal systems mediate the relationship between corporate governance and protection of minority shareholders' rights. In fact, by establishing the CGRs, the CMA has contributed in improving the effectiveness of the market as an active, external corporate governance mechanism.

The board of the CMA should have the sufficient financial and administrative resources and it should be autonomous. This board should be headed by a chairman, otherwise known as the chief executive officer (CEO). The chairman should manage the affairs of the CMA, implement the board decisions, draw policies and place all the strategies that help the CMA

[377]Art (4-b) Saudi CML.
[378]Ibid art (8).
[379]OECD Principles of Corporate Governance, OECD. Available at: http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf, 2004
[380]ibid
[381] Reports on the Observation of Standards and Codes (ROSC), Corporate Governance Country Assessment (World Bank, Washington, USA, 2009).
[382]ibid.

to do its duties in the best way. The vice-chairman should also exist among the members of the board and implement the responsibilities of the chairman, if the chairman is absent or he is unable to do his duties for any reason. In order to implement the responsibilities and functions of the CMA, the board should place the internal regulations of the CMA and determine the ideal method upon which its employees are appointed, including their salaries and remuneration. The board should specify the key structure of the CMA and distribute its main circuits and departments. In fact, the activities of the CMA, in relation to board and employee appointments, are consistent with the stakeholder theory of corporate governance. According to the stakeholder theory, the operation of the firm should focus not only on the financial benefit to their owners, but also for the interests of the relevant broader society (employees, customers, creditors, suppliers, managers and the entire wider community).[383] The OECD principles of corporate governance, especially in relation to the role of stakeholders in corporate governance[384], are also relevant at this point. Specifically, the principle provides that: 'the corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises'.[385]

3.4 The Role of the CMA in Protecting Minority Shareholders' Rights

It has been clear, since the outset, that the Saudi Regulator was keen to make the CMA more powerful and influential. Therefore, the Capital Market Law has stated, in a bundle of rules, that giving the CMA a broad range of powers and jurisdictions would help to improve the economic growth and enhance the confidence of investors in the Saudi stock market. The CMA's roles are implemented in different ways: 1) through regulatory and legislative roles; 2) investigative and punitive roles; 3) monitoring and supervisory roles; and 4) disclosure and informative roles. As stated in the introductory part of this chapter, a substantial attention will be paid, looking at the extent to which the CMA has contributed in protecting the rights of minority shareholders. In the sections below, a detailed analysis of the role of the CMA in protecting minority shareholders' rights is provided.

[383] J. F. Smith, 'The shareholders vs stakeholders debate' (2003). Available at: http://sloanreview.mit.edu/article/the-shareholders-vs-stakeholders-debate/.
[384] OECD Principles of Corporate Governance, OECD (2004) Available at:http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf.
[385] ibid.

3.4.1 Monitoring and Supervision of the Stock Market[386]

Capital Market Institutions Supervision (CMIS) is also considered as one of the most significant departments in the CMA, which is responsible for ensuring that authorised persons adhere strictly to the provisions of Capital Market Law and its implementing regulations.[387] The CMIS has supervisory and monitoring authority over authorised persons' activities in the CMA. It works to ensure the soundness of financial institutions, the stability of the stock market and fairness of an orderly investment environment that safeguards the motives of investors and promotes proper regulations and development of the industry.[388] In fact, this duty is implemented through various departments. The Authorisation Department is primarily responsible for receiving and reviewing all applications related to security business, which are presented to the CMA in order to conduct security business in the Saudi stock market. By virtue of Article 2 of the Securities Business Regulations (SBR), the security business includes a set of deeds, such as dealing, arranging, managing, advising and custody.[389] In addition, the Authorisation Department is responsible for reviewing changes and amendments in the situation of authorised persons, such as to business profiles and changes in ownership and employees' registration requirements.[390] It is also in charge of the review of notifications received from the authorised persons, in accordance with the determined situations in Annexe 3.2 of the Authorised Person Regulations.[391]

Another division in this department is the Inspection Department.[392] This division is responsible for carrying out comprehensive inspections on the site of authorised persons to ensure that it is in compliant with the Capital Market Law and its implementing regulations. Moreover, the CMA has established the so-called Prudential Department to make sure that the capital of Authorised Persons is adequate and to ensure that there are sound financial resources to meet their business obligations, as per the requirements of the implementing regulations. This department is also responsible for reviewing and analysing the balance sheet, income statement and performance risk assessment of authorised persons, so as to identify their financial risks and resolve them in a proactive and timely manner. In order of fight against financial crimes and protect the Saudi Arabian market from exploitation, the

[386]The Capital Market Institutions Supervision. Available at: http://www.cma.org.sa.
[387]Authorized person is any person who applies to obtain license or authorisation to carry out security business in the Saudi Arabian stock market.
[388]The Capital Market Institutions Supervision. Available at: http://www.cma.org.sa.
[389]Art (2) Saudi Securities Business Regulations 2006. Avaliable at: http://www.cma.org.sa/En/Documents/SECURITIES%.
[390]Art (11) Saudi Authorized Persons Regulations 2006.
[391]Annex (3-2) Authorized Persons Regulations 2006.
[392]Prudential Department. Available at: http://www.cma.org.sa.

CMA has established the Department of Compliance and Anti-Money Laundering Department. These departments are responsible for monitoring the authorised persons in order to ensure their activities are compatible with the CMA's Anti-Money Laundering and Counter-Terrorism Financing Rules, and other related laws.[393]

In fact, the above duties of the CMA reflect the assumptions of the agency theory (described in Chapter 2.3.3). The dominant view is that the shareholders usually expect that managers will act and make the best decisions in the owners' interests. In practice, however, it has been shown that managers tend to express their opportunistic nature and look to maximize their own personal goals and selfish interests, to the detriment of the shareholders.[394] Therefore, a form of control mechanism (corporate governance) is needed to prevent managers from shirking and misusing their fiduciary function.[395] According to the agency theory, corporate governance reforms, geared towards monitoring the role of the board and supported by processes such as external audit and reporting requirements, are likely to reduce problems of management pursuing their own interests, or performing poorly.[396] In other words, by monitoring and supervising the market, the CMA is contributing towards reducing agency conflict, which in turn creates an investment climate that ensures adequate protection of the rights of minority shareholders.

3.4.2 Applying Corporate Governance Regulations

In order to consolidate the great efforts made by the Saudi Arabian government in maintaining the best practices of corporate governance, the Corporate Governance Regulations have stipulated clearly that any listed corporations working in the Saudi stock market should identify the essential procedures and precautions it has in place to help shareholders and empower them to exercise all of their lawful rights.[397] As a result, the listed companies were subjected to strict monitoring in order to ensure that they implement these regulations effectively. Furthermore, the CMA established the so-called Corporate Governance Department, which is charged with the responsibility of assessing the extent to which the listed corporations comply with the Corporate Governance Regulations. Importantly, the main objective of establishing this department is to contribute to promoting

[393]Compliance and Anti-Money Laundering Department. Available at: http://www.cma.org.sa.
[394]E.I. Mostovicz, N.K. Kakabadse, and A. Kakabadse, 'Corporate governance: quo vadis? (2011), Corporate Governance: The International Journal of Business in Society, vol 11, no 5, pp 613-626.
[395]A. Shleifer and R.W.Vishny., 'A survey of corporate governance' (1997) The Journal of Finance, vol 52, pp 737-783.
[396]N. Chambers et al., 'Towards a framework for enhancing the performance of NHS boards: a synthesis of the evidence about board governance, board effectiveness and board development' (2013) Health Services and Delivery Research, vol 1, no 6.
[397]Art (4-a) Saudi CGRs.

best practices in protecting shareholders' and stakeholders' rights alike.[398] In fact, the CMA established this department in order to fulfil its mission objectives, which are to raise awareness of the importance of good Corporate Governance Regulations and practices, as well as to promote a culture of good governance amongst the listed companies in the Saudi capital market. Another goal is to reinforce the concepts of responsibility, transparency, and fairness in addition to raising the awareness of investors, concerning good governance. Furthermore, the Corporate Governance Department seeks to enhance coordination and communication with professional, international and domestic organisations as well as institutional investors so as to improve and develop effective corporate governance practices in the Saudi stock market.[399]

To protect minority shareholders and other investors, the department also creates and develops sufficient procedures that help to oversee the governance practices of listed companies and also ensure effective protection of shareholders and investors in the stock market. In this regard, the Corporate Governance Department uses the best tools to ensure the efficient application of the statutory requirements for corporate governance.[400]In addition, previous research has shown that soft regulation is one of the hallmarks of good corporate governance practice.[401] As a result, promoting a culture of soft regulation of corporate governance in listed corporations, through continuous communication, is one of the main goals of this department.[402] It is important to note that soft regulation is one of the initiatives put forward by practitioners to improve corporate governance practices. There is an ongoing debate as to whether firms should follow hard or soft regulation in their corporate governance practices. Whereas the hard regulation defines a set of mandatory instructions (laws) that firms have to adopt, the soft regulation on the other hand, deals with a collection of non-binding guidelines (codes), which are accompanied by a 'comply or explain' principle,[403] whereby firms are expected to report whether they comply with each of the guidelines (or not, and if so, why not).[404] Supporters of soft regulation argued that soft regulation is appealing because it allows firms to choose individual governance structures that reflect firm-specific trade-offs.[405] Importantly, it forces firms to release a Declaration of Conformity

[398]Corporate Governance Department. Available at: http://www.cma.org.sa.
[399]ibid.
[400]ibid.
[401]D. Walker, *A Review of Corporate Governance in UK Banks and other Financial Industry Entities- Final Recommendations* (2009) pp 70.
[402]Corporate Governance Department. Available at: http://www.cma.org.sa.
[403] Cadbury Committee, *Report of the Committee on the Financial Aspects of Corporate Governance* (London, Gee, 1992).
[404]M.S. Rapp et al., 'Is soft regulation of corporate governance efficient from a shareholders' perspective? Work in progress' (Prepared for the conference 'Twenty Years after Cadbury, Ten Years after Sarbanes-Oxley: Challenges of Corporate Governance' June 10, 2013) p 2.
[405]ibid

(DoC), which reveals the firm's government structures to outsiders. One potential benefit of a DoC is that it increases transparency of firms' government structures, which 'allows shareholders – even if they are non-monitoring but decide by exit – as well as the public, to put managers under external pressure to establish efficient governance structures'.[406] In fact, a recent study by Rapp et al[407] suggests that, from the perspective of shareholders, soft regulation of corporate governance practices is an efficient way to regulate governance mechanisms of firms. Despite these benefits, critics have argued that soft regulation does not improve corporate governance in firms with powerful and self-interested managers.[408] Importantly, whether soft regulation will help improve corporate governance practice in Saudi firms dominated by concentrated ownership of wealthy families and the State, however, remains to be determined. Thus, from shareholder's perspective an important question arises: How does soft regulation guarantee adequate protection of minority shareholders' rights? Perhaps given the high level of ownership concentration in Saudi Arabia, hard regulation might likely be preferred to soft regulation, in order to ensure adequate protection of minority shareholders' rights.

3.4.2.1 Inspection and Investigation

Conducting proper inspection and investigation into the securities market is one of the most significant factors that contribute largely in implementing the enforcement action. A chronic lack of resources, skills and independent agency to undertake inspection, investigation and bring enforcement actions, are key reasons for the weakness of regulatory systems over the world.[409] Public enforcement mechanisms, particularly inspection, investigation and penalties are considered a significant means that can contribute to deter those who might be engaging in fraudulent market activities or manipulation. The importance of inspection and investigation, as vital mechanisms to enhance the effectiveness of public enforcement, has been affirmed in the Principles of the IOSCO: 'The regulator should have comprehensive inspection, investigation and surveillance powers'.[410]

In fact, giving the security market authorities an absolute power to undertake the inspection of the listed corporations' activities, and conduct investigation with those who violate the

[406]ibid
[407]ibid
[408]ibid
[409]Corporate Governance Department. Available at: http://www.cma.org.sa.
[410]Principle (8) International Organization of Securities Commissions (IOSCO) 2009.

provisions of the Capital Market Law and its regulations, is very significant in order to create a sound stock market and protect the interests of investors from fraudulent manipulators. The power of the regulator to enforce security market regulations is based on his ability to commence investigation into violations of the law and bring appropriate action, to deter or punish the offenders.[411]

It is obvious from literature that there is a solid relationship between effective enforcement mechanisms and protection of minority shareholders' rights, as well as its role in developing the securities markets in general.[412] In Saudi Arabia, the CMA has declared, since its inception, that its main enforcement task is to protect investors and the public from unfair and unsound practices involving fraud, deceit, cheating, manipulation and insider information trading.[413] In fact, since its outset, the Saudi regulator has acknowledged the value of inspection and investigation as effective mechanisms, especially as it relates to the protection of the security market and minority shareholders from harmful violations. Thus, the CML has given the CMA all jurisdictions to exercise its responsibilities and duties entirely. In accordance with the CML, the CMA established four departments in order to facilitate its mission. The Investigation Department is one of the significant divisions in the Saudi securities market. In accordance with the CML,

> The members of the authority and its employees designated by the board are empowered to subpoena witnesses, take evidence and require the production of any books, papers, or other documents which the authority deems relevant or material to its investigation.[414]

The key role of the Investigation Department is to oversee all investigation processes, collect evidence, interview offenders and conduct interrogation. Furthermore, the department also seeks to:[415]

1) Investigate violations referred by different sources
2) Investigate electronic violations referred by different sources

[411]P. A. Loomis, 'Enforcement Problems under the Federal Securities Law's' (1959), Business Lawyer, vol 14, pp 665.
[412]F. Modigliani and E. Perotti, 'Protection of Minority Interest and the Development of Security Markets' (1997) Managerial and Decision Economics, vol 18, pp 519-525.
[413]Capital Market Authority, About Capital Market Authority, Duties and Authorities. For more information visit: http://www.cma.org.sa.
[414]Art (5-c) Saudi CML.
[415]Capital Market Authority, About Capital Market Authority, CMA Departments- Enforcement. For more insight see http://www.cma.org.sa.

3) Request data and records that support the investigation processes from internal and external sources
4) Subpoena suspects and witnesses for interview and interrogation.

In fact, these investigative powers of the CMA are in line with the recommendations of the agency theory, especially in mitigating the agency conflict. Specifically, the theory recommends that the main role of the board is to obtain the necessary information to monitor the performance of the company and to hold the managers accountable.[416]

With respect to inspection, the CMA is empowered to carry out inspection of the records or any other materials, whoever the holder may be, to determine whether the person 'has violated, or is about to violate' any provision of the CML or its implementing regulations.[417] In addition to that, the Capital Market Law (CML) has also given Tadawul the power to carry out investigations and inspections of any licensed broker or broker's agent, to determine whether a violation of rules has occurred or is about to occur. This power and function is working in concert with the CMA's powers of investigation and involves the power to require the production of any person's testimony, papers, books and documents, which the exchange deems necessary or relevant to its inquiry.[418]

The evidence above suggests that the Saudi regulatory body has given the CMA full statutory powers and functions to discharge its responsibilities and to ensure active enforcement of the securities law and its relevant regulations. In order to protect the stock market and the rights of the minority shareholders against fraudulent manipulators, the CMA established the Investigation Department to achieve this end. The comparison between the CMA and its counterparts in other Arab countries has shown that the Saudi Arabian stock market is more independent and it outperforms its counterparts, in discharge of its function.[419]

In the UK, the investigation process conducted for violations of the Financial Services Act 2012 is slightly different from the situation under the CML. According to the Act, investigations may be conducted based on the Financial Conduct Authority (FCA) initiative

[416] N. Chambers et al., 'Towards a framework for enhancing the performance of NHS boards: a synthesis of the evidence about board governance, board effectiveness and board development' (2013) Health Services and Delivery Research, vol 1, no 6, p 17.
[417]Art (5-c) Saudi CML.
[418]Ibid art (35).
[419]S. Al-Fadhli, 'Independency of the Capital Market Authority Is a Red Line, Statutorily and constitutionally', *Alqabas Newspaper* (28 September, 2011) Available at: http://www.alqabas.com.kw/node/16747.

or upon the directives of the Treasury.[420] The FCA Transitional Board[421] should oversee all the investigation processes, even though the role of the FCA is to verify the objectives of the enforcement system. However, it seems that there is no specialized enforcement department under the UK Act of 2012 because the FCA has to notify the Treasury before commencing or suspending an investigation, which then determines when it will start or resume the investigations.[422] In accordance with the U.K. Financial Services Act of 2012, the Treasury has the right to place certain directions for the regulator, such as:[423]

1) The scope of the investigation[424]
2) The period during which the investigation is to be carried out[425]
3) The conduct of the investigation[426]
4) The making of reports.[427]

3.4.2.2 Imposing Penalties and Sanctions

Effective enforcement mechanisms should comprise of severe penalties and sanctions. Indeed, without harsh sanctions against violators of security market regulations, the enforcement system would not achieve its objectives. Public enforcement mechanisms refer to the use of government bodies to disclose and impose sanctions and penalties against each company or individual that violates security market laws and regulations.[428] The power to make orders and impose sanctions on offenders has become a cornerstone of the process of activation of the enforcement system.[429] Similarly, empowering the stock market agency to impose appropriate sanctions and penalties on those who breach security law has become a crucial factor in ensuring the stability of financial systems and the development of the security market. In fact, imposing penalties plays a fundamental role in protecting minority shareholders' rights from mismanagement and the abuse of controlling shareholders. The above fact has been echoed in the OECD Principles of Corporate Governance, which states that:

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[420]Section (73-77) U.K. Financial Services Act 2012.
[421]In accordance with Article 5 of the Financial Services Act 2012, the FSA has appointed some persons to discharge functions of the FCA.
[422]Section (78-5) U.K. Financial Services Act 2012.
[423]Part (5-69) U.K Financial Act 2012.
[424]ibid.
[425]ibid.
[426]ibid.
[427]ibid.
[428]A. Mitchell Polinsky, Steven Shavell, 'The Theory of Public Enforcement of Law' (2006), Centre for Law, Economic and Business, Harvard Law School, vol 1, pp 3-6.
[429]Mary, G. Condon, Anita, I. Anand and Janis, P. Sarra, *Securities Law in Canada: Cases and Commentary*" (Emond Montgomery Publications Limited, Toronto, Canada, 2010).

> The corporate governance framework provides either ex ante mechanisms for minority shareholders to protect their rights that have proven effective and/or ex post sanctions against controlling shareholders for abusive action taken against them. There are effective means of redress for minority shareholders and adequate remedies.[430]

Indeed, sanctions and penalties are considered as one of the most significant *ex post* means that can contribute largely in reforming the management and protecting the minority shareholders against the oppression of controlling shareholders. Similarly, administrative, financial or criminal punishments are seen as effective mechanisms of redress for minority shareholders, whose rights have been violated. Given the effectiveness of sanctions as a public enforcement mechanism, many countries adopt sanctions as a component of their regulatory milestones.[431]

Specifically, in Saudi Arabia the Articles 57 and 59 of the CML have given the CMA all the rights to impose sanctions against those who violate the provisions of the CML or its relevant regulations. These sanctions range from administrative, monetary and criminal penalties. Article 57 of the CML gives the CMA the right to require the Committee for the Resolution of Securities Disputes (CRSD) to impose the criminal sanctions and punish the violators of Articles 49 and 50, with imprisonment terms for up to five years.[432] In addition to the imprisonment term, Article 59 of the CML also gives the CMA the power to bring other legal action before the CRSD, against a violator, or a potential violator of any of the CML provisions. The administrative sanctions for accusations brought under Article 59 range from the following sanctions:[433]

1) Warning the violator[434]
2) Ceasing and desisting the offending person from carrying out the act which is the subject of the suit[435]
3) Travel ban[436]
4) Seizing and implementing on the property of the offender[437]

[430]Principle (iii-a-2) OECD Principle of Corporate Governance 1999.
[431]Section (4-11) German Securities Trading Act 1998.
[432]Art (57-c) Saudi CML.
[433]Ibid art (59-a).
[434]ibid.
[435]ibid.
[436]ibid.
[437]ibid.

5) Obliging the person concerned to take the essential steps to avoid the violation or to conduct such necessary corrective steps to remedy the consequences of the violation[438]
6) Preventing the violator from working with companies whose are listed on the exchange[439]
7) Suspending the trading in the securities market[440]
8) Obliging the offender to pay to the authority's account the gains realized as a result of such violation[441]
9) Preventing the offending person from working as a broker, portfolio manager or investment adviser for a necessary period, for the safety of the securities market and the protection of investors.[442]

With regard to the amount of public penalties imposed, Article 59b) has given both the Board of the Capital Market Authority (BCMA) and the CRSD the right to impose a financial fine against any person responsible for a violation of the CML, its implementing regulations, and the rules of the CMA (or the exchange's regulations), but the fines shall not be less than SR 10,000 ($2,666) and not exceed SR 100,000 ($26,666), for each violation perpetrated by the defendant.[443] Moreover, if the violator is a security professional (such as an unlicensed dealer or broker), then he or she should be subjected to either a fine, not less than SR 10,000 or more than SR 100,000, for every violation, or imprisonment for a term not exceeding nine months.[444]

In addition to what has been defined by Article 49, concerning the limited actions and practices that lead to false and misleading impressions, the CML also states that any person (as identified in Article 55b)),[445] is responsible for compensation of investors, when the prospectus contains incorrect statements of material matters or omitted substantial facts required to be stipulated in the prospectus. To fulfill the responsibility of protecting investors, including minority shareholders, the CML stipulates that any person who announces, or is

[438]ibid.
[439]ibid.
[440]ibid.
[441]ibid.
[442]ibid.
[443]ibid art (59-b).
[444]Ibid art (60-a).
[445]The Saudi CML give investors entitled to compensation for the damages incurred by them as a result of incorrect prospectus. The persons who are responsible for issuing incorrect prospectus are: The party issuing the security, The senior officers of the issuing party of the financial security, The members of the board of directors of the issuing party, The underwriters who are responsible for offering on behalf of the issuer the security for sale to the public, The accountant, engineer or appraiser and others defined in the prospectus. For more insight see Art (55-b-1-2-3-4-5) SCML.

responsible for another person who announces, either orally or in writing, an untrue statement of material fact, or omits to declare the material facts (leading to misled investors in relation to the sale or purchase of security) should be responsible for compensation of the damages incurred by investors.[446]

With respect to penalties imposed for the interest of affected investors, the CML states that damaged investors are entitled to claim compensation equivalent to the value of the damages incurred by financial security.[447] Despite the seriousness of the CML in enforcing sanctions imposed against violators of its provisions, it should be noted that the provisions of Article 55a) are ambiguous, as they state that the affected investor is entitled to claim compensation for the damages incurred by him, but he must prove that these damages were as a result of incorrect statements or misleading information contained in the prospectus. Sadly in Saudi Arabia, minority shareholders do not have powers to obtain information from companies or boards of directors, apparently due to the concentration of ownership and control at the hands of controlling shareholders and rich families.

It should be noted that the CMA and its Semi-Judicial Committee have a genuine desire to punish any person who violates the provisions of the CML or any of the implementing regulations. Hence, the Saudi security market has witnessed a set of sanctions and penalties against offenders since its inception. The volume of cases that has been dealt with by the Capital Market Authority Board (CMAB) and the CRSD, regarding manipulation and fraud, is high. A recent example is the decision by the Appeal Committee for the Resolution of Securities Conflicts (ACRSC), dated 01/07/2014, regarding the suit filed by the CMA against Hamad bin Abdulwahab bin Mohammed Alabdulwahab (the defendant).[448] The verdict ruled against the defendant, who was found to have violated Article 49 of the CML, as well as Article 2 and Article 3 of the market conduct regulations, whilst trading the equities of the Astra Industrial Group, Saudi Arabian Amiantit Co., Mohammad Al Mojil Group Company, Saudi Transport and Investment Company, Saudi Industrial Services Co., Malath Cooperative Insurance and Reinsurance Company, Saudi Fisheries Co., Saudi IAIC Cooperative Insurance Co, Tourism Enterprise Co., Saudi Indian Company for Co- operative Insurance, ALAHLI Takaful Company and National Agriculture Marketing Co., during the period 03/03/2009 to 26/05/2009. These practices constituted fraud and manipulation and created a false and

[446]Art (56-a) Saudi CML.
[447]Ibid art (57-a).
[448]For more insight see this case. Available at: http://www.cma.org.sa/en/News/Pages/CMA_N_1505.aspx.

misleading impression. Following the verdict, the defendant was urged to pay all the revenues he collected at a total amount of SR 8,146,388, which was equivalent to $2,172,136.18. A penalty charge of SR 300,000 (equivalent to $79991.15) was also imposed as a result of these violations.[449]

In the UK, the Financial Conduct Authority (FCA) has the legal right to exercise its powers and authorities against those who violate the provisions of security market laws. Consequently, the FCA is empowered as a sole entity to take action against any person (individual or corporation) that violates the provisions of the Authority.[450] It imposed fines of about £241,305,700 in 2014 against violators of its standards and provisions.[451] In this regard, the FCA has a bundle of disciplinary, civil and criminal powers to undertake action against firms or individuals who are failing, or have failed to meet the FCA's standards. The sanctions imposed by the FCA can be summarized as follows:[452]

1) Withdraw a company's license[453]
2) Outlaw an individual from working in financial services[454]
3) Deter an individual from conducting specific regulated activities[455]
4) Cease a firm for up to 12 months from undertaking identified, regulated activities[456]
5) Halt an individual for up to 2 years from undertaking determined controlled functions[457]
6) Censure companies and individuals via public statements[458]
7) Impose financial penalties[459]
8) Require injunctions[460]
9) Apply to courts to freeze assets[461]
10) Require restitution orders[462]
11) Litigate companies and individuals who undertake regulated activities without licenses.[463]

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[449]Art (57-c) Saudi CML.
[450]Section (88A-89Q) U.K. Financial Services Act 2012.
[451]For more information see these fines. Available at: http://www.fca.org.uk/firms/being-regulated/enforcement/fines.
[452]FCA's General Enforcement Powers. For more insight see http://www.fca.org.uk/your fca/documents/enforcement-information-guide.
[453]ibid.
[454]ibid.
[455]ibid.
[456]ibid; Section (1-d) UK Combined Code on Corporate Governance; Section (88A-89Q) U.K. Financial Services Act 2012.
[457]ibid.
[458]ibid.
[459]ibid.
[460]ibid.
[461]ibid.
[462]ibid.
[463]ibid.

It is important to note that the method used to punish violators of the provisions of the CML and its implementation of regulations, does not differ much from those punishments applied in the UK. Indeed, there are some differences among these legal systems but they also share some similarities. For example, the CML has stated clearly that manipulation and insider trading are prohibited actions in the Saudi stock market. In accordance with the CML, any person who intentionally behaves or engages in any action that results in creating false or misleading impressions concerning the market, the prices and the value of securities, which influence a third party to buy, sell or engage in any securities or refrain from acting or exercising their rights according to the CML, is guilty against the law.[464] The CML defined the actions and practices that fall within a 'false and misleading impression' as follows:[465]

1) To perform any act or practice aimed at creating a false or misleading impression of an existing active trading in security, as may be contrary to the reality. These acts and practices shall include, but not be limited to the following:

(a) Undertaking transactions in securities which do not involve a true transfer of ownership thereof.
(b) Entering an order or orders for the purchase of a particular security with prior knowledge that an order or orders of substantially the same size, price and timing for the sale of the same security has been or will be entered into by a different party or parties.
(c) Entering an order or orders for the sale of a particular security, with prior knowledge that an order or orders of substantially the same size, price and timing for the purchase of the same security, has been or will be entered into by the same party or different parties.

2) To affect, alone or with others, the price of a particular security or securities traded on the exchange through executing a series of transactions in such security or securities, creating actual or apparent active trading or causing an increase or decrease in the prices of such securities, for the purpose of inducing third parties to buy or sell such securities as the case may be.
3) To affect, alone or with others through any series of transactions such as buying or selling a security traded on the exchange for the purpose of pegging or stabilizing the

[464]Art (49 & 50) Saudi CML.
[465]Ibid art (49-1-2-3).

price of such security, in violation of the rules set forth by the authority for the safety of the market and the protection of investors.

Furthermore, the CML prohibits direct and indirect trading in the security market for any person who obtains insider information through family, business, other party or contractual relationships, especially if this information will have a material effect on the frenzy or value of the security.[466] Accordingly, much of the current debate revolves around the fact that further criminal prosecution may be required in the UK securities market in order to guarantee additional protection for the financial system. Some scholars are of the opinion that criminal prosecutions are weak in the UK securities market, that the FSA's resources are very broadly spread among its large jurisdictions, or that the enforcement approach sends out selective messages and some illegal activities leave without sanctions.[467] These views were supported by Margaret Cole, Director of Enforcement in FSA, who said that:

> For the last two years or so I have been signaling our intention to use our powers as a criminal prosecutor. Why? It is a direct reaction to the findings of the market cleanliness study, anecdotal evidence from the marketplace and the media, the things we see as a result of real time market monitoring, and the belief that criminal prosecution, where a custodial sentence is a real risk, will act as a stronger deterrent than a civil/administrative market abuse prosecution under the FSMA, even though we have the power to impose unlimited fines. I don't think this can be described as being enforcement averse. It is a significant shift of emphasis for the FSA and it comes with risk. Commentators are always eager to point out the UK's poor record on prosecutions for insider dealing.[468]

Unlike the fines imposed under the UK FCA, the penalty charges imposed against violators of the CML and its implementing regulations in Saudi Arabia are relatively weak, especially compared with those imposed by the FCA in the UK. Meanwhile, regarding criminal sanctions, the CMA and its counterparts in the UK are not authorized to award custodian sentences to anyone who violates the provisions of security laws. However, the main difference here is that the prison sentences imposed by the ACRSC are not commensurate

[466]Ibid art (50-a-b).
[467]William Michael Treanor, Ben A. Indek and Jill E. Fisch, 'The Seventh Annual A.A. Sommer, Jr. Lecture on Corporate, Securities & Financial Law: The U.K FSA: Nobody Does It Better?' (2007) vol 12, no 2, p 267.
[468]For more insight see participation of Margaret Cole, Director of Enforcement, FSA in European Policy Forum, held on 4th April 2008 under the title: "Enforcing Financial Services Regulation: The U.K. FSA Perspective". This reference quoted from Kyla Malcolm, Mark Tilden, Scott Coope, and Charlie Xie, (2009), "Assessing the Effectiveness of Enforcement and Regulation", CRA International, p 32.

with the size of the material damage to these violations, or the period of imprisonment, which may not be sufficient to prevent and deter the commission of similar offence in the Saudi securities market. This is because the CML identified the period of imprisonment as only five years, while perpetrating insider trading in the UK leads to imprisonment for a term not exceeding seven years.[469] In addition, the CML has excluded any of the persons mentioned in paragraph b.2, 3 and 4 of Article 55 from liability, if their act was committed unintentionally, or if there was no violation at all.[470]

Despite minor differences between the UK Financial Conduct Authority and Saudi's Capital Market Authority, the evidence above suggests that both jurisdictions have mechanisms in place to punish offenders who violate the provisions of security market regulations. Hence, this is a reflection of good corporate governance practice and it is consistent with the OECD principles of corporate governance. [471]

3.5 Major Drawbacks Directed to the CMA

3.5.1 Lack of Cooperation between Investigation Authorities

Giving regulators the absolute right to undertake inspection into corporations and conduct appropriate investigations into listed corporations has been seen as a crucial factor in protecting security markets from legal infringements. Indeed, the lack of an independent body to undertake inspections and investigations and enforce laws and regulations efficiently was one of the key issues facing security regulators worldwide.[472] As mentioned previously, the importance of the investigation procedures was demonstrated in the Principles of IOSCO, which recommends for adequate powers to be given to regulators, to carry out inspections and investigations effectively.[473] This recommendation suggests that there is a robust relationship between effective investigation tools and the protection of the rights of minority shareholders.[474] The rationale behind this is empowering the investigation agency to contribute largely in detecting and deterring unfair and unsound practices, such as deceit, fraud, manipulation and cheating. For instance, in Saudi Arabia the CML has given the Capital Market Authority the right to carry out proper inspection and investigation of those who they think have breached the provisions of the law. As previously mentioned, the CMA

[469]Section (92-1-b) UK Financial Services Act 2012.
[470]Art (55-c) Saudi CML.
[471]OECD Principle of Corporate Governance 1999, Principle No, (III-a-2).
[472] M. Becht et al., 'Corporate Governance and Control' (2002) ECGI Working Paper Series in Finance, pp 122.
[473]ibid.
[474]F. Modigliani and E. Perotti, 'Protection of Minority Interest and the Development of Security Markets' (1997) Managerial and Decision Economics, vol 18, pp 519-525.

has established the specialized Investigation Department in this regard. However, in practice there are some obstacles that may impede its work. Perhaps a shortage of staff and limited financial resources may be two of the main barriers hindering the Investigation Department from achieving its objectives.

Furthermore, collaborating with competent governmental and financial authorities and bodies in order to collect information and materials that help to identify those who violate the provisions of the CML and its implementing regulations is an essential element in the course of strengthening the activities of the Inspection and Investigation Department. The importance of collaboration amongst investigative authorities has been confirmed in several studies. For example, Ana Carvajal and Jennifer Elliott suggest that:

> The regulator should have mechanisms to obtain such information either directly or through other authorities subject, of course, to due-process protections. In the latter case, it is particularly important that there be mechanisms in place (such as memoranda of understanding) to ensure effective and efficient cooperation from the other authority (for example, the securities regulator commonly needs cooperation of the banking regulator). There should also be mechanisms to enforce such power, including sanctions for noncompliance and for providing false information.[475]

The present study has revealed, through analysing the work of Investigation Department in the CMA, that there is a weak relationship between the CMA and other Saudi Arabian agencies, especially in the context of investigations concerning violations of the securities law. To support the collaboration theory among governmental bodies, some studies have recommended that the CMA should cooperate with the Saudi Arabian bodies (such as the Saudi Arabian Monetary Agency (SAMA)) to obtain and access banks records, or with the Ministry of Justice in order to effectively implement its policies, or deal with cases that contravene the provisions of the CML.[476]

[475]A. Carvajal and J. Elliott, 'The Challenge of Enforcement in Securities Markets: Mission Impossible?' (Working Paper, International Monetary Fund) 2009 17.
[476]A. Y. Baamir, 'Issue of Transparency and Disclosure in the Saudi Stock Market' (2008). Arab Law Quarterly, vol 22, no 1, pp 63-87.

3.5.2 Weak Information Provided by the CMA

Maintaining transparency in the security market is an essential element in providing necessary protection for minority shareholders. The importance of the transparency has been affirmed by international bodies such as in the OECD Principles of Corporate Governance and by the International Organisation of Securities Commission (IOSCO). Both international bodies have agreed that security regulators should play a vital role in ensuring protection through enacting robust regulations that support and provide information regarding the stock market, as well as the performance of the security regulators.[477]

Investors lost confidence in the Saudi securities market, particularly in the wake of the financial crisis in 2006. Indeed, the lack of transparency and insufficient information provided by the CMA largely contributed to the failure of the market in 2006. Some studies argued that the information provided by the CMA was insufficient.[478] The Saudi securities market is deemed as one of the biggest and fastest growing markets in the MENA region. However, it is still characterized by some irregularities, especially in relation to the issue of transparency and disclosure.[479] A report presented by one of the analysts in the Saudi economy illustrates that the Saudi securities market will not only be the largest market in the region, but rather that it will be the most liquid and developed. Regarding transparency, however, this report further suggests that 'hopefully, the progressive involvement of international institutions will dive forward transparency and governance in the Kingdom'.[480]

Therefore, it is obvious that the situation of the transparency and governance process is still worrying for those interested in the affairs of the Saudi securities market. In reality, it is reasonable to say that the capital market suffers from losing the investors' confidence but there are many irregularities in the market, which have been ongoing without the knowledge of the CMA.[481] As a result, the CMA is required to restore public confidence in the security market by reinforcing the principle of transparency and disclosure within its actions.

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[477]Principle (v) OECD Principles of Corporate Governance 1999; J. Zufferey and M. Tschanz-Norton, *Regulation of Trading Systems on Financial Markets*' (Kluwer Law International 1997) 140.
[478]A. A. Al-Kholifey, *The Saudi Arabia Stock Market: Efficient Market Hypothesis and Investors' Behavior* (Colorado State University, 2000).
[479]W. Alajlan, 'Ownership Patterns and the Saudi Market' (2004) Advances in Financial Economics 9, pp 161-184.
[480]Grant Thornton International Ltd, 'Middle East: towards innovation and transparency' (2008) Capital Markets Guide p 8.
[481]Aleqtisadiah, 'Analysts: Financial Market Authority need to be reformed' (3 December 2011) No. 6627. Available at: http://www.aleqt.com/2011/12/03/article_603590.html. [Arabic edition]

3.5.3 Weak Intervention by the CMA to Protect Minority Shareholders

It has been suggested that the effective enforcement of the securities market regulations is largely based on the ability and expertise of the regulators, to address and deal with all the threats facing the securities market. Indeed, protecting the security market and minority shareholders' rights from manipulation and fraud needs fast and quick intervention, at the appropriate time. Previous research has demonstrated a relationship between the professional regulators and the efficient enforcement of security laws. By contrast, the lack of experience or expertise amongst security authorities usually leads to weakening of the enforcement of market law.[482]

The International Organisation of Securities Commission has discussed this issue and concluded that security bodies must possess a set of abilities that assist in protecting security markets from unsound practices. Therefore, the commission recommends that the existence of technical factors and specialized circuits in its own field is substantial in order to ensure the enforcement of security laws and regulations.[483] In the aftermath of the global financial crisis of 2008, the IOSCO issued a report for appraising the performance of the securities market, in particular for the emerging markets. It affirmed that '…prompt and consistent enforcement action is undoubtedly one of the key criteria for building a fair, efficient and transparent market'.[484]

As far as protection of minority shareholders' rights is concerned, the early interference by security bodies to prevent illegal speculations that usually lead to the abnormal rise in stock prices, is considered a significant factor in the course of protecting the rights of minority shareholders. The intervention of the capital market authority in a timely manner is one of the successful means that stabilizes the financial system. Indeed, weak intervention and the weakness of enforcement mechanisms were key reasons behind the US financial crisis.[485]

After establishing the CMA in Saudi Arabia, there have been many attempts to control and adjust the securities market. In reality, the CMA has always sought, since its inception, to enhance the performance of the capital market and protect the investors, and therefore it

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[482]F. Modigliani and E. Perotti, 'Protection of minority interest and the development of security markets' (1997) John Wiley & Sons Ltd, vol 18, no 7-8, pp 520-521.
[483]Development Committee of International Organization of Securities Commission, 'The Role of Securities Commission' (1990) 5.
[484]Emerging Market Committee of the IOSCO, 'Impact on and Responses of Emerging Market to the Financial Crisis' (2009) 41.
[485]E. Wyatt, 'SEC Pursuing More Cases Tied to Financial Crisis', *New York Times* (2000). Available at: http://www.nytimes.com/2010/07/21/business/21sec.html, 2000.

enacted a bundle of laws and regulations to help in this regard. However, the problem facing the Saudi Arabian securities market was related to the weak intervention by the CMA.[486] Hence, the financial crisis that hit the Saudi Arabian securities market in 2006 was attributed to the weak interference of the CMA. Prior to the collapse of Saudi Arabian securities market in 2006, there had been indications and warnings, which showed overpricing of shares that were unrelated to the actual performance of the listed corporations.[487] Nonetheless, the CMA disregarded those warnings and did not intervene to save the market. As a result, many Saudi people lost their money and they are still unable to retrieve their investments, or at least be compensated for their losses.

Intervention of the Capital Market Authority through suspension of trading, particularly in the wake of huge volatility in the stock market or in the situation of abnormal speculations, is a successful strategy that is needed to protect the market and its shareholders, including minority shareholders. For example, the IOSCO report after the financial crisis showed that a trading halt was deemed as one of the significant instruments used by the securities regulator for protecting investors.[488] Other evidence demonstrated that a trading halt would effectively contribute to confronting the risks that threaten the stability of the securities market, as well as protecting the market through detecting unreasonable prices.[489]

Once again, in Saudi Arabia, it can be said that the Saudi securities market suffers from a deficiency of intervention by the CMA in a timely manner, even though the Capital Market Law (CML) gives it the genuine right to intervene and suspend the market's activities for a period (not exceeding one day) when it is essential to protect the market and its investors.[490] However, practice on the ground indicates that the failure of the securities market in 2006 and the stock market slackness in 2008 were attributed to weak intervention, as well as a lack of sufficient experience in dealing with situations such as this.

Several Saudi scholars have directed their criticism against the work of the CMA in the wake of the financial crisis in 2006 '…the governmental authorities remained passive and stood by,

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[486]S. Cleassens et al., 'Expropriation of Minority Shareholders in East Asia' (1999) The World Bank, pp 1-57.
[487]M. Haddad and S. R. Hakim, 'Irrational Exuberance on the Saudi Stock Exchange' (Equity and Economic Development 15th Annual Conference, 2008) 1-4.
[488]Emerging Markets Committee of the IOSCO, 'Effectiveness of Market Interventions in Emerging Markets' (2010) International Organization of Securities Commissions (IOSCO) 22.
[489]O. Bacha, 'The efficiency of trading halts: Emerging market evidence' (2008) International Journal of Banking and Finance, vol 5, no 2, pp125-147.
[490]Art (6-a-5) Saudi CML.

watching this painful economic catastrophe without attempting to intervene and halt the collapse in an effort to save the country and its citizens from its destructive consequences'.[491]

3.5.4 Inadequacy of Imposing Penalties and Sanctions against Violators

The CMA has exercised a great deal of effort in ensuring that the securities market and minority shareholders' rights are protected through imposing a set of fines and sanctions against any firm or individual that breaches the provisions of the Capital Market Law, or any of its implementing regulations. However, compared with other jurisdictions (such as the UK, Germany and the US) there is a severe deficiency, particularly in terms of the financial penalties and criminal sanctions imposed by either the CMA or the CRSD. The present study has shown that those penalties are not compatible with the volume and magnitude of the capital of Saudi listed companies. In fact, the listed firms in the Saudi securities market are characterized by the high financial capabilities which make those fines useless. As we have seen above, the CML has granted the CMA the power to impose a financial penalty against any violators of the CML, the implementing regulations or the stock exchange's regulations, but the penalties shall not be less than SR 10,000 ($2,666) and not exceeding SR 100,000 ($26,666), for each violation perpetrated by the defendant.[492] In addition, it has the right to require the Committee for the Resolution of Securities Disputes (CRSD) to impose criminal sanctions against the violators of Articles 49 and 50 with imprisonment terms of up to five years.[493]

Nonetheless, certain analysts who are interested in the Saudi Arabian securities market commented by saying that the penalties imposed by the CMA against listed firms are lenient, and not commensurate, to the impact these violations have on the market and/or its investors.[494] According to the Annual Report of the CMA in 2013, the aggregate of cases violated was about 287.[495] Previous research has shown that the total financial penalties levied against violators of the security laws are considered one of the most significant standards of implementing the enforcement tools.[496] The aim of imposing appropriate sanctions is to force listed corporations to comply with the provisions of the security market laws, as well as to prevent breaches that will harm investors and damage their interests. It is

[491]F. Frank and C. Mayer, *Ownership and Control of German Corporations (*Oxford University Press, 2001) 943-977.
[492]Art (59-b) Saudi CML.
[493]Ibid art (57-c).
[494]M. Ismail, 'No one is feared the Capital Market Authority sanctions', *Alyaum newspaper* (10 May 2012). Available at: http://www.alyaum.com/article/3049621, 2012. [Arabic edition].
[495]Annual Report of the CMA for 2013. Available at: http://www.cma.org.sa/En/Publicationsreports/Reports/CMA%20En-Annual%20Report%202013.pdf.
[496]M.C. Jensen and W.H. Meckling, 'Theory of The Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) Journal of Financial Economics, vol 3, no 4, pp 261.

reasonable to say that the amount of financial penalties and imprisonment terms enforced by either the CMA or the CRSD are not sufficient to deter offenders, and in addition they are not compatible with the size of the securities market in Saudi Arabia.

As a consequence, it is essential that the Saudi regulator intervenes and places new adjustments on Articles 57c) and 59b) of the CML in order to boost the level of the financial penalties and criminal sanctions. Indeed, amendments of the CML's Articles, by imposing severe penalties to violators of the CML, will contribute to protecting minority shareholders' rights and project the CML as a strong pillar that will stabilize the Saudi Arabian securities market.

3.6 The Major Shortcomings Directed to the Stock Market in Saudi Arabia

The previous sections have demonstrated some of the huge efforts made in reforming the Saudi capital market. However, these developments have also been characterized by certain limitations, which have important implications for the CMA's desire to achieve its functions and roles effectively, and in particular, protect the rights of minority shareholders. Several reasons have been given but the main reasons are discussed in the sections below.

3.6.1 Concentrated Ownership and Absence of Awareness

As previously mentioned, the concentration of ownership and control in the hands of a small number of controlling shareholders/owners is deemed as one of the significant factors that may harm or damage the rights of minority shareholders (especially in those markets characterised by weak disclosure, transparency and poor corporate governance practices).[497] Previous research has shown that wealthy families dominate and control the majority of widely-held corporations, especially in Asian countries including Saudi Arabia. Importantly, it was found that the percentage of market capitalization in those countries' stock exchanges is dominated by 1, 5 and 10 rich families.[498] In the Saudi stock market for example, the ownership of a considerable percentage of equities is owned by the board members and founders. Importantly, several listed companies are still being managed and controlled by their founders. For example, in the Al Khodari Company, the chairman and 2 other board members out of 6, belong to the same family who own about 60% of its shares.[499]

[497]H. K. Leong, 'Reforming Corporate Governance in Southeast Asia: Economics, Politics, and Regulations' (2005) Institute of the Southeast Asia Studies, Singapore, pp 20-23.
[498]ibid.
[499]Abdullah Al *Khodari* Company. Available at: http://www.alkhodari.com/organizational.html, accessed 8 October 2013.

Furthermore, there are at least 2 out of 11 local banks that are controlled by wealthy Saudi families.[500] The proliferation of the government and family ownership structure of listed corporations in the Saudi capital market is considered to be one of the main problems faced by the market.[501]

This dominance and control of shares by a small number of wealthy individuals will definitely jeopardise the efforts of the CMA and thus make its surveillance and overseeing functions more complicated. It is difficult for one government body to monitor and direct these listed corporations in the light of this absolute dominance, in particular if we keep in mind the poor collaboration between the CMA and the controlling shareholders or families. In addition, the effective application of the corporate governance rules in Saudi Arabia is based on a self-regulation and non-binding manner. Consequently, there is no real guarantee that the family-listed corporations adhere strictly to the provisions of these laws and regulations, given the inefficiency and shortage of personnel in the CMA.

Furthermore, the idea of relying on shareholders so as to implement the Corporate Governance Regulations (CGRs) may be unsuccessful in the Saudi securities market for a good number of reasons. Perhaps the most important of them is that the engagement of the minority shareholders in the company's decision-making is somewhat vulnerable. Indeed, Saudi Arabia is considered an emerging State, thus the exercise of rights and participation in popular life has not reached full maturity yet. This phenomenon is reflected in the way and manner in which people engage in business and economic life in Saudi Arabia. Therefore, there is limited participation in the decision-making and ineptitude when it comes to challenging the controlling shareholders and managerial decisions.[502] In addition, most shareholders in the Saudi securities market have limited knowledge about the activities and operations of the stock market, thus they are not fully empowered to participate effectively in stock market operations and transactions.[503] Another problem is that the Saudi securities market is based on predictions and rumours, given the lack of sufficient, substantive analysis and accurate information.

It should be noted that even in certain sophisticated legal systems, such as in the UK, the stock market seeks to encourage the shareholders to participate effectively in implementing

[500]These two banks are Albilad Bank's which 36% of its shares are owned by two families: Al-Subai and Al-Rajhi. Other bank is Al-Rajhi bank which 44% of its shares are owned by his family. For more insight, see Tadawul website.
[501]FTSE Quality of Markets Criteria (Middle East) in March 2014. Available at: http://www.ftse.com.
[502]F. M. Almajid, *A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: a Comparative and Analytical Study from a Legal Perspective* (School of Law, University of Manchester, 2011) 198.
[503]M. A. Ramady, *The Saudi Arabian Economy: Policies, Achievements, and Challenges* (King Fahad University, Saudi Arabia, 2010) 115.

the provisions of corporate governance rules, but in general this participation does not usually work in practice.[504] Moreover, it is important to note that one of the crucial factors that can help the CMA to achieve its objectives smoothly is through determining and defining the institutional investors. The institutional investors can be used to improve and motivate corporate governance practice, as is the case in the UK and the US. However, in the Saudi securities market, the CMA has not yet identified these institutions as disciplinary forces and thus the market is relatively low in terms of institutional ownership.[505] It has been suggested that protection of shareholders, including minority shareholders and the security market in general, from manipulation and misconduct of directors and the abuse of controlling shareholders needs constant checking. The institutional shareholders can contribute largely in safeguarding the market, particularly in the light of the lack of scrutiny on the senior executives of listed firms.[506]

In effect, the Saudi security market is still suffering from increasing the proportion of individual investors, which accounts for 92% of trading transactions in the Saudi stock market, without encouraging the culture of institutional shareholders, as seen in the UK and the US. The implication of this is that individual investors lack adequate experience that can enable them to make suitable decisions and challenge any violations of their rights. Thus, the absence of institutional shareholders may lead minority shareholders to lose their rights.[507]

3.6.2 Volatility and Instability of the Stock Market

According to the views of many Saudi financial analysts and economists, the security market is still volatile and unstable in Saudi Arabia. The instability of the market has been attributed to two main reasons. Firstly, the financial crisis that hit the Saudi securities market in 2006 has led to a negative result on the performance of the market. This has been counterproductive, leading to a lack of confidence in the securities market generally. In particular, the 2006 crisis has led to withdrawal of most investments from the market, which in turn led to an 8% decline in profits over 4 years.[508] Indeed, the trust in the securities market plays a crucial role in attracting investors. However, the market collapse in 2006 has led to a decline in investors' confidence in the Saudi securities market. The securities market is still

[504] J. Charkham, *Keeping Better Company: Corporate Governance Ten Years On* (Oxford University Press, Oxford, 2005) 301.
[505] FTSE Quality of Markets Criteria (Middle East) in March 2014. It is Available at: http://www.ftse.com.
[506] Fahad M, Almajid, (2011), "A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: a Comparative and Analytical Study from a Legal Perspective", PhD Thesis, School of Law, University of Manchester.
[507] Al-Riyadh Newspaper, 'Shura Criticises the Capital Market Authority' (2012). Available at: http://www.alriyadh.com, [Arabic edition].
[508] Al-Riyadh Newspaper, 'The financial crisis was a supporting factor in the vibrations' (2010) no 15381. Available at: http://www.alriyadh.com [Arabic edition].

suffering from investors fleeing the market, as they prefer not to invest their funds in the market. This has led to a significant decline in the trading volume and flow of funds in the securities market. The observers said that the market crashed in 2006 and that market volatility and weaker market were the key factors that led to the loss of investors' confidence.[509]

As previous research has shown, investors' confidence in the securities market is seen as a fundamental element in investment decision-making, and indeed an essential factor in promoting the investors to place their funds into the market.[510] As a consequence, it is reasonable to say that the financial market crash that hit the Saudi securities market in 2006 has negatively affected the growth of the capital market so far. Secondly, the Saudi Arabian economy is based entirely on the oil industry. Therefore, high or low oil prices can directly affect the securities market, either negatively or positively. Importantly, there is a nature of relationship between oil production and the securities market in Saudi Arabia. Some reports in this regard have shown that increased oil prices in the period from 2003 to 2005 had a positive impact on Saudi economic growth, including increasing the performance of the securities market.[511] The causal relationship between these two elements (oil prices and the stock market) has been endorsed by a recent empirical study, which showed that 'the strongest influence on the Saudi stock market returns variation was the price of the oil, 2.2%, followed by the U.S. stock market, 2%'.[512]

Other empirical evidence suggests that most securities markets in the GCC region are largely dependent on the prices of oil. This study revealed an interesting finding: that there is a strong connection between the oil prices variables and the input and output variables of the securities markets, especially in the United Arab Emirates, Qatar and Saudi Arabia.[513] In fact, the price of oil is one of the hazards that threaten the securities market in Saudi Arabia and others in the GCC.[514] As a result, many have been calling for investments in resources other than the oil, so as to protect the securities market and its investors from the crisis, due to the drop in oil prices.

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[509]S. Al-Nwaisir, 'Saudi Stock Market Needs to Be Reformed', *Arab News* (2012). Available at: http://www.eurasiareview.com.

[510]J. A. Haddad, *Stock Exchanges in the Middle East: Risky Business or Smart Investing?* (Bryant University, 2011) 7.

[511]This study has made by Gulf Base which is the premier source of detailed financial information on the joint stock companies in the GCC region (Saudi Arabia, UAE, State of Kuwait, Bahrain, Oman and Qatar). Gulf Base offers up-to-date financial information, market data, advanced investment tools, IPO central, mutual funds, investment tutorial and more. For more insight visit: http://www.gulfbase.com.

[512]M. A. Al-Shogeathri, *Macroeconomic Determinants of the Stock Market Movements: Empirical Evidence from the Saudi Stock Market* (Kansa State University, 2011) 173.

[513]S. Hammoudeh and E. Al-Eisa, 'Dynamic Relationship Strongest among GCC Stock Markets and AYMEX Oil Futures' (2004) Contemporary Economic Policy, pp 250-267; C. Rault and M. El HediArouri, 'On the influence of oil prices on stock markets: Evidence from panel analysis in GCC countries' (2009) William Davidson Institute Working Paper Number 961, pp 6.

[514]Oil revenue represents about 75% of the Saudi Arabian government's annual budget. For more insight see Nimrod Raphaeli, 'Saudi Arabia: a Brief Guide to its Politics and Problems' (2003) Middle East Review of Affairs 7, pp 21-22.

3.6.3 Inadequate Compliance of Listed Firms in Meeting with the Disclosure Requirements

As is well-known, disclosure and transparency of company's information and its financial reports are considered as crucial elements in reforming any financial system across the globe, and importantly, they are one of the most significant tools of corporate governance principles.[515] One main objective of a sound corporate governance practice is building a solid financial system. Hence, financial systems in listed corporations should be kept in such a manner that ensures accurate and timely information.[516] Indeed, sound disclosure and transparency policies assist shareholders in making decisions concerning whether to retain or purchase the company shares. One of the key issues identified as contributing to the collapse of some giant international corporations was a poor disclosure system in the company. Thus, it remains a crucial factor in building investors' confidence in the capital market. Indeed, the importance of disclosure has been emphasised by many, as contained in the following report:

'Disclosure can be a powerful regulatory tool; it creates an incentive to comply with best practice, and allows members and third parties to take necessary actions. Disclosure requirements can be more efficient, more flexible and easier to enforce'.[517]

In the Saudi Arabian case, for instance, the importance of disclosure and transparency has been emphasized, in particular following the enactment of the CML and its sister regulations, such as Listing Rules and Corporate Governance Regulations. According to the Saudi capital market regulations, disclosure of the company's information is forming part of the corporate culture among listed firms operating in the stock market.[518] Specifically, the board of directors and chief executives have the responsibility of ensuring that each company implements disclosure and transparency requirements efficiently. The board of directors must disclose a wide range of proceedings and operations conducted at the board level and should also explain how it conducts its duties. In fact, the board's report should include the following items: 1) the company's performance; 2) the compliance of the company for the

[515]OECD Principles of Corporate Governance 2004, Principle (v).
[516]F. Kahn, 'Transparency and Accountability: Rethinking Corporate Fiduciary Law's Relevance to Corporate Disclosure' (2000) Georgia Law Review 34, pp 512.
[517]Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, Brussels (4 November 2002) 4.
[518]In 2008, the Capital Market Authority Board issued its resolution, No. 1-36-2008 regarding making article 9 of the CGRs be obligatory for all the listed companies.

CML and other relevant regulations, particularly the Corporate Governance Regulations; 3) how it implements its duties; and 4) the role of its committees.[519]

Disclosure policy mandates all listed corporations to report all developments and changes undertaken by the company during each financial year. Changes in the financial status, changes in management or board members and adjustments in ownership shareholdings, as well as descriptions of the company's business activities, issues and other changes identified by the law, are considered as substantial information, which must be included in the company's annual and quarterly reports and/or financial statements.[520] In fact, previous legal cases decided by the CMA, in matters relating to violations of the disclosure provisions, suggest how serious the CMA is about implementing the disclosure requirements. However, previous court cases have shown that some of the listed companies are yet to fully comply with the disclosure and transparency standards. In the Saudi securities market, there is a kind of weakness in financial statements and reports provided by the listed corporations, which according to some studies suggests negligence of the policy by the listed firms.[521]

The prevalence of the financial penalties imposed by the CMA against violations of the Saudi securities market has proven that there have been large breaches to the CML's provisions, especially with the disclosure and transparency regulations. For example, in 2010, Al-Baha Investment and Development Company failed to illustrate in its board annual report that its board members were also working with other listed corporations' boards. Accordingly, the CMA imposed a fine of $13,333.[522] Other cases reported showed that on 26 March 2011, the Saudi Cement Company took a loan of $120,000,000 from the SAMBA Financial Group in 2011. Yet, the company failed to declare this debt in its board's annual report. Therefore, in virtue of Article 43b) 2 of the Listing Rules, the CMA issued a punitive decision against this company, which was a fine of $13,333.[523]

3.7 Chapter Summary

Chapter 3 provides an overview of the development of corporate governance in Saudi Arabia. A detailed analysis of the Capital Market Authority has also been provided including its

[519] Art (11-c) Saudi CGRs.
[520] Art (45-b) Saudi CML.
[521] F. M. Almajid, *A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: a Comparative and Analytical Study from a Legal Perspective* (School of Law, University of Manchester 2011) 172.
[522] Decision of the Capital Market Authority, No 5-32-2011 (23/10/2011). Available at: http://www.cma.org.sa/ar/News/Pages/CMA_N_1002.aspx.
[523] Decision of the Capital Market Authority, No 4-23-2011 (03/07/2011). Available at: http://www.cma.org.sa/En/News/Pages/CMA_N_823.aspx.

history, formation and roles in protecting the rights of minority shareholders. Indeed, the stock market in Saudi Arabia has greatly developed over the years, through combined influences of many activities such as nationalization of foreign banks operating in the Saudi economy, the introduction of mutual funds in the Saudi Arabian stock market and the establishment of the Saudi Share Registration Company (SSRC), to mention but a few. The analysis further shows that over the years, the capital market in Saudi Arabia has undergone significant reforms. Specifically, the major revolution in the Saudi Arabian economy, which started following the enactment of the Capital Market Law in 2003 by the Saudi Arabian government, which made provisions for the establishment of the Capital Market Authority.

In fact, the introduction of the CMA to the stock market in Saudi Arabia was seen by many as a paradigm shift and importantly a major legal landmark in the business and economic activities of the Kingdom. Particularly in keeping with the OECD principles of corporate governance, the Saudi government introduced other laws alongside the CML to regulate the activities of the stock market. As a result, the Listing Rules and the Corporate Governance Regulations were born. This also suggests that the country was quick to respond to the financial crisis and corporate scandals that hit the global economy in 2002. The role of the CMA in protecting minority shareholders in Saudi Arabia was also explored. Specifically, the analysis showed that the CMA, through its various regulations, has outlined different mechanisms to ensure minority shareholders' protection. These include monitoring and supervision of the stock market, inspection and investigation, applying Corporate Governance Regulations and imposition of penalties and sanctions. Despite all these efforts, the Saudi stock market, as well as the CMA, has suffered some major shortcomings over the years.
These shortcomings have been attributed to a number of factors, which include concentrated ownership and absence of the awareness, volatility and instability of the stock market, inadequate compliance of listed firms in meeting with the disclosure requirements, lack of cooperation between investigation authorities, weak information provided by the CMA, weak intervention by the CMA to protect minority shareholders and so on.

Furthermore, a comparative analysis was done between the UK FCA and the Saudi Arabian CMA with regards to investors' protection. As the analysis suggests, one of the greatest challenges facing the Saudi Arabian securities market is weak intervention by the CMA. This was evident in the financial crisis that hit the Saudi Arabian securities market in 2006, which was attributed to the weak interference of the CMA. The UK FCA performs better than the

CMA in this regard. Specifically, as mentioned in their conduct mandate, the FCA approach to intervention focused on prevention rather than redress.[524] This was echoed in the FCA Position Paper, which stated that 'the FCA will need to: spot issues earlier; be willing to intervene early to improve standards either in specific firms or wider; take robust action designed to address weaknesses in competition revealed by economic analysis'.[525]

Similarly, the FCA's intervention strategy places much emphasis on intelligent gathering to identify emerging conduct risks. In particular, the FCA Position Paper focused on thematic review and trend-spotting, rather than close supervision of individual firms. As a consequence, the FCA stated 'by bringing together our information-gathering analysis, research and policy making into one place, we aim to make sure that we are in a position to make timey and effective interventions when we identify risks'.[526] These recommendations suggest that the UK FCA has taken a proactive approach in intervening about issues relating to corporate governance. Indeed, there is a possibility of transplanting this initiative in order to improve the activities of the CMA in protecting the Saudi Arabian stock market and minority shareholders' rights in general. Indeed, protecting the security market and minority shareholders' rights from manipulation and fraud needs fast and quick intervention at the appropriate time.

Another drawback of the Saudi Arabian CMA is lack of cooperation between the CMA and other regulatory authorities in Saudi Arabia, such as the Saudi Arabian Monetary Agency (SAMA), the Ministry of Finance and the Ministry of Commerce and Industry. However, in the UK, there is increased cooperation between the FCA and other regulatory authorities such as the Financial Policy Committee (FPC) and the Prudential Regulation Authority (PRA).[527] Indeed, with such cooperation the confidence of investors is enhanced. This research recommends that the Saudi Arabia CMA will benefit from the UK, especially in the areas of intervention and cooperation among regulatory bodies.

Taken together, the analysis above suggests that Saudi Arabia is complying with the principles of Good Corporate Governance as recommended by the OECD. According to the OECD principles of corporate governance 'effective corporate governance requires a sound

[524]The Financial Conduct Authority: An Overview (1 April 2013) 15-16.
[525]Ibid. p 15.
[526]ibid.
[527]The UK's New Financial Services Regulatory Landscape: Policy Briefing. The Chartered Insurance Institute (April 2013) 2-14.

legal, regulatory and institutional framework that market participants can rely on when they establish their private contractual relations'.[528]

Therefore, the protection of minority shareholders in Saudi Arabia is indeed supported by regulatory frameworks. However, the effectiveness of these legal structures in safeguarding the rights of minority shareholders remains a contentious issue. As the analysis reveals, the existing legislations are not strong enough when it comes to enforcement of the provisions of the Capital Market Law and its implementing regulations. Perhaps the weakness of these legislations is exacerbated by the ownership structure in Saudi Arabia, which sees many wealthy families and controlling shareholders wielding their enormous power and influence in the Saudi stock market. It is also important to note that the issue regarding the role of controlling families in expropriating the minority shareholders, especially in countries with weak legal protection of their shareholders (and where family control is a ubiquitous practice), has remained a subject of controversy and scholarly debate in the corporate governance literature. In the next chapter (Chapter 4), a review of relevant legal structures to corporate governance and protecting minority shareholders rights in Saudi Arabia is provided.

[528]OECD Principles of Corporate Governance Draft for Public Comment (November 2014). Available at: http://www.oecd.org/daf/ca/OECD-Principles-CG-2014-Draft.pdf.

Chapter 4

Relevant Legal Structures to Corporate Governance and Protecting Minority Shareholders' Rights in Saudi Arabia

4.1 Introduction

The issue regarding the protection of minority shareholders has been greatly acknowledged amongst different approaches to corporate governance in recent years. The OECD Principles of Corporate Governance are a public policy instrument intended to assist governments and regulators in their efforts to evaluate and improve the legal, regulatory and institutional framework for corporate governance. First published in 1999 and revised in 2004, the current draft amendment of the OECD principles of corporate governance states that 'effective corporate governance requires a sound legal, regulatory and institutional framework that market participants can rely on when they establish their private contractual relations'.[529]

The principle also suggests that a sound legal structure should be in place to promote efficient and effective processes of corporate governance. Indeed, as noted in the OECD document, the trust of investors is enhanced when the legal and judicial system allow for minority shareholders to bring legal action when they have reasonable grounds to believe that their rights have been violated.[530] The provision of such enforcement mechanisms is a key responsibility of legislators and regulators.[531] Dulic and Kuzman also reasoned that if a violated right cannot be protected by the shareholder in front of coercive authorities (such as courts and security committees), the shareholder shall not enjoy effective and actual protection, even when he/she is protected by 'the right on the paper'.[532]

Concerns have been raised regarding the infringement of minority shareholders by controlling shareholders, which according to La Porta et al is a global phenomenon (although, the extent of infringement differs across countries, depending on whether it is a developed or developing country).[533] Indeed, there is greater minority protection in the developed countries

[529]OECD Principles of Corporate Governance Draft for Public Comment (November 2014). Available at: http://www.oecd.org/daf/ca/OECD-Principles-CG-2014-Draft.pdf.
[530]OECD, 'OECD Principles of Corporate Governance of 2004'.
[531]ibid.
[532]Dulic, K., and Kuzman, T. ,'Protection of rights of minority shareholders: legal framework and enforcement' (2012) Quarterly Monitor no 30.
[533]R. La Porta et al., 'Investor Protection and Corporate Valuation' (2002) Journal of Finance, vol LV 11, no 3, pp 1147-1170.

compared to developing countries.[534] For instance, Yu noted that despite dispersed ownership structure in countries like the UK and the US, the rights of minority shareholders are well protected by a well-developed legal infrastructure, managerial labour market and active takeover markets.[535] Similar to La Porta et al[536] and Nenova[537], a study by Grant and Kirchmaier affirmed that the UK and the US systems provide stronger protection of shareholders' rights. Thus, they might act as drivers of widely-held corporations' structures.[538] Previous studies suggest that the effectiveness of a governance system relies on the strength of the legal system in a State. Therefore, a sufficient legal system protects minority shareholders' rights from being expropriated by management or by controlling shareholders.[539]

According to Enriques, having sufficient protection of minority shareholders encourages financial stability and economic growth.[540] He further stressed that accounting standard rules are stronger in the UK and the US systems compared to civil law countries, whereby the legal protection of minority shareholders is weak.[541] In fact, the traditional view that minority shareholders are mere opportunists and useless has been changed. The minority shareholders are seen as significant engines for financial development and economic growth.[542]

In Chapter 1 of this thesis, the concepts of minority shareholders were explored including the rights of minority shareholders and their protection issues. In Chapter 2, a critical review of relevant theories of corporate governance was conducted in order to understand which theory or theories are appropriate in explaining how corporate governance may be explicitly protected under the current Saudi regulatory regime. This analysis was supported by looking at how corporate governance framework developed in Saudi Arabia (Chapter 3). In the current chapter, an analysis of relevant legal structures to corporate governance and protection of minority shareholders rights will be provided. Importantly, this analysis will contribute in addressing the research objectives stated in Chapter 1 of this thesis: how the

[534]ibid.
[535]Yu, M., 'State ownership and firm performance: Empirical evidence from Chinese listed companies' (2013) China Journal of Accounting Research 6, pp 75–87.
[536]R. La Porta et al., 'Investor Protection and Corporate Valuation (2002) Journal of Finance, vol LV11, no 3, pp 1147-1170.
[537]T. Nenova, 'The value of corporate voting rights and control: A cross-country analysis' (2003) Journal of Financial Economics, vol. 68, pp 325-351.
[538]Jeremy Grant and Thomas Kirchmaier., 'Corporate Ownership Structure and Performance in Europe' (2004) CEP Discussion Paper No 631, Center for Economic Performance, p 16.
[539]Toru Yoshikawa, Hongjin Zhu, and Pengji Wang, 'National Governance System, Corporate Ownership, and Roles of outside Directors: A Corporate Governance Bundle Perspective' (2014) Corporate Governance: An International Review, vol 22, no3, p 254.
[540]L, Enriques., ' The Law on Company Directors' Self-Dealing: A Comparative Analysis' (2000) International &Comparative Corporate Law Journal, vol 2. Available at: http://ssrn.com/abstract=271591.
[541]ibid.
[542]Bruno Meyerhof Salama and Viviane Muller Prado, 'Legal Protection of Minority Shareholders of Listed Corporations in Brazil: Brief History, Legal Structure and Empirical Evidence' (2001) Journal of Civil Law Studies, vol 4, no 1, p 148.

Saudi Arabian legal system mediates the relationship between corporate governance and protection of rights of minority shareholders. To this end, the chapter will provide an overview of the Saudi legal system. This will be followed with a review of Islamic law and their relationship with corporate governance, especially in relation to protection of minority shareholders' rights. It is important to note that, the mention of Islam is to provide background information about the foundation of the Saudi legal system and specifically, how the principles of corporate governance are supplemented in Islamic laws. Therefore, the analysis of the Saudi legal system in relation to corporate governance and minority shareholders will not be based on Islamic law. Instead, the analysis will focus on statutory laws that are based on Western tradition. Therefore, a review of statutory laws and regulations in Saudi Arabian corporate governance will be provided and their relevance in the protection of minority shareholders' rights. The judicial enforcement committees that deal with security market disputes will also be covered as well as the shortcomings directed to those committees. The chapter is concluded with a summary, highlighting keys issues discussed and the transition to the next chapter.

4.2 The Saudi Legal System: An Overview

The Saudi Arabian legislations are described as sophisticated, contradictory and ambiguous in many aspects.[543] Specifically, the Saudi Arabian legal system is built upon a duality method with shariah principles on the one hand and the civil law principles on the other hand. The inconsistency in the Saudi legal and judicial setting may be attributed to the variation in the views on maintaining the Islamic traditions, in which the State was built upon, and accepting the contemporary laws. This duplication of Saudi regulatory and legislative structure has been described by Vogel in the following statement:

> In most Islamic states, the legal system is bifurcated: one part is based on man-made, positive law; the other part is Islamic law. Saudi Arabia also has a dual legal system … the Islamic component of the legal system is fundamental and dominant. The positive law, on the other hand, is subordinate, constitutionally and in scope.[544]

[543]G. N. Sfeir, 'The Saudi Approach to Law Reform' (1988) The American Journal of Comparative Law, vol 36, p 734.
[544]Vogel, F., (2000), *Islamic Law and Legal System: Studies of Saudi Arabia* (Brill, Boston 2000) 322. This reference has quoted from Fahad, M.A., (2008), *A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective* (The Faculty of Humanities, University of Manchester 2008) 140.

As a consequence, the Saudi Arabian laws are divided into two categories:[545] one is based on the rules of Islamic law (shariah), in particular personal status law, criminal law and property law; and another is based on the modern laws, in particular those which depend on international conventions or global standards. The legal system in the Kingdom of Saudi Arabia is based on the rules of Islamic law, which were established by King Abdulaziz. However, the oil discovery in 1938 saw the need to enact a set of modern statutory laws and regulations to regulate and govern its relations with other countries, especially the Western countries. Consequently, between the periods of 1957 and 2006, the Saudi government have made considerable progress in reforming parts of its laws and regulations.

Specifically, since 1965, statutory laws in Saudi Arabia have played a vital role in activities such as commerce, the banking sector, business, labour, taxation, arbitration and the settlement of commercial and securities disputes. The contemporary legal system in Saudi Arabia has been affected by the model of civil law countries, particularly in commercial law, company law, securities law and administrative law. As a result, the concept of company, as an independent legal, personal, as well as the legal provisions has been transplanted into the Saudi Company Law from Western European laws.[546]

Importantly, most of the company law's Articles are analogous to Egyptian Company Law, which is based largely on civil law. In fact, the modernization of the Saudi legal system has been challenged by Islamic scholars who are concerned with replacing Islamic law (shariah law) with Western laws. Despite the adoption of the new laws, Islamic law is still viewed as the major source of legislation in the State.[547]

In order to give a whole picture about the legislation and regulatory structure in the Kingdom of Saudi Arabia, the section below provides an analysis of Islamic law and its effects on protecting the rights of minority shareholders in Saudi Arabia. It also examines statutory laws regulating the Saudi stock market, especially the Company Law of 1965, the Capital Market Law of 2003, the Corporate Governance Regulations of 2006 and the Listing Rules of 2004, respectively.

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[545]Macgorine A. Cassell and Rebecca J. Blake, 'Analysis of Hofstede's 5-D Model: The Implications of Conducting Business in Saudi Arabia' (2011 New Orleans International Academic Conference New Orleans, Louisiana, USA) 1055.
[546]Fahad, M. Almajid., *A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective* (The Faculty of Humanities, University of Manchester, 2008) 208.
[547]George, N. Sfeir, 'The Saudi Approach to Law Reform' (2008) American Society of Comparative Law, vol 36, no 4, pp 729-759.

4.3 Islamic Law

In reality, shariah principles are a comprehensive framework for laws in the Kingdom of Saudi Arabia. The Basic Law of Governance affirmed that the Quran and the Sunnah of the Prophet Mohammed (Peace be upon him) are the State's constitution, where it clearly states that:

> The Kingdom of Saudi Arabia is a fully sovereign Arab Islamic State. Its religion shall be Islam and its constitution shall be the Book of God and the Sunnah (Traditions) of His Messenger, may God's blessings and peace be upon him (PBUH).[548]

Given the significance of Islamic law in all aspects of life in Saudi Arabia, all deeds and people must be subject to sharia rules. Shariah consists of a set of essential principles derived from a number of various sources, including the Holy Quran, the Sunnah (sayings and deeds of the Prophet Mohammed, peace be upon him), Al- Ejma'a (collective) and Al-Qeas (measurement). The Holy Quran is considered a main source of laws. However, if there is any issue not mentioned in the Quran, then Sunnah will be the second source of evidence to resolve the matter. If the Holy Quran and Sunnah do not address the issue, then the Islamic scholars should create new rules and standards to find appropriate solutions for all matters facing the Islamic community, on the condition that these solutions do not conflict with the Quran and Sunnah provisions. To assert this principle*, the BLG* has provided that 'The courts shall apply to cases before them the provisions of Islamic Shari'ah, as indicated by the Qur'an and the Sunnah, and whatever laws not in conflict with the Qur'an and the Sunnah which the authorities may promulgate'.[549]

From the above considerations, laws and regulations in Saudi Arabia should be based on these basic sources that govern the Saudi community. Specifically, as earlier mentioned Islamic laws take precedence to other existing laws in Saudi Arabia. This is the basic foundation of the Saudi legal system given that the State was established by its founder, King

[548]Art (1) Basic Law of Governance issued by the Royal Order No (A/91) 27 Sha'ban 1412 H (1 March 1992.of 1992).
[549]ibid art (48).

Abdulla-Aziz Al-Saud, who affirmed his commitment to the Saudi people to build a country according to the Islamic directives.[550]

4.3.1 Protecting Minority Shareholders from the Shariah Law Perspective

Shariah law provides full programmes of life for the individual and the community alike. It organised a set of relationships among humans, communities and Allah (God), respectively. Islamic law has come to regulate two aspects of the people's life: worship and transactions. Worships are the actions that Muslims are required to perform to Allah, such as Iman (faith), Salah (prayer), Zakah (charity), Saum Ramadan (fasting), and Hajj (pilgrimage). Transactions are the dealings that all Muslims do with each other, with the non-Muslims and also with their environment.[551]

In Muslim communities, there is a famous aphorism that 'Islamic religion is treatment'. Consequently, the Islamic religion aims to set and remedy all issues facing human beings. It is a comprehensive system for family, neighbours, society, the environment, business, law, the economy, politics, ethics and all factors surrounding the people's life. In order to establish the justice principle, Islamic law has defined people's responsibilities and rights. Shariah law has required Muslims to adopt the Islamic directives and teachings in all aspects of their lives and dealings. As a result, it is hard to dissociate Islamic teachings and the way and manner in which the adherents behave. To affirm that all transactions are conducted within the framework of Islamic principles, the Holy Quran said 'This day I have perfected for you your religion and completed My favor upon you and have approved for you Islam as religion'.[552]

Therefore, since the Kingdom of Saudi Arabia is the heartland of Islam, it is necessary when studying corporate governance in the Kingdom to consider the effects of Islam on corporate governance, especially in relation to minority shareholders. In effect, shariah law has placed some guiding principles, which regulate people's behaviour and conduct. One of the most important Islamic principles is fairness and accountability, which are deemed as essential factors in Islamic law and regulations. Allah (God) has put humans as successors on the earth in order to operate and develop them in the best way as Allah requested. Therefore, Allah said:

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[550]Khaled I. Falgi, *Corporate Governance in Saudi Arabia: A stakeholder Perspective* (University of Dundee, U.K, 2009) 43-44; Fahad, M. Almajid., *A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective* (The Faculty of Humanities, University of Manchester, 2008) 142-143.
[550]ibid
[551]For more insight visit: http://www.islam101.com/dawah/05_concept_worship.html.
[552]Holy Quran, Surat Al-Maidah, Verse, 3.

> O David, indeed We have made you a successor upon the earth, so judge between the people in truth and do not follow [your own] desire, as it will lead you astray from the way of Allah. Indeed, those who go astray from the way of Allah will have a severe punishment for having forgotten the Day of Account.[553]

Justice and fairness are two of the basic humanity values in Islam which are considered fundamental elements in building communities. The Holy Quran, making the construction of fairness between people, is the aim of the heavenly messages, where Allah said "We have already sent our messengers with clear evidences and sent down with them the Scripture and the balance that the people may maintain [their affairs] in justice".[554]

Justice in Islam is not affected by love or hate. It does not differentiate between poor or rich. And it does not differentiate between a Muslim and non-Muslim, but it is enjoyed by all residents on his land, whether Muslim or non-Muslim. Islam encourages fairness and considers oppression as a taboo, whether it causes injustice of self or others, the injustice of the rich against the poor, or the injustice of the ruler against the ruled. Consequently, the Messenger of Allah, the Prophet Mohammed (Peace be upon him) in Hadith Al-Qudsi has affirmed that by saying "O My servants, I have forbidden oppression for Myself and have made it forbidden amongst you, so do not oppress one another".[555]

According to the speech of Allah and the teachings of the Prophet Mohammed (PBUH), the research found out that there is an inherent relationship between the Islamic principles and international corporate governance standards in relation to prevention of the oppression of minority shareholders and the expropriation of their rights unjustly. Therefore, it can be said that there is convergence between the Islamic provisions and teachings and the corporate governance principles in many aspects, especially in terms of forbidding the oppression of minority shareholders' rights. Specifically, in order to satisfy Allah's requirements for sanctification while conducting business, Muslims (whether individuals or corporations) are expected to undertake their diverse obligations. For instance, business dealings should be stimulated and directed by the concept of tawheed (unity with God), which refers to

[553]Holy Quran Surat Al-Sad, Verse, 26.
[554]Ibid Surat Al-Hadid, Verse, 25.
[555]Imam Muslim, *Book of Righteousness and Morality and the Relevant*, p 2577. This reference is written in Arabic Language. Translation available at: http://www.dailyhadithonline.com.

awareness and continuance of the unity and oneness of Allah in everyone's activities.[556] Therefore, from the Islamic perspective, corporations should be encouraged to conduct business with a sense of fairness, which is one of the basic principles of good corporate governance. In fact, boards of directors are expected to offer fair treatment to all shareholders without discrimination.[557]

Evidence for the above has been demonstrated by the Prophet Mohammed (PBUH) who affirmed that fairness and accountability are fundamental standards in all aspects of people's lives and their dealings, including financial and economic transactions. Hence, the Messenger of Allah said that:

> You are all custodians, and you all will be questioned about the things under your custody. The Imam (Leader) is a custodian and he shall be questioned about his custody. The man is a custodian of his family and he shall be questioned about his custody. The woman is a custodian in her husband's home and she will be questioned about her custody. The employee is a custodian of the property of his employer and he shall be questioned about his custody.[558]

Accountability from the Islamic perspective is divided into two parties, which we call the *principle* and the *agent.* Compared with the current contractual relationships in financial institutions, the *principle* can be classified as the government, the community, shareholders and other stakeholders, who authorise others to do something on their behalf. The agent is a person who accepts to do the task on behalf of the principal, who are usually managers and boards of directors. According to Islamic principles, Islamic banking should be accountable to the community and stakeholders.[559] For instance, managers are accountable to provide employees with welfare, training and development opportunities and reasonable rewards. Specifically, this idea about stakeholder responsibility is not binding. The rationale is that by engaging in such voluntary actions, the company's CSR, as a key element of corporate governance, is raised eventually, which in turn increases investors' confidence in the corporation.

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[556]M. Haneef, 'The Islamic Worldview, and Islamic Economics' (1997) IIUM Journal of Economics and Management, vol 5, no 1, p 39.
[557]F. Al Omar, 'The Role of Values and Ethics in Enhancing the Confidence of Shareholders, Customers and Investors: International Experiences, Methods and Models', Arabic edition, (Seminar of the Organisation for Economic Institutions, 2008) 5.
[558]SahihAl- Bukhari, Hadith no 844. Al-Bukhari is one of the most famous Muslim scholars; his book is considered as one of the three most trusted collections of hadith (Speech of the Prophet Mohammed).
[559]Haniffa, R. & Hudaib, M., 'Exploring the Ethical Identity of Islamic Banks via Communication in Annual Reports (2007) Journal of Business Ethics 76, pp 97-116.

Furthermore, shareholders also have rights in Islam to get sufficient information about the performance of the company.[560] As far as the protection of minority shareholders' rights is concerned, the relationship between the *principle* and the *agent* must be built on the basis of transparency, accountability and fairness. As a consequence, literature has shown that Islamic law orders companies to exercise full disclosure in order to demonstrate social accountability: 'private accountability and limited disclosure are insufficient criteria to reflect the ethical precepts of Islamic law. Consistency of disclosure practices with Islamic law requires application of the more all-embracing criteria of social accountability and full disclosure'.[561]

Furthermore, the board of directors is considered as one of the most significant mechanisms of effective application of corporate governance. According to the Islamic perspective, the decision-making should be made in accordance with the participation principle. As a consequence, the Holy Quran has endorsed the consultation principle, which states that '.... and consult them in the matter. And when you have decided, then rely upon Allah. Indeed, Allah loves those who rely [upon Him]'.[562]

The Holy Quran urged the Prophet Mohammed (PBUH) to consult Muslim scholars and intellectuals in the matters facing Muslims and give all interested parties the chance to be part of the consultation process (Shura). The participation principle in Islam is not restricted to worship alone. It also extends to include all legal, economic, business and managerial aspects in our life. As a result, the Shura principle encourages all companies to establish a consultation board, whose duty is to mentor, supervise, recommend, account and control. The board of director should consist of all various stakeholders, such as shareholders, employees, suppliers, creditors, debtors and the community as a whole, so that all a company's deeds and activities are subject to supervision and monitoring by the consultation board. The function of the consultation board in Islam is entirely compatible with the role of the board of directors, as shown in the global principles of corporate governance. Hence, the role of the Shura board (consultative board) is to enhance and strengthen the fairness and accountability principle into the financial institutions, as well as to prevent mismanagement and opportunistic corporate executives. As far as the protection of minority shareholders' rights is concerned, there is no doubt that the Shura principle (consultative board) reinforces the concept of protecting minority shareholders' interests against the controlling shareholders and

[560]ibid.
[561]Baydoun, N, & Willett, R., 'Islamic Corporate Report' (2000) A Journal of Accounting, Finance and Business Studies, BACUS, 36(1), p 81.
[562]Holy Quran, Surat Al-Imran, Verse 159.

wrongdoing of management. Table 2 below presents Islamic principles in relation to corporate governance and minority shareholders protection, and how these principles compare with the OECD principles of corporate governance.

Table 2: Comparison of Islamic Corporate Governance Principles with OECD principles[563]

Principle Number	OECD Principles and Annotation	Islamic Principles
1	***Insuring the basis for an effective corporate governance framework***	
	Promotion of transparent and efficient markets with rule of law and division of responsibilities.	• Promotion of business within ethical • framework of shariah; • Believes in profit and loss; • Primacy of justice and social welfare with social and spiritual obligations; • Prohibition of interest.
2	***The rights of shareholders and key ownership functions***	
	• Basic shareholder rights; • Participation in decision-making at the general meetings; • Structures and arrangements markets for corporate control; • Ownership rights by all shareholders including institutional shareholders; • Consultative process between shareholders and institutional shareholders.	• Property as trust from God; • Sole authority is God. • Society as stakeholders; • Accountability not only to stakeholders but also to God, the ultimate owner.
3	***The equitable treatment of shareholders***	
	• Protection to minority and foreign shareholders.	• Just and fairness of value; • Equitable distribution of

[563]See A. M. Abu-Tapanjeh, (2009), "Corporate governance from the Islamic perspective: A comparative analysis with OECD principles". Critical Perspectives on Accounting, Vol.20, Issues.5, pp. 556-567.

		wealth to all stakeholders and disadvantages for members in the form of *Zakat* and *Sadqa;* • Social and individual welfare with both spiritual and moral obligation; • Sensation of equality.
4	***The role of stakeholders in corporate governance***	
	• In creating wealth, jobs and sustainability of financially sound enterprises.	• Islamic accountability to social welfare orientation; • Haram/Halal dichotomy in transaction; • Social & individual welfare from both spiritual and material; • Consideration to whole community.
5	***Disclosure and transparency***	
	• Matters regarding corporation ; • Financial situation; • Performance, ownership and governance.	• Accountability with shariah compliance • Socio-economic; objectives related to firms' control and accountability to all its stakeholders; • Justice, equality, truthfulness transparency; • Wider accountability with written as well as oral disclosure.
6	***The responsibilities of the board***	
	• Strategic guidance; • Monitoring of management; • Accountability to company and stakeholders.	• Accountability not only to company or board or stakeholders but also to Allah the ultimate authority who leads to welfare and success; • Holistic and integrative guidance; • Negotiation and cooperation.

		• Consultation and consensus seeking for each decision with related stakeholders.

Table 2 suggests that there is some degree of convergence between the OECD principles of good corporate governance and Islamic (shariah) law perspectives on corporate governance. However, as Al-Harkan argued, there is little genuine difference between the ethical and altruistic foundation of Islamic law and the ethical principles of good corporate governance.[564] For instance, one element, which is at variance, is that shariah law generally prohibits interest, whereas corporate governance principles do not.[565] According to Al Kahtani, due to the link between corporate governance from the Islamic view and the islamic religious teachings, such as the Islamic objective of wealth and the Islamic view for values, researchers have discussed whether corporate governance from the Islamic perspective converges with the the corporate governance models in the West countries, and they found out that:

> There are a variety of ideologies that highlight the differences between the model of Islamic corporate governance and theories that are common elsewhere. Firstly, the ethical basics of Western business morals stem chiefly from socially derived secular values and not religious moral values. Secondly, the fundamental beliefs and values of Western corporate governance theories persist in emphasising self-interest, although there is a trend to amend some principles to suit the interests of society. Finally, the greatest corporate governance theoretical framework is based on the agency theory.[566]

To sum up, the research has found, from the above discussion and analysis, that the attitude of shariah law, in terms of protecting minority shareholders, is very clear as Islamic law has established a solid basis, stating that all people's rights and interests must be protected against any assault or expropriation. From the above, the Saudi Arabian laws and regulations should apply the Islamic provisions and teachings in all aspects of life. Consequently, the Saudi regulator has a responsibility to take into account the fairness considerations stipulated

[564]A. Al-Harkan, *An Investigation into the Emerging Corporate Governance Framework in Saudi Arabia* (Unpublished thesis: Cardiff Business School, 2005).
[565]J. Solomon, *Corporate Governance and Accountability* (2nd Edition, Hoboken, NJ, Wiley, Chichester, UK, 2010).
[566]F.S. Al Kahtani, *Current practices of Saudi corporate governance: A case for reform* (Brunel University, London, 2013) pp.76-77.

by sharia law, in particular those related to the rights of minority shareholders. However, as stated in the introduction of this chapter, the analysis of legal structures and how they mediate the relationship between corporate governance and protection of minority shareholders' rights will be only based on Saudi statutory laws, rather than Islamic teachings. This is because of the fundamental differences between Islamic law and Western law in many aspects. This will also reduce some ambiguities that may perhaps affect the comparison between UK and Saudi corporate governance, in relation to protection of minority shareholders' rights. In this regard, the subsequent sections will focus on providing analysis of Saudi statutory laws and their role in protecting minority shareholders' rights.

4.4 Statutory Laws

4.4.1 Basic Law of Governance

In principle, there is no formal institutional law in Saudi Arabia because as previously mentioned, the Saudi constitutional system is based purely on the Holy Quran and the Sunnah principles.[567] The alternative for constitutional law is the so-called Saudi Arabian Basic Law of Governance (BLG). The BLG emerged in the era of King Fahad Al-Saud in 1992.[568] It is considered as a relatively recent law. The BLG was issued by the Royal Order and has four significant laws, namely: the Basic Law of Governance (BLG), the Consultative Council Law, the Law of Regions, and the law of Council Ministers.[569]

The Consultative Council was one of the greatest bodies that have recently originated in Saudi Arabia. Despite the fact that the Consultative Council was established mainly to act as an advisory body to the Council of Ministers, it has lately been playing a crucial role in reviewing and developing the laws, regulations, contracts, international conventions and others. It has a commitment to advise and comment on government policies and offer suggestions concerning annual reports prepared by the ministries.[570] In some cases, the Consultative Council has a jurisdiction to query the Saudi ministers about performance of their ministries.

The Basic Law of Governance consists of 83 Articles. The BLG involve many sophisticated principles. Perhaps the most important of them are: the system of government; the foundation

[567]Art (1) Saudi BLG 1992.
[568]King Fahad Al-Saud is the fifth king of the Kingdom of Saudi Arabia.
[569]The Basic Law of Governance issued by the Royal Order, No. A-90, dated 1 March 1992. The Consultative Council Law issued by the Royal Order, No. A-91 (1 March 1992). The Regional Law issued by the Royal Order, No. A-92 (1 March 1992), and the Council of Ministers Law issued by the Royal Order, No. A-13 (20 August 1994).
[570]For more insight visit: http://www.shura.gov.sa.

of Saudi society; economic principles; rights and duties of the State and citizens; authorities of the State; financial affairs and auditing agencies. The BLG has included several legal principles, which can be used to reinforce protection of minority shareholders' rights in the Saudi stock market.

In this regard, it is very obvious, from the provisions of the BLG, that protecting human rights represents a key element in the Saudi Arabian government policy. Therefore, the BLG has affirmed that human rights must be protected by the law.[571] The rights of minority shareholders are also contained in some of the BLG Articles. For instance, 'the right of litigation shall be guaranteed equally for both citizens and residents in the Kingdom. The law shall set forth the procedures required thereof'.[572]

From the foregoing, the BLG has granted anyone the right to bring legal action before the Saudi courts and it also states that the laws and regulations should be enacted to facilitate this purpose. Indeed, the above text seems to support the interests of minority shareholders. It can be said that the former text has explicitly affirmed the rights of minority shareholders to bring a liability suit against anyone who assaults or abuses their rights, whether they are controlling shareholders, management or the board of directors.

Linking the provisions of Article 47 of the BLG and the Global Standards of corporate governance, particularly the OECD Principles show that there is, to a large extent, some degree of convergence between the provisions of Article 47 and the global principles of corporate governance.

4.4.2 Company Laws of 1965

Despite the early emergence of business and economic activities in Saudi Arabia, following the discovery of oil in the year 1938, there were no laws to regulate companies' activities until the year 1965.[573] During that period, the commercial and economic life was governed by Islamic law and this was no without written laws and regulations.[574] From 1931 to 1972, there were some modest attempts to regulate the firms' activities in the Saudi Arabian economy. At first, there was a special regulation issued by the Commercial Council otherwise

[571]Art (26) Saudi BLG 1992.
[572]Ibid art (47).
[573]Company Law of 1965 was the first code issued by the Royal Decree No. (M/6) Dated 22/3/1385H (corresponding to 22/7/1965AD) to regulate the companies' affairs in Saudi Arabia.
[574]Hamdallah, M. Hamdallah, (2005), '*the Saudi Commercial Law',* (Al-Khawarism, Jeddah, 2005).21. [Arabic edition].

known as the Nizam Al-Majilis Al-Tijari (Commercial Council Law 1972). This law was approved by the Saudi Arabian Consultative Council and it aimed to organise the business activities in the Saudi market.

In that year, the Commercial Council also established the so-called company registry system, which required all companies to be registered in this system. To support the organisation of companies' activities, the Saudi government established the Nazam Al-Mhakamah Al-Tijari (Commercial Court Law 1931), which was deemed as the first formal court in Saudi Arabia. Unfortunately however, this court faced some obstacles which ultimately led to its being repealed in 1954.[575] The paradigm shift occurred in 1965, when the Saudi regulator issued company law (CL).[576] Since that time, CL has been considered the main legislative body and the key reference for all types of commercial business activities in Saudi Arabia.

In reality, company law contributed largely in developing investment and regulating the stock market and companies' affairs, in particular joint-stock companies' affairs until the introduction of Capital Market Law in 2003, which was solely established to regulate the stock market affairs. It should be noted that most of the Company Law's Articles were taken from Egyptian Company Law, which is largely based on civil law principles. Therefore, there were initial fears and concerns amongst the Saudi people that the Westernization of the Saudi laws could end up as a replacement or alternative to Islamic Law.

However, company law has explicitly stipulated that all existing companies are permitted to work in commercial and economic activities in Saudi Arabia. However, these companies must not contravene the provisions of Islamic jurisprudence.[577] Company law contains 233 Articles which extensively cover eight forms of business entities, which are classified as follows: (1) general partnership; (2) limited partnership; (3) joint venture; (4) a joint stock corporation; (5) partnership limited by shares; (6) limited liability partnership; (7) company with variable capital; and (8) a cooperative company.[578]

Of specific importance is part five of company law (Articles 48 to 148), which regulates all aspects associated with the affairs of the joint-stock corporations, such as registration,

[575] *Aleqtisadiah Newspaper* 'The Commercial Court Jurisdictions' (2012) issue no 6879. Available at: http://www.aleqt.com.
[576] The Saudi Company Law issued by the Royal Decree NO. M/6 Dated 22/3/1385H equivalent 1965. It has been amended four times; the last amendment was made by the Royal Decree No. M/29 dated 16/09/1418 H equivalent 15/01/1998.
[577] Art (2) Saudi CL 1965.
[578] ibid art (2-a).

configuration, public offerings, annual and extraordinary general meetings, general assembly responsibilities, duties of board of directors, disclosure requirements, accounting rules, merger and acquisition, tenders offers, shareholders' rights and others. The SCL defined the joint-stock company as follows:

> The capital of a joint-stock corporation shall be divided into negotiable shares of equal value. The members thereof shall be responsible only to the extent of the value of their shares, and their number shall not be less than five.[579]

In accordance with Article 49 of the SCL, the capital of a joint-stock company, that offers its shares for public offerings, shall not be less than SR 10 million which is equivalent to $2.67 million. The joint-stock companies are incorporated by two methods: namely by virtue of an authorisation issued by a royal decree, which is approved by the Council of Ministries and the recommendations of the Minister of Commerce and Industry. Other corporations may be incorporated by the decision of the Ministry of Commerce and Industry.[580]

It should be noted that the SCL contains a set of provisions related to corporate governance rules. As a consequence, Articles 66 to 97 and 106 to 109 deal mainly with regulating the internal corporate governance structure of publicly listed corporations, such as the responsibilities of the board of directors, the civil liability of directors, the duties of the general assembly, the procedures of the annual general and extraordinary meetings, shareholders' rights and remedies, the discloser requirements and other relevant issues.

With respect to the issue of protecting minority shareholders, the SCL has included some Articles to deal with issues related to the rights of minority shareholders in the joint-stock corporations. However, the problem is that the SCL gives the majority shareholders unrestricted control at the expense of minority shareholders. The protection of minority shareholders in the SCL is, to a large extent, ambiguous and unclear. Furthermore, it was enacted since 1965 and thus it is no longer able to keep with the pace of new commercial and economic variables in the Saudi securities market.

[579]ibid art (48).
[580]Ibid art (52).

The SCL created serious problems that hindered the development of the Saudi stock market. These problems relate to primary and secondary offerings. Firstly, the main shortcomings in the primary offerings were as follows:[581]

1. Corporations had just 30 days to decide whether they would become public after incorporation or not.[582] Thus, this procedure placed unjustified restraints on the company's decision-making.
2. Buyer of shares was not required to receive or read the prospectus if he or she acts as an agent.[583]
3. Such prospectuses were not required to involve useful information about the company's operation and assets.[584]
4. There was no monitoring on the seller's behaviour, communications, or advertising during the initial publicly offering (IPO).[585]
5. Company law did not contain provisions covering anti-competitive behaviour, such as deceptive marketing, insider trading and market manipulation.[586]
6. The sanctions issued against violators of company law were relatively weak, as the Company Law of 1965 stated that:

> without prejudice to what is required under the provisions of the Islamic regulation, violators of this law provision shall be punishable by imprisonment for a period not less than three months but not exceeding one year and a fine of not less than five thousand Saudi Riyals and not exceeding twenty thousand Saudi Riyals, or either.[587]

Secondly, in spite of the procedures associated with the secondary offerings, it is still better that the primary offerings in general. However, it also had some limitations which are described as follows:[588]

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[581]Joseph W. Beach, 'The Saudi Arabian Capital Market Law: A Practical Study of the Creation of Law in Developing Markets' (2005) Stanford Journal of International Law, p 7.
[582]Art (54) Saudi CL.
[583]Joseph W. Beach, 'The Saudi Arabian Capital Market Law: A Practical Study of the Creation of Law in Developing Markets' (2005) Stanford Journal of International Law, p 7.
[584]Art (119) Saudi CL 1965.
[585]Joseph W. Beach, 'The Saudi Arabian Capital Market Law: A Practical Study of the Creation of Law in Developing Markets' (2005) Stanford Journal of International Law, p 7.
[586]ibid.
[587]Art (229-231) Saudi CL 1965.
[588]ibid.

1. There was no required license or regulatory scheme for market brokers.
2. There was no professional or regulatory oversight on investors' actions.
3. There was no liability for misdeeds or manipulation in the stock market.
4. The regulatory framework of merger and acquisition was inadequate.
5. Transparency and disclosure was insufficient.

Given the above limitations of the SCL, the Saudi Arabian regulator is working now to introduce a new company law which will replace the current SCL of 1965.[589] Therefore, it is expected that the new company law will be introduced sooner to help in addressing some of the miscellaneous issues facing the business sector in Saudi Arabia. Recently, the Saudi legislator introduced several regulations, such as the Capital Market Law (CML) of 2003, the Listing Rules of 2003, and the Corporate Governance Regulations (CGRs) of 2006 to tackle those shortcomings created by the SCL, including those that relate to the protection of minority shareholders' rights. As a consequence, the SCL jurisdiction over the publicly listed companies has been reduced, following the release of the above new regulations.

In spite of the Capital Market Law has jurisdiction over stock market issues. However, the SCL is still regulating some relevant aspects, such as the establishment and incorporation of joint-stock corporations, the board of directors and its duties, shareholder meetings, the company's account, auditing, capital increase and reduction and the expiration of a joint-stock corporation.

4.4.3 The Capital Market Law of 2003

The Saudi stock market witnessed a paradigm shift when the Saudi government issued the Capital Market Law (CML) in 2003.[590] This was in response to a boost in the Saudi economy, which led the Saudi government to take decisive measures to enact a bundle of laws and regulations to deal with stock market issues and other financial matters facing the economy. As a result, the CML was established, which in turn led to establishment of the Capital Market Authority (CMA). The CMA was established to govern and supervise the issues

[589]The Former Minister of Commerce and Industry, Abdullah Yamani, announced in 2007 that the bill of the new Company Law sent to the Prime Minister, King Abdullah Al-Saud, waiting for approval it by a royal decree; *Asharq Alawsat Newspaper* (edition 10284, 24.01.2007).
[590]The Capital Markets Law promulgated under the Royal Decree No. M/30 dated 2/6/1424 H (31 July 2003).

facing the Saudi securities market. The CMA is an independent government authority and is directly linked to the president of the Saudi Council of Ministries.[591]

By law, the Capital Market Authority is deemed as a legal personality and enjoyed with financial and administrative autonomy.[592] Furthermore, it is responsible for issuing regulations, rules and instructions for implementing the provisions of the Capital Market Law.[593] In reality, the aims of the CML are to produce an appropriate investment environment, to protect investors and guarantee accountability, fairness and efficiency in the stock market. [594] According to the CML, the CMA must be governed by a board known as the Capital Market Authority Board (CMAB). The CMAB comprises of five members, who must be Saudi Arabian citizens working on a full-time basis, and they must be professionally qualified. The board members must be appointed and their salaries and financial benefits determined by the Royal Order. Among the board members, the Royal Order shall specify the chairman and deputy chairman (who will replace the chairman in his absence).[595]

The Capital Market Law contains 67 Articles, which became enforceable at the beginning of 2004.[596] The CML is a legislative framework for all miscellaneous security matters in Saudi Arabia. According to the CML, the Capital Market Authority has issued eleven key implementing regulations[597], namely: (1) prudential rules; (2) listing rules; (3) anti-money laundering and counter-terrorist financing rules; (4) authorised persons regulations; (5) merger and acquisition regulations; (6) real estate investment funds regulations; (7) securities business regulations; (7) market conduct regulations; (8) corporate governance regulations; (9) offers of securities regulations; (10) investment funds regulations; (11) the resolution of securities disputes proceedings regulations.

The Saudi stock exchange (Tadawul) is one of the most significant institutions established by the Capital Market Law. The key objective of Tadawul is to maintain market integrity, operate the market effectively and efficiently, present a quality services for investors, brokers, issuers, vendors and others. Also, it aims to increase investors' education and awareness efforts and develop the exchange's capabilities and competencies.[598] According to

[591]Art (4) Saudi CML 2003.
[592]Ibid art (4-a).
[593]Ibid art (5).
[594]Ibid art (5&6).
[595]Ibid art (7).
[596]Ibid art (67).
[597]Implementing Regulations at the website of the CMA. Available at: http://www.cma.org.sa.
[598]For more insight see the website of Tadawual. Available at: http://www.tadawul.com.sa.

the CML, Tadawul shall be '...the sole entity authorised to carry out trading in securities in the Kingdom'.[599]

The above text reveals the seriousness of the Saudi regulator, which concentrated the function of market monitoring into a single exchange so that it facilitates the task of regulatory oversight over the shares trading operations. In effect, the CML has paved the way for the Capital Market Authority to create new rules, make decisions and place appropriate procedures, which contribute to addressing all matters affecting the market, including challenges and stockholders demands. Evidence in support of this is contained in the CML provision, which defines the function of the Capital Market Authority as follows: 'the Authority shall be the agency responsible for issuing regulations, rules and instructions, and for applying the provisions of this Law'.[600]

As far as the protection of minority shareholders' rights is concerned, the CML has also stated that one of the objectives of the establishment of the CMA is to provide a statutory protection for those dealers in the Saudi stock market including minority shareholders. As a consequence, in order to accomplish the protection of investors and achieve the market integrity, the CML has stipulated clearly that the CMA must do the following:[601]

1. Regulate and develop the exchange, seek to develop and improve methods of systems and entities trading in securities and develop the procedures that will reduce the risks related to securities transactions.
2. Regulate the issuance of securities and monitor securities and dealing in securities.
3. Regulate and monitor the works and activities of parties, subject to the control and supervision of the authority.
4. Protect citizens and investors in securities from unfair and unsound practices or practices involving fraud, deceit, cheating or manipulation.
5. Seek to achieve fairness, efficiency and transparency in securities transactions.
6. Regulate and monitor the full disclosure of information regarding securities and their issuers, the dealings of informed persons, major shareholders and investors, and define and make available information which the participants in the market should provide and disclose to shareholders and the public.

[599]Art (20-a) Saudi CML 2003.
[600]Ibid art (5-a).
[601]Ibid art (5-a).

7. Regulate proxy and purchase requests and public offers of shares.

The CML has, indeed, put in place the legal framework for regulating the securities market, including those provisions that provide sound protection for minority shareholders. Consequently, the CMA released a bundle of regulations in this context. For example, the Corporate Governance Regulations (CGRs) were enacted in 2006 in order to provide further protection for investors and buyers of securities. These new regulations were indeed, a great step in the process of protecting shareholders and enhancing the confidence in the Saudi securities market. Moreover, the listing rules were enacted in 2004, in order to regulate the public offering, registration and admission to listing of securities in the Kingdom.

In addition, to reinforce the justice principle among dealers in the Saudi securities market (including minority shareholders), the CMA has also established a Committee for the Resolution of Securities Disputes (CRSD) so as to redress the shareholders from misconduct and abuse of the management and board of directors.[602] Despite the fact that the CRSD has jurisdiction over the disputes falling under the provisions of the CML,[603] there are some shortcomings regarding its work, autonomy, advocacy measures and implementing decisions. Giving the importance of the CRSD and its vital role in providing good protection for minority shareholders, the thesis will fully analyse the committees' actions later on in Chapter 3, including full discussion of key criticisms of the CRSD.

4.5 Regulations

4.5.1 Corporate Governance Regulations (CGRs) of 2006

Since 2000, the Saudi government has had a genuine desire to restore the reputation of the Saudi economy and attract foreign investments. Indeed, there was serious work aimed at improving the national economic performance. These efforts have culminated into establishing several institutions and enacting sophisticated laws and regulations. Without going into details, perhaps the most significance of these institutions is the establishment of the Supreme Economic Council in 1999, the creation of the Saudi Arabian General Investment Authority in 2000, and lately the launching of the Capital Market Authority in 2003.

[602] Art (25-a) Saudi CML 2003.
[603] ibid.

Furthermore, the Saudi regulator released a bundle of laws and regulations in order to enhance the level of the confidence in the Saudi economy. The Foreign Investment Act in 2000, the Capital Market Law of 2003 and the Listing Rules of 2004 were some of the substantial regulations introduced to increase investors' trust and improve the investment climate in the Saudi stock market. However, it should be noted that the interest of the Saudi government, in the field of corporate governance, did not come to limelight until 2006, when the Saudi stock market was hit by a large stocks bubble in its history. [604]

In the aftermath of the collapse of the stock market, the Saudi government (represented in the Capital Market Authority Board) decided to establish a good legal framework in order to provide sufficient protection for all participants and practitioners in the securities market. As a consequence, the Capital Market Authority Board (CMAB) issued the Corporate Governance Regulations in November 2006. The CGRs aim to ensure that the listed corporations comply with the best governance practices, which ensure effective protection of shareholders and stakeholders alike. This assurance is clearly reflected as follows:

> These Regulations include the rules and standards that regulate the management of joint stock companies listed in the exchange to ensure their compliance with the best governance practices that would ensure the protection of shareholders' rights as well as the rights of stakeholders.[605]

In reality, there is a common belief that soft laws are considered more flexible in the formation of joint-stock corporations. It was argued that giving listed corporations the chance to design their internal arrangements and management has a positive effect on the good performance of these companies.[606] The soft law method, including corporate governance policy, may largely contribute to addressing companies' issues and enhancing their performance.[607] Some went on to say that the self-regulation of corporate governance is more appropriate for listed corporations, since self-regulation comes out of different views and opinions, and thus this method will be more acceptable, instead of the binding statutes.[608]

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[604]Some reports had issued by the Tadawul all Share Index (TASI) shown that the Saudi Stock Market had lost, at the end of 2006, approximately 2 trillion Saudi Riyals. At that period, the TASI reached a highest level, as it was arrived 20634 points. Within 10 months the TASI lost 12775 points. For more insight see: http://www.tadawul.com.sa.

[605]Art (1-a) Saudi CGRs 2006.

[606]Du Plessis, J. J., McConvill, J. and Bagaric, M., *Principles of Contemporary Corporate Governance* (Cambridge University Press, New York, 2005) 120.

[607]David Walker, *A Review of Corporate Governance in UK Banks and other Financial Industry Entities- Final Recommendations* (2009) 70.

[608]Jonathan Charkham, *Keeping Better Company: Corporate Governance Ten Years on (*Oxford University Press, Oxford, 2005) 301.

The above view was endorsed by one of the prominent scholars in the field of corporate governance, Jonathan Charkham, who asserted that:

> Soft law, as in the codes of corporate governance, is similar to a sword with two edges. At best, this way of proceeding secures flexibility and avoids the need for primary legislation at every turn; at worst, such sanctions as there are, seem inadequate to secure compliance. Therefore, it rests on the shareholders to enforce them and if they are unable to do so, codes will be ineffective.[609]

Based on this perspective, the significance of corporate governance principles have come from being considered as non-binding principles. The OECD Principles have also affirmed this as a major element of the objectives of its principles, where it has stipulated that '.....to provide guidance and suggestions for stock exchanges, investors, corporations and other parties that have a role in the process of developing good corporate governance…'.[610]

In Saudi Arabia, the CGRs have also asserted that self-regulation is a general norm. Consequently, the CGRs are considered as the guiding principles for all corporations listed in the stock exchange and they are not obligatory, except as provided for in Article 1b), where these regulations stated that: '....a company must disclose in the Board of Directors` report, the provisions that have been implemented and the provisions that have not been implemented as well as the reasons for not implementing them'.[611]

This challenged the board of directors to effectively act in order, to reflect a good picture for their corporations. Despite the fact that these regulations are distinguished as non-binding, they reflect the position and performance of the company positively among its counterparts in the stock market. Hence, the company which applies the CGRs effectively will definitely be distinct and attractive for investments and increase investors' trust.[612] In effect, obtaining accurate statistics on the number of the listed corporations that apply the self-regulation of corporate governance in the Saudi stock exchange is extremely difficult.

Nevertheless, there has been a study which showed that about 57.1% of the number of listed corporations sufficiently apply corporate governance policy since these companies have

[609]ibid.
[610]OECD Principles of Corporate Governance (2004), p 11.
[611]Art (1-c) Saudi CGRs 2006.
[612]Saleh Al Shaalan, *Corporate Governance in Saudi Joint Stock Companies* (King Saud University, 2007) 114 [Arabic edition].

established independent departments to ensure the implementation of the CGRs.[613] However, on the other hand, other studies have revealed that the number of the listed companies that recognised self-regulatory corporate governance do not exceed 25 corporations, out of 150 corporations listed in the stock exchange.[614] In fact, these results present a negative picture regarding the extent of the effective application of the corporate governance regulations, on the corporations operating in the Saudi stock market.

Thus, given that only a limited number of companies (including family-listed companies) implement corporate governance regulations, it is fair to say that most Saudi family-listed corporations have still not adapted the method of self-regulation of corporate governance. This in turn, suggests that the position of minority shareholders is still weak in family-listed corporations on the Saudi stock market. In fact, the CGRs have covered all elements existing in the global standards of corporate governance, which are divided into four parts, as follows: part 1 covers preliminary provisions; part 2 covers rights of shareholders and the general assembly; part 3 covers disclosure and transparency; and part 4 covers the board of directors.

4.5.2 The Listing Rules of 2004

The Listing Rules are great initiatives issued by the Capital Market Authority Board (CMAB).[615] The LRs were enacted as standards to disclose and monitor publicly listed companies' behaviours. They have been defined as one of the best ways to assist stock market authorities in overseeing the performance of listed corporations.[616] The main purpose of the LRs is to regulate the public offerings of securitises and register and incorporate these securities in its official list.[617] These rules are distinguished as they are strictly obligatory, as companies must either declare their commitment to these rules or explain any deviation from them.[618] The compliance with these rules is a condition to invest in the Saudi stock market as stipulated in Article 20 of these rules 'Issuers must comply with the listing rules and must

[613]ibid.
[614]Faleh AL-Kahtani, *Current Practices of Saudi Corporate Governance: A Case for Reform* (School of Law, Brunel University, London, UK, 2013) 96-97.
[615]The Listing Rules were issued by the Board of the Capital Market Authority upon its Resolution Number 3-11-2004 Dated 20/8/1425H Corresponding to 4/10/2004 G based on the Capital Market Law. Also, the Listing Rules were amended by Resolution of the Board of the CMA, No. 2-128-2006, dated 22/12/1426H (22/1/2006).
[616]Du Plessis, J. J., McConvill, J. and Bagaric, M., *Principles of Contemporary Corporate Governance* (Cambridge University Press, New York, 2005) 117-18.
[617]Art (8-9) Saudi LRs 2004.
[618]Steven Tankiso Moloi, *Assessment of Corporate Governance Reporting in the Annual Reports of South African Listed Companies* (University of South Africa, 2008) 32.

provide to the authority without delay all information, explanations, books and records that the authority may require'.[619]

To strengthen the protection of the stock market and its stakeholders, the LRs gave the CMA absolute rights to intervene directly, to suspend the shares of listed corporations that are trying to manipulate the market or the shareholders' interests.[620] Previous literature shows that these rules are intended to protect existing and potential shareholders by ensuring full disclosure of financial material and other information, and giving investors all the rights to vote on certain matters.[621] In protecting minority shareholders' rights, the LRs have included a number of provisions, such as access to information, disclosure of financial information, board of directors' reports, its duties, notification relating to substantial shareholdings and continuing obligations.

According to the LRs, or 'continuing obligations', listed corporations must be committed to notify the CMA and shareholders, without delay, of any major developments in their field of activity, which are not public knowledge and which may have an effect on the issuer's assets and liabilities, the financial position, the general course of its business, or any major developments as mentioned in Article 25a) of the LRs. The LRs have come to affirm on the value of protecting shareholders' rights, including minority shareholders. Thus, these rules have stated clearly that the issuer must ensure equality of treatment for all shareholders who hold the same class, in respect of all rights attaching to such equities.[622] Thus, it is suitable to say that the LRs have introduced, at least in theory, a number of rules that can help protect the rights of minority shareholders against the abuse of power by management and boards of directors. These rules have paved the way before the CMA to exercise power and competences in order to protect the stock market and investors against manipulation of management or directors.

4.6 Judicial Enforcement Authority

A sound judicial system is a fundamental prerequisite for financial stability and protection of minority shareholders' rights. Similarly, adequate legal and judicial enforcements are significant corporate governance mechanisms that support the protection of minority

[619]Art (20-a) Saudi LRs 2004.
[620]Ibid art (21).
[621]Padraig Cronin and Frances Murphy, Slaughter and May, 'Corporate Governance for Main Market and AIM Companies' (2012) Paper Published in Association with London Stock Exchange, White Page Ltd, p 56.
[622]Art (39-a-b) Saudi LRs.

shareholders' rights and the growth of enterprises.[623] Importantly, effective judicial enforcement raises investors' confidence in the legal and financial system and thus, encourages them to invest their funds in the security market. Previous research suggests that 'Firm-level protection of minority rights is less likely to be effective if legal enforcement and judicial efficiency is weak'.[624] In fact, violations of security market laws cause a lot of damage in the market, which has implications for the rights of minority shareholders. For instance, victims of such violations always resort to the judiciary to seek justice and redress wrongs done to them. There is no doubt that the existence of a sound judicial system will contribute largely in ensuring effective public enforcement. Moreover, it is a significant means of protecting minority shareholders from the abuse and misconduct of management and controlling shareholders.

Evidence that sound legal and judicial enforcement mechanisms play a fundamental role in protecting minority shareholders' rights have been demonstrated in previous literature. For instance, the Canadian Securities Administrators (CSA) asserted that 'prosecuting cases of misconduct either through administrative tribunal hearings or court proceedings (civil and quasi-criminal) and the resulting sanctions and penalties are visible signs of active enforcement'.[625]

Other legal scholars have also emphasised that the protection of public investment is one of the significant objectives of the enforcement of the securities laws.[626] A number of theories in law and finance have also suggested that development of the securities market, improvement of investment environments and reformation of company structure are to a large extent dependent on the effectiveness of the enforcement of the law.[627] In fact, influencing investors' decisions to invest in the security market and increasing their confidence in the stock market rely to a large extent on how strongly the securities market laws and regulations are enforced.[628]

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[623]E. Berglöf and S. Claessens, *Corporate Governance and Enforcement* (Stockholm School of Economics, University of Amsterdam, 2004) 22-37.
[624]L. F. Klapper and I. Love, 'Corporate Governance, Investor Protection, and Performance in Emerging Markets', *World Bank Policy Research Working Paper, No. 281* (2002) pp 19.
[625]The Canadian Securities Administrators (CSA) is deemed as the council of the 10 provincial and three territorial securities regulators in Canada. The CSA is basically responsible for developing a consistent approach to regulate securities market over the country. For more insight see 2008 Enforcement Report issued by The Canadian Securities Administrators (CSA). Available at: http://www.bcsc.bc.ca/uploadedFiles/News/News_Releases/2008_CSA_Enforcement_Report.pdf?t=1414345172063.
[626]R. Tomasic, 'Corporations Law Enforcement Strategies in Australia: the Influence of Professional, Corporate and Bureaucratic Cultures (1993) Australian Journal for Corporate Law, vol 3, pp 192-229.
[627]R. La Porta et al., 'Investor protection and corporate governance' (2000) Journal of Financial Economics, vol 58, pp 3-27.
[628]T. Beck and R. Levine, 'Legal Institutions and Financial Development' (2003) NBER Working Paper No w10126, pp 5-7.

Taken together, the evidence above suggests that the protection of investors' rights (the rights of minority shareholders) is one of the substantial objectives of the public enforcement mechanisms. Specifically, the mere existence of law in a book is not enough to guarantee effective protection of minority shareholders. Instead, there needs to be a sound judicial system with qualified judges to ensure that the security laws and regulations are enforced appropriately. In Saudi Arabia, several calls have been made on the importance of reforming the judicial system, particularly in relation to the security market. As a consequence, the Saudi regulator responded to this call and thus, developed effective means of improving the level of judicial services provided to investors in the Saudi securities market. The following sections highlight and analyze the judicial enforcement mechanisms in Saudi Arabia that deal with cases violating the provisions of the security market laws (the CML) and it's implementing regulations.

4.6.1 Competent Judicial Body to deal with Stock Market Disputes in Saudi Arabia

In Saudi Arabia, the judicial system is analogous to other judicial systems in the world. The composition of the Saudi judiciary system is reflected in the description below:

> In most Islamic states . . . the legal system is bifurcated: one part is based on man-made, positive law; the other part is Islamic law. Saudi Arabia also has a dual legal system … the Islamic component of the legal system is fundamental and dominant. The positive law, on the other hand, is subordinate, constitutional and in scope.[629]

The composition of the Saudi judicial system shows that alongside the shariah courts, there are various administrative committees enjoying full judicial powers. These committees are entirely independent from the shariah courts and they rely on the written legal rules rather than on the provisions of Islamic Law. The quasi-judicial committees have developed in Saudi Arabia as an alternative court in order to deal with the resolution of administrative and commercial disputes outside shariah court jurisdiction. This type of judicial system emerged as a consequence of rejection by Islamic (shariah) scholars on the establishment of the commercial court system in 1931, which was supposed to be the first commercial tribunal court that has jurisdiction over all commercial and financial activities.[630] In Saudi Arabia,

[629]F. Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (Brill, Boston, 2000) 322.
[630]The Commercial Court System was involved 633 Articles distributed into four sections, namely Commercial Paper, Bankruptcy, Land, Maritime Trade, Arbitration Rules, Bills and Exchange. However, this Court terminated in 1954 under pressure of Shariah Clerics.

concerns have been raised regarding the application of the principles of civil law on certain issues, which some have argued contravene the provisions of Islamic law. Previous research has shared a similar view as has argued that '…the expansion of civil jurisdiction would only come at the expense of Shari'ah courts'.[631]

Following the rejection of shariah judges to adjudicate on both commercial and financial disputes, the Saudi regulator saw the necessity to create a new legal system to deal with the challenges/issues arising from rapid growth in the Saudi economy. As a result, quasi-judicial committees came into existence to fill this gap in the Saudi judiciary system.[632] The quasi-judicial committees are always established by Royal decree and members of those committees are also appointed by Royal decree. The decisions of these committees are final and cannot be appealed.[633] The main difference between these committees and the judicial authorities is that the members of these committees are chosen by Saudi legal scholars, while the members of the judicial authorities are selected by shariah scholars.

Over the years, the Saudi government has established several judicial committees following the adoption of quasi-judicial committees as an alternative judicial system to hear cases outside the jurisdiction of shariah courts. The main judicial committees are the Labour Disputes Committees, the Custom Disputes Committees, and the Banking Disputes Committees.[634] As far as security market disputes are concerned, the Saudi government has established committees for resolution of security conflicts, which are divided into two major committees: the Committee for the Resolution of Security Disputes (CRSD), otherwise known as the First-degree Court, and the Appeal Committee for the Resolution of Securities Conflicts (ACRSC), otherwise known as the Second-degree Court. The CRSD and ACRSC are two of the prominent quasi-judicial committees in Saudi Arabia which have jurisdiction over commercial, administrative and criminal matters arising from violation of the Capital Market Law and its implementing regulations.

By virtue of the provisions of the CML, the CRSD and the ACRSC are competent judicial bodies for adjudicating in all lawsuits and conflicts arising from such parties of the securities market, when the shareholders, listed corporations, brokers or any other party has dealings

[631]G.N. Sfeir, 'The Saudi Approach to Law Reform' (1988) the American Journal of Comparative Law 36, p 746.
[632]A.A. Al-Ghadyan, 'The Judiciary in Saudi Arabia' (1988) Arab Law Quarterly, pp 246-247.
[633]The decision of the Appeal Committee of Resolution of Securities Conflicts (ACRC), "as an example" is considered final and is not subject to appeal before any courts in Saudi Arabia.
[634]M. Al-Ghamdi et al., *The Dispute Resolution Review: Saud Arabia* (Law Business Research Ltd, Fourth Edition, 2012) 664.

with the Saudi Arabian stock exchange market. The CRSD's establishment is laid down in Article 25 of the CML and it provides that the Capital Market Authority should establish a judicial committee known as the:

> Committee for the Resolution of Securities Disputes' which shall have jurisdiction over the disputes falling under the provisions of this Law, its implementing regulations, and the regulations, rules and instructions issued by the authority and the exchange, with respect to the public and private actions.[635]

The CRSD is deemed as a quasi-judicial authority; hence its decisions are judicial in nature. Besides, the decisions reached by these committees are not subject to any appeal before other judicial authorities. These committees are entirely independent from the judicial authority in Saudi Arabia. It has its own special judicial proceedings outside those applicable to other Saudi Arabian judicial bodies. In the section that follows, the composition, jurisdiction and powers of the CRSD and ACRSC are provided.

4.6.2 The Committees for Resolution of Securities Disputes (CRSD)

4.6.2.1 Composition of the CRSD

The CRSD was created by the CML in 2004 and classified as a first-degree court. In accordance with the provisions of the CML, this committee should comprise of legal advisors who are specialists in the financial transactions and stock markets, and have sufficient experience in the securities markets.[636] The Capital Market Authority Board should appoint the members of the CRSD for a renewable period of three years.[637] In order to ensure its objective of providing justice is maintained, the members of this committee must not have any direct or indirect financial or commercial interest, or have any family relationship up to the fourth degree with the complainants or the litigations brought before the CRSD.[638] In accordance with the CML, the committee must begin litigations or hear the complaints within 14 days from the date of filing the lawsuits or the complaints with the CRSD.[639]

[635]Art (25-a) Saudi CML.
[636]Ibid art (25-b).
[637]ibid.
[638]ibid.
[639]ibid.

4.6.2.2 Jurisdictions of the CRSD

The CML established the CRSD to receive and address any conflicts relating to the implementation of the provisions of the CML or its implementing regulations, as well as those that relate to implementation or violation of the stock market regulations, rules and instructions (either public or private).[640] The CRSD's jurisdictions include litigations, decisions and actions taken by the authority or the exchange market.[641] In addition, the committee has the absolute right to make claims against decisions and actions taken by the authority or the exchange and the Committee shall have the right to issue a decision awarding damages and request to revert to the original status, or issue another decision as appropriate (that would guarantee the rights of the aggrieved).[642] Since the Capital Market Law picks up various cases and provisions, the CRSD implements its jurisdictions to review litigations in accordance with such rules. The CRSD's jurisdictions can be summarized in the following points:[643]

1) To consider the grievance of decisions and actions made by the Capital Market Authority or the Saudi stock exchange which is known as the administrative lawsuit;
2) To review lawsuits arising between investors themselves relating to the CML and its implementing regulations, as well as CMA and the exchange market regulations, rules and instructions in terms of public and private actions, what is known as the civil lawsuit;
3) To consider litigations filed by the CMA (as a general prosecutor) against violators of the CML and its implementing regulations, what is known as the (penal lawsuit)

It should be noted that these jurisdictions are currently applied at the wider geographical level, covering all cities and provinces of Saudi Arabia. The reason behind bringing the judicial committee under one umbrella is to ensure justice and fairness in the judicial system and to prevent conflicts as to which court has the competent jurisdiction to hear the stock market-related cases.[644]

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[640]For more insight about the jurisdictions of the Committee for the Resolution of the Securities Disputes (CRSD) see http://www.crsd.org.sa/En/Dispute/Pages/authority.aspx.
[641]Art (25-c) Saudi CML.
[642]ibid.
[643]For more insight see these jurisdictions at: http://www.crsd.org.sa/En/Dispute/Pages/authority.aspx.
[644]Ibid. No.150.

4.6.2.3 Powers of the CRSD

A wide range of jurisdictions and powers have been granted to the CRSD by the CML in order to reinforce its power in the market and enable it to confront the issues and conflicts arising from the contractual relationships in the securities market, or from the violations of the CML and its regulations. In accordance with the CML, the CRSD is granted the following powers in exercise of its legal duties and functions:[645]

1) To investigate and settle complaints and litigations
2) To issue subpoenas witnesses
3) To issue essential decisions to tackle the lawsuits
4) To impose dissuasive sanctions and penalties
5) To request the presentation of proof and documents
6) To issue a decision granting compensation
7) To retrieve parties to the original status, or issue another decision as appropriate that would guarantee the rights of the aggrieved.

4.6.3 The Appeal Committee for the Resolution of the Securities Conflicts (ACRSC)

4.6.3.1 Composition of the ACRSC

For ensuring the rights of litigants and attaining the purposes of justice, the CML has given litigants the right to appeal the CRSD's decision before the Appeal Committee within 30 days from the notification date.[646] The ACRSC is constituted by the Council of Ministers Royal Decree.[647] The membership of the ACRSC is comprised of three members representing the Ministry of Finance, the Ministry of Commerce and Industry and the Bureau of Experts at the Council of Ministers.[648] The membership is renewable for a period of three years.[649] The ACRSC is classified as a second-degree court in the course of prosecution in Saudi Arabia. It grants all the aggrieved parties the right of appeal against the perceived unfair decision of the CRSD. Importantly, membership of the ACRSC is different from the CRSD.

[645]Art (25-a) of the Saudi CML. These powers are available on the website of the CRSD at: http://www.crsd.org.sa/En/Pages/Home.aspx.
[646]Art (25-f) Saudi CML.
[647]Ibid art (25-g) Saudi CML. The Council of Ministers has recently re-appointed the Appeal Committee for the Resolution of Securities Conflicts members for three years since October 2011. Available at: http://crsd.org.sa/En/Conflict/Pages/Member.aspx.
[648]ibid.
[649]ibid.

4.6.3.2 Jurisdictions and Powers of the ACRSC

In accordance with the provisions of the CML, the ACRSC has jurisdiction over complaints and litigations arising either from investors themselves or from the decisions of the Capital Market Authority, or the stock exchange market (Tadawul).[650] The CML has given the ACRSC the right to review, reconsider and issue decisions regarding the complaints or suits whatever the nature of the cases, which means that the ACRSC is empowered to adjudicate in all cases, whatever their nature, whether the case is an administrative suit, civil suit or even a criminal suit.[651]

On the other hand, however, the difference between the CRSD and the ACRSC lie in their powers. By virtue of the CML, the ACRSC is granted the power to:[652]

1) Refuse to review the decisions that are issued by the CRSD
2) Assert such decisions issued by the CRSD
3) Reconsider the complaint or suit, based on constant information in the litigation's file before the CRSD
4) Issue an appropriate decision for the litigation or complaint.

According to the CML, the decision issued by the Appeal Committee for the Resolution of the Securities Conflict is considered to be final.[653]

4.6.4 Shortcomings Directed to the Judicial Committees

As it is well-known, the CMA established the so-called specialised judicial committees to address the issues arising from violations of the provisions of the CML and implementing regulations, as well as to adjudicate in the securities disputes emerging among investors. In fact, these two committees (the CRSD and the ACRSC) are playing fundamental roles in the activities of the Saudi Arabian securities market. In particular, these two committees are making enormous efforts to promote and boost confidence among dealers in the market, in particular among minority shareholders. In fact, the numbers of sanctions issued within the security laws are not in themselves the ultimate target. The most important target is to enforce and/or implement these sanctions and penalties efficiently. Indeed, the role of the judicial

[650]Appeal Committee for Resolution of Securities Conflict (ACRSC). Available at: http://crsd.org.sa/En/Conflict/Pages/Member.aspx.
[651]For more insight see these jurisdictions at: http://www.crsd.org.sa/En/Dispute/Pages/authority.aspx.
[652]Art (25-g) Saudi CML.
[653]ibid.

authority in imposing appropriate sanctions against those who violate the securities law cannot be underestimated. Previous research has shown that the quality of justice is measured by the quality of the judiciary system.[654] In the section that follows, an overview of the number of committees, its members' independence, educational qualifications and experiences is provided.

4.6.4.1 Insufficient Numbers of Judicial Committees, its Members and its Independence

As previously stated, the committees for resolution of securities conflicts are divided into two major committees: the CRSD (First-degree Court) and the ACRSC (Second-degree Court). Both the CRSD and the ACRSC are headquartered in Riyadh, which is the capital of the Kingdom of Saudi Arabia. There are no branches of these committees in other Saudi Arabian cities. The lack of other judicial committees in other cities in Saudi Arabia continues to pose a problem to investors in general, and in particular for minority shareholders. Perhaps this limitation could weaken the efficiency of the judiciary system in enforcing the security laws. Previous research has argued that obtaining a distinct justice regime requires the necessity of providing easy access to justice, regardless of its geographical location.[655] In fact, creating easy court access to litigators is one of the fundamental prerequisites for protecting minority shareholders' rights.

Indeed, Saudi Arabia is a large country, thus the lack of other judicial committees in other provinces is considered a huge barrier that may prevent investors from bringing their trade disputes before the committees, due to high cost and distance of getting to the capital. To address this problem, previous research has recommended the need to establish additional quasi-judicial committees in each province in Saudi Arabia, in that this will reinforce investors' confidence and encourage investment in the security market.[656] Therefore, it is necessary that the Saudi regulator adjust the provisions of Article 25 of the CML to establish other divisions of the Committee for the Resolution of Securities Disputes (CRSD) in various provinces in Saudi Arabia.

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[654]P. J. White, 'Judging Judges: Securing Judicial Independence by Use of Judicial Performance Evaluations (2002) Fordham Urban Law Journal, vol 29, pp 1053-1064.
[655]L. R. Spain, 'The Opportunities and Challenges of Providing Equal Access to Justice in Rural Communities' (2011) William Mitchell Law Review, vol 28, pp 367.
[656]Aleqtisadiah, 'Analysts: Legal abuses by the Capital Market Authority lead to investors fleeing' (26 November 2011) No. 66203. Available at: http://www.aleqt.com/2011/11/26/article_601506.html [Arabic edition].

In fact, granting minority shareholders' easy access to courts is an essential requirement in the enforcement of security laws. Indeed, as the International Organisation of Securities Commissions (IOSCO) assert, access to courts and other mechanisms of dispute resolutions should be available to the aggrieved parties or investors, whose rights have been violated.[657] Therefore, it is strongly recommended that Saudi regulator benefit from the UK's system in this regard. In the UK, the High Court is considered as a first-instance court that hears all security disputes. The High Court is divided into three main divisions, namely:[658]

1) The Queens's Bench Division, which deals with litigations including negligence, personal injury, breach of contracts, non-payment of a debt and possession of land or property and defamation.
2) The Chancery Division, which is presided over by the Chancellor and about 20 High Court Judges and involved many specialised courts, such as the Bankruptcy and Companies Court, the Commercial Court, the Technology Construction Court and the Patent Court. The High Court deals with all disputes arising from the securities market including fraud, manipulation, and deceit and so on.
3) The Family Division, which deals with matters related to personal human issues, such as divorce, children, probate and medical treatment.

The High Court Divisions are distributed over the UK. As a result, these divisions facilitate the process of court hearings, as the affected or aggrieved investors can file their litigation at the nearest court without having to travel to the headquarters.

In addition to the above problem, the number of members of these committees is really insufficient and constitutes a major flaw in terms of protection of minority shareholders' rights in the Saudi securities market. Previous research suggests that the existence of a sufficient number of judges is one of the most significant factors that contribute to creating an effective enforcement of security laws.[659] Therefore, the number of judges should be large enough to respond to the volume of cases. This view is consistent with those of the Chief Justice of the US state of California who stressed that: "the lack of available courtrooms and judges is a reflection of legislative failure to provide a number of courtrooms and judges

[657]IOSCO, 'Objectives and Principles of Securities Regulation', p 6.
[658]The UK Courts and Tribunals Judiciary, 'Civil Justice in England and Wales'. Available at: http://www.judiciary.gov.uk/about-the-judiciary/the-justice-system/jurisdictions/civil-jurisdiction/.
[659]M. Dakolias, 'Court Performance around the World: A Comparative Perspective' (1999) Yale Human Rights and Development Journal, vol 2, no 1, p 104.

sufficient to cope with the rapid growing population".[660] He further stressed that these failures have led to many problems in the administration of justice. The main problem is that several criminal cases were rejected under the pretense that the defendants were not able to exercise their constitutional rights to speed up the trial.[661]

According to the CML, membership of both the CRSD and c should be three has to be chosen by Saudi legal scholars.[662] The members of the CRSD and the ACRSC are in charge of adjudicating in all cases arising from the Saudi securities market. However, with the rapid growth in the Saudi security market and existence of a number of cases, the number of members of both committees is no longer enough to deal with the size of the market and its accompanying problems. Indeed, three members in each committee make the process of litigation very slow, and therefore the number of the committees' members may be seen as a bottleneck for investors, particularly minority shareholders. Furthermore, the independence of the judicial system is deemed as an essential requirement in ensuring fairness and justice. Judges in any judicial regime must enjoy some form of independence that enables them to deliberate on cases and award verdicts without any external influences. Previous research has shown that protecting judicial processes from inappropriate interventions strengthens the rule of law.[663] Besides, the judicial independence has been becoming one of the most significant aspects of democracy over the world.[664]

In addition to the necessity of judicial independence, judges should be accountable to the public. Accounting judges is considered a crucial element when it comes to reinforcing judicial independence. Shetreet argued that, 'judicial independence cannot be maintained without judicial accountability for failure, errors and misconduct'.[665] In the Saudi context, the Saudi judges have the absolute authority to exercise their power without external influences or intervention, thus demonstrating judicial independence. Importantly, the rights of the Saudi judges have been endorsed and supported by the law of the judiciary, which states that 'judges are independent and, in the administration of justice, they shall be subject to no

[660]J. Chung, 'Lack of Judges, Courtrooms, Leads to Calif. Accused Walking Free', *The Wall Street Journal, Criminal Law* (25 October 2010) Available at: http://blogs.wsj.com/law/2010/10/25/lack-of-judges-courtrooms-leads-to-calif-accused-walking-free/.
[661]ibid.
[662]Art (25) Saudi CML.
[663]E. Handsley, 'Issues Paper on Judicial Accountability' (2011) Journal of Judicial Administration, vol 10, pp 180-187.
[664]P. Russell, *Toward a General Theory of Judicial Independence* (Judicial Independence in the Age of Democracy. eds. P. H. Russell and D. O'Brien, Charlottesville: University Press of Virginia, 1, 2001).
[665]S. Shetreet, 'Judicial Accountability: A Comparative Analysis of the Models and the Recent Trends' (1996) International Legal Practitioner, vol 11, pp 38.

authority other than the provisions of shariah and laws in force. No one may interfere with the judiciary'.[666]

Nonetheless, the situation is entirely different when it comes to members of judicial committees in the Saudi securities market. Specifically, the members of the quasi-judicial committees in the Saudi market are not independent, neither are they accountable. In fact, the Capital Market Law (CML) has not made any provision with regards to issues of judicial independence of the committees' members and also it has not made any provision for legal accountability of the members, when they make mistakes, errors, or misconduct whilst discharging their duties. For example, in the Saudi security market, the members of the CRSD are appointed by the BCMA's decisions for a renewable term of three years.[667] Therefore, a conflict of interests may arise between the CRSD and the Board Capital Market Authority Board (BCMA). It is reasonable to say that the members of the CRSD cannot make any decision that is at variance with the directives of the BCMA. As a result, the performance of the CRSD will be biased, which will negatively reflect on the justice and integrity of the members and cases they decide.

As previous mentioned, investors in the UK can file legal action before the High Court. However, in terms of the appeal against the decisions of the Financial Conduct Authority (FCA), the UK's judicial system has given the aggrieved parties the right to challenge its decisions at multiple stages. For example, the first-tier tribunal has jurisdiction to deal with appeals from executive agencies decisions, including the decisions issued by the Financial Conduct Authority (FCA).[668] However, anybody that feels he/she is unhappy with the decision of the first-tire tribunal can challenge this decision before the Upper Tribunal Administrative Chamber. The Upper Tribunal Chamber has jurisdiction to adjust or revoke the decision of the first-tier tribunal.[669] In addition, the aggrieved party has the right to appeal the decision of the Upper Tribunal Chamber before the Court of Appeal, which handles appeal only on points of law.[670] In order to reinforce the role of judicial integrity and satisfying litigators, the aggrieved can challenge the decisions of the Appeal of Court before the UK Supreme Court.[671]

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[666]Art (1) Saudi Law of the Judiciary of 1975.
[667]Art (25-b) Saudi CML.
[668] The First-tier Tribunal and Upper Tribunal (Chambers) Order 2010 (S.I. 2010/2655), as it came into force on 8th August 2014. For more insight see http://www.justice.gov.uk/downloads/tribunals/general/si-2010-2655.pdf.
[669]See Administrative Appeals Tribunal guidance. Available at: http://www.justice.gov.uk/tribunals/aa.
[670]The Structure of the Courts in the U.K. Available at:
http://www.judiciary.gov.uk/wp-content/uploads/JCO/Images/Layout/courts_structure.pdf.
[671]ibid.

On the other hand, the CML has not prevented the members of these committees from working in the public or private sectors. Consequently, the members of these committees are still holding other jobs, either in the Saudi government or in the private sector. In fact, the concept of judicial independence requires that judges must be protected from any external interference or influence which may affect their legal decisions or opinions.[672] In order to ensure the integrity of the judicial independence, the judges should not receive any wages or premiums from government or from any other sector. According to Ronald Sackaville, '…unlike the legal practitioner, the judge must be independent of governments, institutions and individuals and must be impartial in the discharge of his or her adjudicative responsibilities'.[673]

In addition to these shortcomings, the members of these committees do not enjoy judicial immunity. Consequently, the lack of sufficient protection for the committees' members would indeed, affects their work and make them susceptible to judgment bias. The importance of judicial immunity has been demonstrated in many studies. For instance, Williams has suggested that:

> …adequate constitutional protection and remuneration must be afforded to judicial office, as these protections will allow judges to deal with all cases that come before them without having to worry about the security of their office, or having their pay reduced, if decisions unfavorable to the government are made.[674]

To sum up, it is true to say that the members of quasi-judicial committees in the Saudi securities market still have deficiencies in three areas: the absence of other branches of judicial committees in different provinces of the Kingdom of Saudi Arabia; insufficient number of members of the CRSD and the ACRSC; and lack of judicial protection and/or immunity by the committees compared to their counterparts in the Saudi judiciary. As a consequence, adequate intervention by the Saudi regulator is required to address these shortcomings so as to reinforce statutory protection for its investors, particularly minority shareholders.

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[672]C. M. Larkins, 'Judicial Independence and Democratisation: A Theoretical and Conceptual Analysis' (1996) American Journal of Comparative Law, vol. 44, pp 605-608.
[673]R. Sackville, 'Judicial Ethics and Judicial Misbehaviour: Two Sides of the One Coin?' (2009) The Journal of Law and Social Justice, vol 3, art 6 ,p 9.
[674]D. Williams,'Judicial Independence and the High Court', (1998) University of Western Australia Law Review, vol 27, p 140.

4.6.4.2 Weak Education, Qualifications and Experiences of the Committees' Members

The confidence of investors in the security market is inversely related to a sound legal system. Similarly, the existence of qualified and well-educated personnel with solid backgrounds in the field of law are fundamental prerequisites for developing sophisticated laws to deal with capital market issues, in particular protecting investors' rights and interests. This view is consistent with the recommendation made by the International Organisation of Securities Commission (IOSCO). According to the IOSCO, securities regulators should be equipped with sufficient skills, experience and qualifications that are appropriate to the private sector.[675] Moreover, the IOSCO also proposed that security market staff should receive constant training as required.[676] This recommendation also applies to both the members of the CRSD and the ACRSC. Specifically, the CML provides that the CRSD should comprise of three legal consultants with specialist knowledge in transactions and dealings in the security market, as well as financial and commercial affairs.[677] On the other hand, the CML provides that the members of the ACRSC should consist of three members representing the Ministry of Commerce and Industry, the Ministry of Finance and the Bureau of Experts at the Council of Ministers.[678]

In fact, investment in the securities markets either directly or indirectly, via mutual funds, is growing rapidly.[679] Furthermore, lawsuits between the securities market and its participants, as well as between investors have also increased. With an increase in the size of the market and widening scope of internet trading, cases related to security dealings have continued to rise steadily.[680] As is well-known, the cases of the securities market are complicated and not easy to resolve. As a result, perfect knowledge in the science of law is required. In particular, the appointment of a member of the judicial body should take into account the legal qualifications and experiences of the candidates. Unarguably, appointment in legislative authorities relies on certain factors. Perhaps the most important of which has to deal with individual competences and a specialized ability in law. Therefore, appointing an international attorney on any judicial committee who is a specialist in agricultural and forestry would be a waste of talent and effort.[681]

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[675]International Organization of Securities Commission (IOSCO), (2003), "Objectives and Principles of Securities Regulation", Report IOSCO, No, 253, p 10. Available at: http://www.iosco.org/library/pubdocs/pdf/ioscopd154.pdf>.
[676]ibid.
[677]Art (25-b) Saudi CML.
[678]ibid Art (25-g).
[679]C. N. Katsoris, 'The Resolution of Securities Disputes' (2001) Fordham Journal of Corporate & Financial Law, vol 6, no 2, p 309.
[680]ibid.
[681]D. G. Farrelly, 'The Senate Judiciary Committee: Qualifications of Members' (1943) The American Political Science Review, vol 37, no 3, pp 469-471.

In addition to the above, practical training and enormous experiences are crucial elements in designating judicial committee members. In reality, a legally competent person with qualifications and experiences in law should describe the profile of any member of the judicial committee. Previous research suggests that a set of criteria should be taken into consideration when selecting members of the judiciary committee. These criteria should include training in law, judicial experience and legal knowledge gained from working in prosecution or in legal administration.[682] The importance of the existence of qualified and experienced persons in law on judicial committees is clearly reflected in the composition of the United States Senate, as it is a common phenomenon to see that most congressmen are attorneys. Evidence shows that slightly more than 60% of the total numbers of senators elected to the seventy-seventh congress were qualified solicitors.[683]

In terms of the Saudi Arabian securities judicial committees, the present study found that there are a number of issues surrounding the members of these committees, particularly in terms of their education, qualifications and experiences in the ambit of security markets cases. One main issue identified is that the committees' website does not make provision of any demographic characteristics of the committee members, especially their educational status, competencies and experience in the field of security and capital market laws. This raises a question as to whether the committee members have the relevant qualifications and skills needed to serve on the committee. The information available on the website of the CRSD suggests that the members of the ACRSC work as legal advisors in their governmental bodies.[684] The nature of their professional work is in the scope of administrative law and thus they express their legal opinions before the Board of Grievances (administrative court) regarding issues that arise from administrative, contractual relationships.[685]

As a result, it can be said that the securities judicial committees in the Capital Market Authority are composed of individuals who lack professional qualification or experience needed to tackle all security-related matters in the Saudi capital market.[686] Perhaps these

[682]ibid. p 470.
[683]D. R. Matthews, 'United State Senators: A Collective Portrait' (1961) International Social Science Journal, vol XIII, no 4, p 628.
[684]For more insight see http://www.crsd.org.sa/En/Appeal/Pages/Member.aspx.
[685]For more information review Badar Mohammed Almeajel , *Investor Protection and the Civil Liability for Defective Disclosures in the Saudi Securities Market: a legal analysis,* (University of Wollongong, 2012) p.385.
[686]ibid, pp.385-393.

limitations would likely affect the performance of these committee members, especially in protecting minority shareholders' rights.

4.6.4.3 Duplication of Functions between the Board Capital Market Authority (BCMA) And the CRSD

In principle, the Committee for Resolution of Securities Disputes (CRSD) has entire jurisdiction over imposing appropriate sanctions against any person who breaches the provisions of the CML, regulations issued by the CMA and/or the Saudi stock exchange. It also has the legal right to settle or adjudicate on all litigations filed before it, either regardless of the referral source (the Capital Market Authority) or by investors themselves.[687] In the same vein, the Saudi regulator has also given the BCMA the right to impose financial penalties against those who infringe on the provisions of the CML, or the regulations issued by the CMA and/ or Saudi stock exchange. This right is contained in Article 59 of the CML and states that 'as an alternative to the foregoing, the board may impose a financial fine upon any person responsible for the violation of this Law, its implementing regulations, the rules of the authority and the regulations of the exchange'.[688]

However, it should be noted that the BCMA is just entitled to imposing a financial sanction against those who violate the provisions of the CML or the rules of the stock exchange. Therefore, it is obvious that the power of the BCMA is restricted in this regard. The settlement of securities disputes or adjudication in those disputes is outside the jurisdiction of the BCMA. In addition to this, the criminal sanctions and imprisonment terms fall within the province of the CRSD. The main problem in this context is that giving the BCMA the right to impose financial fines against violators of the CML, and its implementing regulations without returning to the CRSD, will lead to weakening of the role of the CRSD. Thus, granting this right to the BCMA may largely contribute to further breaches of the securities law and regulations. The role of the CMAB in this respect has been challenged in a financial committee's report by Majlis Al-Shura (Consultative Council).

The Financial Committee's report revealed that in 2002, the BCMA dealt with 166 cases of violations, but that approximately 90% of these violations had been resolved through direct

[687] Art (25 &55 & 59) Saudi CML.
[688] Ibid art (59-b).

imposition of fines by the BCMA, without referring the cases to the CRSD, thus demonstrating duplication of functions between the two bodies.[689] The Financial Committee believes that imposing fines by the BCMA indicates a strict violation of the provisions of the CML in that it gives the violators the chance to pay fines without proper investigation of the case by the CRSD.

As a consequence, the Financial Committee recommended the need to refer all violators of the provisions of the CML or its implementing regulations to the CRSD. This recommendation is contained in the following statement:

> Upon the Board of the Capital Market Authority (BCMA) to refer all violators of the provisions of the securities law pursuant to Article 59 to the Committee for Resolution of Securities Disputes (CRSD) and it should not be expanded in imposing fines directly by the BCMA.

In line with the foregoing, it is necessary that the Saudi regulator amend Article 59b) of the CML so that the CRSD will be seen as the only court that has the power to impose sanctions and penalties against those who violate the provisions of the securities law. This modification of the Article would contribute to enhancing investors' confidence in the Saudi market as well as prevent the duplication of roles between the BCMA and the CRSD.

4.6.4.4 Investors have no Right to Appeal against Decisions of the CRSC before the High Court

As a general principle, the Saudi judges have the absolute authority to exercise their powers and jurisdictions over all criminal and civil claims, except for the claims that fall outside their jurisdictions by law. For example, those cases have to be heard by specialized judicial bodies, such as the Board of Grievances or the quasi-judicial committees.[690] The specialized judicial committees are considered as the third degree of judicial authorities in Saudi Arabia.[691] It should be reiterated that the key reason that led to the emergence of the quasi-judicial committees is the refusal of the shariah courts to hear some cases, particular those that relate

[689]Report of the Financial Committee into Consultative Council Regarding the Performance of the Board of the Capital Market Authority in imposing fines against violators of the Securities Law. See this report on the Website of *Alriyadh Newspaper* (5 November 2012) no 16205. Available at: http://www.alriyadh.com/781714.
[690]Art (26) Saudi Law of the Judiciary 1975. Also, this article has endorsed by the new Law of the Judiciary amended in 2008.
[691]D. Karl, 'Islamic Law in Saudi Arabia: What Foreign Attorneys Should Know' (1991) George Washington Journal of International Law and Economics 25, p 142.

to commercial aspects under the assumption that their operations, in many cases, conflict with the shariah principles.[692]

These judicial committees are always established by Royal decree and its members are appointed by Royal decree. The decision of the judicial committees is final and cannot be appealed before the Court of Appeal or the High Court. The main difference between the quasi-judicial committees and other judicial authorities is that the members of these committees are chosen by Saudi legal scholars, while the judicial authorities' members are selected amongst shariah scholars. In fact, there are diverse judicial committees in Saudi Arabia, such as the Labour Disputes Committees, Custom Disputes Committees, the Banking Disputes Committees, and lately the Committees for Resolution of the Securities Disputes (CRSD). It should be noted that the Saudi judiciary has given each person the right to appeal to the High Court when there is any deviation in the application of laws or regulations. In turn however, the decisions of the Appeal Committee for Resolution of Securities Conflicts (CRSC) are final and cannot be overturned by the law.[693]

This exception has raised many questions, especially regarding what the alternative legal means to obtain redress when the decision of the ACRSC works against the aggrieved minority shareholders is. In reality, putting all the issues of shareholders under one judicial committee, without giving them the right to seek redress before either the High Court or the Board of Grievances, may cause injustice and lead to expropriation of their rights. In order to give the shareholders, in particular the minority shareholders, further judicial protection, the present study recommends that the Saudi regulator should amend some of the Articles of the CML so as to allow shareholders to appeal the decisions of the CRSD before the High Court or the Board of Grievances. The reason behind this recommendation is to ensure fairness and justice for the aggrieved shareholders (minority shareholders). This in turn, complies with the OECD principles of good corporate governance, which states that:

> The corporate governance framework should protect and facilitate the exercise of shareholders' rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights[694]

[692]A. Al Ghadyan, 'The Judiciary in Saudi Arabia' (1998) Arab Law Quarterly, p 243.
[693]Jurisdiction, Authority and Nature of ACRSC Decisions. Available at: http://www.crsd.org.sa.
[694]OECD Principles of Corporate Governance Draft for Public Comment (November 2014). Available at: http://www.oecd.org/daf/ca/OECD-Principles-CG-2014-Draft.pdf.

The research believes that it is worthwhile to give investors the right to file their legal action against the decisions of the ACRSC before the High Court or before the Board of Grievances.

4.7 Chapter Summary

The relevant legal structures to corporate governance and protecting minority shareholders' rights were explored in this chapter. The analysis revealed that the Saudi government has enacted some legislation to deal with corporate governance issues in the Kingdom. Specifically, corporate governance from the Islamic law perspective was explored in relation to protection of minority shareholders' rights. As the analysis revealed, the Islamic law perspective on corporate governance has some degree of convergence with the OECD principles of good corporate governance. However, the two differ in some aspects. The Saudi statutory laws were also reviewed including the basic law of governance, company law and the Capital Market Law. Corporate governance regulations and listing rules were also reviewed. Importantly, the CGRs were seen as the guiding principles for all corporations listed in the stock exchange. Despite the fact that they are non-binding, they do reflect positively the position and performance of the company among its counterparts, in the stock market. The listing rules were enacted as standards to disclose and monitor publicly listed companies' behaviours and are considered as one of the best ways to assist stock market authorities in overseeing the performance of listed corporations. Similarly, the Saudi government has established competent judicial bodies to deal with stock market disputes in Saudi Arabia. These judicial bodies, otherwise known as quasi-judicial committees, were established to serve as an alternative court that deals with the resolution of administrative and commercial disputes outside the shariah court jurisdiction. Indeed, previous research has shown that in an environment where the legal system cannot provide the needed minority shareholders' protection, regulators can be an effective substitute for weak judicial systems.[695] However, there are several weaknesses that characterise effective performance of these committees, especially in discharge of their functions.

In summary, the evidence above suggests that the Saudi government has taken some decisive steps in reforming its security market through enactment of laws and regulations to deal with

[695]Glaeser, E., Johnson, S., and Shleifer, A. 'Coase versus the coasians' (2001), Quarterly Journal of Economics 116, pp 853–899. Available at: http://dx.doi.org/10.1162/00335530152466250.

corporate governance issues. In the next chapter, mechanisms for protecting minority shareholders' rights will be explored in both Saudi and UK jurisdictions. The rationale is to highlight the similarities and differences between the two countries, whilst considering the possibility of transplanting some of the UK corporate governance practices to improve the situation in Saudi Arabia.

Chapter 5

Mechanisms for Protecting Minority Shareholders' Rights in the UK and Saudi Arabia

5.1 Introduction

The definitions and theoretical underpinnings of corporate governance were provided in Chapter 2 of this thesis. Specifically, the analysis revealed some variations in perspectives amongst scholars and international organisations as to what corporate governance entails. Importantly, these variations reflect differences in scholars' backgrounds, country experiences, trade policies and standards. Despite these variations, good corporate governance framework represents a combination of the external and internal structures. Importantly, each of these structures has a particular significance in improving the stability of stock markets and protecting shareholders. Previous chapters[696] have analysed the external mechanisms of corporate governance in the Saudi legal system in comparison with the UK legal system. The existence of a robust external structure of corporate governance, in particular the sound legal and judicial mechanisms, is a fundamental prerequisite for implementing good corporate governance practice. Specifically, harmonization between the internal and external tools is required in order to create a solid corporate governance system. The internal mechanisms are not less important than the external mechanisms. Theoretically, most corporate governance systems are similar regarding the internal mechanisms and any corporate governance system should comprise of: a shares ownership structure, a board of directors, transparency and disclosure requirements and basic shareholders' rights.[697]

In practice however, the features of the internal structure of corporate governance differ from one country to another due to differences in legal structure, political status and cultural setting.[698] These differences can be seen in terms of equities ownership structure and the compositions of the boards of directors. For instance, the countries that follow the common law model, such as the US, the UK, Canada, Australia and New Zealand have adopted a separation of ownership and management, whereas this ownership separation is not

[696]Chapter 1 provides background information to the research including definitions of key concepts: minority shareholders, control and ownership structures. Research questions and aims as well as methodology were also provided. Chapter 2 reviews relevant theoretical underpinnings to the concept of corporate governance and their relevance to Saudi Arabia. Chapter 3 explored the development of corporate governance in Saudi Arabia, particularly the role of CMA in protecting minority shareholders rights. The relevant legal structures to corporate governance and protecting minority shareholders rights were explored in Chapter 4.
[697]For more insight, see Saudi Corporate Governance Regulations 2006 and UK Corporate Governance code 2012.
[698]J. Salacuse, 'Corporate Governance in the New Century' (2004) Company Lawyer, vol 25, pp 76-78.

applicable in most civil law countries, such as Germany, France, Italy and the Netherlands.[699] In Saudi Arabia, ownership and management are characterised by concentrated ownership. However, the board composition in Saudi Arabia is one-tier, which is analogous to UK. The board has full discretion to select members for the board of directors.[700]

Given the importance of the internal structure of corporate governance, and in keeping with the objectives of this thesis, the present chapter seeks to analyse and compare the following elements in the UK and Saudi Arabia: equities ownership structure and key players, the board of directors (including their responsibilities and committees), transparency and disclosure requirements and the basic rights of minority shareholders. In order to explore this, the chapter will begin by examining the above elements under the UK system, followed by the Saudi legal system. The choice of the UK is significant to enable the analysis of similarities in the two jurisdictions. Furthermore, the implications of these similarities and differences on protecting minority shareholders' rights are also provided.

5.2 The UK Experience

5.2.1 Share Ownership Structure

Berle and Mean's concept of ownership structure has a significant impact on the life of the UK's corporations. The separation of ownership and control is an inherent notion in the UK's securities market.[701] Specifically, the emergence of a corporate governance system in the UK is traced to the failures of the agency theory, particularly in resolving the conflict of interest between the owners and managers. The UK system is based on the diversification of shareholders and enhancing the role of the board of directors. In the last decade, the level of equity ownership by individuals has dropped in the US and the UK.[702] Available evidence suggests that less than 1/5 of the UK's listed corporations have a controlling ownership with more than 25% of the equities.[703] Interestingly, the notion of controlling family shareholders is no longer prevalent in widely-held corporations that operate in the UK securities market.

[699]H. Ooghe and V. De Vuyst, 'The Anglo-Saxon Versus the Continental European Corporate Governance Model: Empirical Evidence of Board Composition in Belgium', Department of Corporate Finance Ghent University, Belgium, pp 2-41; J. Franks and C. Mayer, 'Ownership and Control of German Corporations' (2001) The Review of Financial Studies, vol 14, no 4, pp 943-977.
[700]J. Salacuse, 'Corporate Governance in the New Century' (2004) Company Lawyer, vol 25, pp 76-78.
[701]A. Smith, 'The Wealth of Nations', in D.K. Denis and J.J. McConnell, 'International Corporate Governance' (2003) The Journal of Financial and Quantitative Analysis, vol 38, no 1, pp 1-36.
[702]J. A. McCahery et al., *Corporate Governance Regimes: Convergence and Diversity* (Oxford University Press, New York) 252-277; M. Goergen and L. Renneboog, *Prediction of control concentration in German and UK Initial Public Offerings* (Manchester School of Management, University of Manchester, Institute of Science & Technology, Working Paper, 2000) 1-29.
[703]ibid.

The main reason behind the disappearance of controlling ownership is because wealthy families no longer intend to own a large proportion of shares in listed corporations.[704]

Instead, the market has witnessed a rapid growth in the level of shares ownership by institutional investors. The pension system and insurance companies in the UK are established sources of liquidity provision in the securities market.[705] In the aftermath of the financial scandals and the corporate fraud that hit the global economy, there has been increasing pressure on institutional investors to act on behalf of individuals and monitor the performance of corporations.[706] As a result, the institutional investors have recently become a powerful force in the UK securities market.[707] Specifically, it has been shown that the institutional shareholders own almost more than 50% of the shares of the listed corporations in the UK securities market.[708] In fact, the wave of investing, through institutional shareholdings rather than individual investment, is influenced by the notion that institutions have the professionalism and technical resources needed to function effectively in the stock market. Similarly, other factors such as the UK tax system have been identified as the reason why UK investors prefer investing via institutions compared to individual investors.[709]

In the UK, the presence of publicly traded corporations is growing deeply. However, this is not so in other countries where a relatively small percentage of the total number of companies is listed.[710] According to the UK regulations, the financial institutions are not allowed to own shares in publicly listed companies, instead they act as agents on behalf of shareholders.[711] However, in some countries, the families and financial institutions (banks or companies) can hold shares directly and do not require agents to manage their funds.[712]

It should be noted that most of the equities in the UK are held by the agents of financial institutions and they play a robust role in the life of the UK securities market.[713] As far as protection of minority shareholders' rights is concerned, it is obvious from the literature that

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[704]R. La Porta et al., 'Corporate Ownership around the World' (1999) Journal of Finance, vol 54, pp 501.
[705]H. Ooghe and V. De Vuyst, *The Anglo-Saxon Versus the Continental European Corporate Governance Model: Empirical Evidence of Board Composition in Belgium* (Department of Corporate Finance Ghent University, Belgium) 2-41; J. Franks and C. Mayer, 'Ownership and Control of German Corporations' (2001) The Review of Financial Studies, vol 14, no 4, pp 943-977.
[706]C.A. Mallin, *Corporate Governance* (Oxford University Press, 2006) 14.
[707]ibid.
[708]SH. Short and K. Keasey, 'Institutional Shareholders and Corporate Governance' in K. Keasey, S. Thompson and M. Wright, (eds, John Wiley & Sons Ltd, West Sussex, 2005) p 63.
[709]W. Hutton, *The State We're In (Revised Edition): Why Britain Is in Crisis and How to Overcome It* (Vintage, London, 1996) pp 304-305.
[710]ibid.
[711]H. Ooghe and V. De Vuyst, *The Anglo-Saxon Versus the Continental European Corporate Governance Model: Empirical Evidence of Board Composition in Belgium* (Department of Corporate Finance Ghent University, Belgium) 5.
[712]ibid.
[713]ibid.

the model of ownership structure under the UK system provides much better protection of minority shareholders, unlike the protection provided under the concentrated model.[714] Thus, it can be said that investment in the UK securities market is more safe and attractive than in other countries that rely on insider-based models of corporate governance.[715]

5.2.2 One-Tier Board System and the Board Duties

In the UK, the board system consists of the executive and non-executive directors who operate under one single board, otherwise known as one-tier board or unitary system.[716] Both the executive and non-executive directors are nominated by the shareholders during the firm's annual meeting and their role is to monitor the company's activities to ensure that the company abides by the provisions of the law.[717] Shareholders in the UK elect directors to set business strategies and oversee management and the company board must also consist of insider and outsider directors.[718] The insider is usually an executive, manager or employee who has a business relationship with the management of the company or is designated by the corporation.[719] The outsider director on the other hand, is a person who has no direct business relationship with the firm or management.[720] The division of the board into two categories of executives follows the recommendation of the Cadbury Report in 1992, which provides that every publicly traded UK corporations should create insider and outsider directors in one board. The Cadbury recommendation also suggests that the board should consist of at least three outsider directors.[721]

The Combined Code on Corporate Governance (CCCG) of 2006 stated that the boards of huge corporations should consist of a reasonable number of non-executive directors.[722] The Combined Code on Corporate Governance (CCCG) was produced in 2006 to set standards of good practice for listed companies on board composition and development, remuneration, shareholder relations, accountability and audit. However, an updated version of the CCCG was published on 17 September 2014 by the FRC with some minor revisions. A review of the

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[714]L.R. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Creation and Agency Costs of Separating Control from Cash Flow Rights* (Working Paper no 6951, 1999, NBER); R. La Porta et al., 'Legal Determinants of External Finance' (1997), The Journal of Finance, vol 52, no 3, pp 1131-1149; J.C. Coffee, 'The Rise of Dispersed Ownership: the Roles of Law and State in the Separation of Ownership and Control' (2001) T he Yale Law Journal, vol 111, no 1, pp 1-82.
[715]R. La Porta et al., 'Law and Finance' (1998) Journal of Political Economy, vol 106, pp 1151-1152.
[716]P. L Davies, *Gower and Davies' Principles of Modern Company Law* (7th edn, Sweet & Maxwell, London, 2003), pp 316-321; J. Rickford, 'Fundamentals, Developments and Trends in British Company Law – Some Wider Reflections; Second Part: Current British Priorities and Wider Reflections' (2005) 2 ECFR 63, pp 73-78.
[717]C.A. Mallin, *Corporate Governance* (Oxford University Press, 2007), pp 121-13.
[718]X. Vives, *Corporate Governance: Theoretical and Empirical Perspectives* (Cambridge University Press, First Edition, 2000) 37.
[719]J. Dahya and J. J. McConnell, *Outside Directors and Corporate Board Decisions* (Purdue University, 2003) pp 2-29.
[720]ibid.
[721]Cadbury Report of the Committee on the Financial Aspects of Corporate Governance (Gee Publications, December 1992). It is available at: http://www.ecgn.org/ecgn/docs/codes/cadbury.pdf.
[722]Sec (a-4-1) UK Combined Code on Corporate Governance 2006.

major changes in the new code, otherwise known as UK Corporate Governance Code is provided to further broaden understanding of corporate governance practices in the UK. The new main changes to the UK Corporate Governance Code included:

> that boards should confirm that the annual report and accounts taken as a whole are fair, balanced and understandable; that audit committees should report more fully on their activities; that FTSE 350 companies should put the external audit contract out to tender at least every ten years; and that companies should report on their boardroom diversity policies.[723]

Other new recommendations made include that FTSE 350 companies should put all directors forward for re-election annually; the appraisal of the boards of FTSE 350 corporations should be facilitated at least each three years;[724] the chairman should agree and regularly review a personalised approach to training and development with each director; that corporations should dedect the personality of the external facilitator and whether they had any other bind to the corporation, since some firms were not doing so;[725] that FTSE 350 corporations should place the external audit contract into tender at least each ten years.[726] In addition, it should put forward 'proposed transitional arrangements, recognising that it was neither realistic nor desirable to expect all companies that had not undertaken a tendering exercise in the previous ten years to do so within the first year of applying the revised Code'.[727]

In relation to diversity, the 2012 edition of the UK Corporate Governance Code recommended that listed firms should show in their annual reports their policy on boardroom multiplicity and also that they should introduce a report reveals any own personal objectives.[728] In terms of the role of the chairman of the board of directors, a new principle was added to the code and states that: 'the chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role'.[729] Furthermore, a new principle clarifies that 'non-executive directors should constructively challenge and help develop proposals on strategy';[730] Moreover, the new developments of 2013 recommended that the directors' annual reports should explores the business model and the strategy for achieving

[723]Developments in Corporate Governance and Stewardship. Financial Reporting Council, 2014, p 11
[724]ibid p 9.
[725]Developments in Corporate Governance 2013, p 12.
[726]ibid p 6.
[727]ibid p 18.
[728]Developments in Corporate Governance and Stewardship 2014, p 10.
[729]Developments in Corporate Governance 2013, p 4.
[730]ibid.

the objectives of the company;[731] and that 'the board should satisfy itself that appropriate systems are in place to identify, evaluate and manage the significant risks faced by the company'.[732]

In accordance with the UK regulator's orientation, maintaining a balance between executive and non-executive directors, particularly with independent non-executive directors, is becoming a necessity. Thus, no individual or small group of individuals can dominate the decision-making process on the board.[733] The main controversy in this regard revolves around the question: How to dissociate the role of a non-executive director from the role of the executive director? Therefore, the CCCG of 2006 went on to state that non-executive directors should be out of the company. In addition, they 'should constructively challenge and help develop proposals on strategy'.[734] Previous research has shown that there exists a mutual relationship between the effectiveness of the board and the existence of non-executive directors. Accordingly, supporting non-executive directors is positively reflected on the strength of the board.[735] In fact, the duty of non-executive directors under the UK legal system is reflected in the affirmation: '…non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance'.[736]

In terms of board election, Provisions B.7.1 and B.7.2 of the UK Corporate Governance Code stated that the papers accompanying resolutions for the election of directors should be understandable and detailed. This should be contained: biography of the board of directors, affirmation from the chairman that the individual's act continues to be helpful and the reason why the individual should be nominated.[737] The new code also requires the board to prove that the company's annual report and accounts taken as a whole are reasnoable, impartial and understandable.[738]

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[731]ibid.
[732]Corporate governance Developments in the UK. CIMA Briefing, 2010, p 5.
[733]Sec (a-3) UK Combined Code on Corporate Governance 2006.
[734]ibid Sec (a-1).
[735]J. Dahya et al., *The Cadbury Committee, Corporate Performance, and Top Management Turnover* (Purdue University, Purdue CIBER Working Papers, 2002) pp 5-28.
[736]ibid.
[737]Developments in Corporate Governance 2013 The impact and implementation of the UK Corporate Governance and Stewardship Codes. The Financial Reporting Council Limited, 2013, p.18.
[738]ibid.

As can be seen from above, the UK corporate governance has undergone some significant changes in certain areas. Reports published by the Financial Reporting Council indicate that majority of companies have begun to comply with the provisions of the new code and some have offered explanations as to why they fail to comply with some provisions of the code.

Importantly, dividing the board into executive and non-executive directors has helped to reinforce the effectiveness of the board within the company as well as protect the company and its shareholders from the misconduct of the management. In addition, some commentators have said that the one-tier board is characterized by a closer relationship between executive and non-executive directors, and this could easily facilitate exchange of information between the executive directors and non-executive directors.[739] Nonetheless, others argue that the composition of the single board could perhaps create a negative effect on the efficiency of the information provided.[740] They believe that putting the insider and outsider directors together in a single room will weaken the independence and efficiency of the board.[741] Furthermore, corporate governance analysts suggest that non-executive directors in this type of board usually suffer from lack of information from executive (insider) directors;[742] thus, their capability to provide effective monitoring is reduced. However, it should be noted that despite this problem, there is a trend towards increasing the proportion of non-executive directors in the UK and US firms.[743]

5.2.2.1 The Chairman and the CEO

Traditionally, the chairman is a person who leads the board of directors of a company. The chairman is responsible for conducting the business of the board, ensuring that board meetings are conducted efficiently[744] and that the directors have easy access to the needed information during board meetings. Moreover, the chairman should monitor the process of appraising, hiring and compensating the chief executive officer (CEO).[745] The code states that the roles of the chairman and the CEO should be separated and not held by the same person. The main reason behind this provision is to prevent the individual acting based on selfish

[739]X. Vives, *Corporate Governance: Theoretical and Empirical Perspectives* (Cambridge University Press, First Edition, 2000) 37.
[740]G.F. Massen and F.A.J. Van Den Bosch, 'On the Supposed Independence of Two-Tier Boards: Formal Structure and Reality in the Netherlands' (1999) vol 7, no 1, p 13.
[741]ibid.
[742]UK and Irlands' Consultative Committee of Accountincy Bodies (CCAB) of 2011, 'Ethical Dilemmas case studies: professional accountants working as non-executive directors' p 15.
[743]J. Dahya and J. J. McConnell, *Outside Directors and Corporate Board Decisions* (Purdue University, 2003) pp 2-29.
[744]S. Arcot et al., 'Corporate Governance in the UK: is the Comply-or-Explain Approach Working?' (2005) LES, p 3.
[745]M.C. Jensen, 'The Modern Industrial Revolution, Exit, and the Failure of Internal Control System' (1993) Journal of Finance, vol 48, no 3, pp 831-880.

interest, rather than the interest of the corporation. Specifically, previous research has shown that combining the roles of the chairperson and the CEO may undermine the board's monitoring power.[746] Besides, self-serving managers may take advantage of this weak monitoring by expropriating the firm's resources, such as paying themselves huge bonuses regardless of their performance.[747] Similarly, studies by Mashayekhi and Bazaz suggest that combining the role of the CEO and the chairman can offer opportunities for self-serving CEOs to dominate board meetings, which has negative implications for the financial performance of the corporation.[748] These findings are consistent with the agency theory assumptions, which suggest a negative relationship between CEO duality and firms' financial performance.[749] Nevertheless, the findings contrast the assumptions of the stewardship theory of corporate governance.[750]

Another reason is that if power is concentrated in the hands of one person, he or she may disregard the interests of outside shareholders, thus weakening their protection against mismanagement. As a result, there is a growing belief that the chairman should be independent and separate from the CEO.[751] The separation between the roles of the chairman and the CEO has become a necessity for a company's success and growth. Other advantages include preventing the control of management over the board, increasing the company's efficiency and protecting shareholders' rights. This reflects the assumptions of the agency theory, which suggest that, owing to the conflict of interest between agents and principals, management control over the board can be minimised through the presence of independent directors, which in turn reduces the agency problem.[752]

In fact, calls to separate the duties of the chairman and the CEO has been received by international bodies and national laws, since they are seen as essential ingredients for sound corporate governance practice. For instance, the Organisation for Economic Cooperation and Development (OECD) Principles of Corporate Governance (2004) provided that 'separation of the two posts may be regarded as good practice, as it can help to achieve an appropriate

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[746] V. Blackburn, 'The effectiveness of corporate control in the U.S, Corporate Governance: An International Review', vol 2, no 4, pp 196-202.
[747] A. Berle and G. Means, *the Modern Corporation and Private Property* (Macmillian, New York, US, 1932).
[748] B. Mashayekhi and M. Bazaz, 'Corporate governance and firm performance in Iran', Journal of Financial Economics, vol 27, no 2, pp 595-612.
[749] Agency theory discussed in Chapter 2.3.1
[750] According to the Stewardship theory, CEO duality is the appropriate mechanism to run a corporation since managers are trustworthy.
[751] V. Blackburn, 'The effectiveness of corporate control in the U.S, Corporate Governance: An International Review', vol 2, no 4, pp 196-202.
[752] L. Bebchuk and M. Weisbach, 'The State of Corporate Governance Research' (2010) The Review of Financial Studies, vol 23, no 3, pp 939-961.

balance of power, increase accountability and improve the board's capacity for decision-making, independent of management'.[753]

In the same context, the UK Combined Code (2006) also advocated the importance of the separation of the role of the chairman and the CEO as it stated that:

> A chief executive should not go on to be chairman of the same company. If exceptionally a board decides that a chief executive should become chairman, the board should consult major shareholders in advance and should set out its reason to shareholders at the time of the appointment and in the next annual report.[754]

As a result, the UK Corporate Governance Code of 2012 has endorsed this orientation by asserting that the responsibilities of the person who is running the board (chairman) and the one running the enterprises' business (CEO) should be separated. The decision-making should not be subjected to one individual without unfettered powers.[755] Despite the large encouragement for the idea of a split between the roles of chairman and the chief executive officer, nonetheless, this notion is still a subject of controversy across many studies.[756] In the US for example, the executives strongly endorse the notion of duplication of functions between the chairman and the CEO. However, Bagley and Koppes suggested that placing the two roles in the hands of a single individual is often seen as a vote of trust by the board and a reward for an excellent service.[757] This latter view is affirmed in the Business Roundtable Report, which stated that[758] 'most members of The Business Roundtable believe their corporations are generally well served by a structure in which the CEO also serves as chairman of the board'.

One famous case study that illustrates the above controversy between the separation of duties of the chairman and the CEO is seen in the case of U.K. big firm, Marks and Spencer where the roles of the chairman and the CEO have been combined. For example, Sir Stuart Rose, the then CEO of the company, was on 10 March 2008 handed the job of the chairman, which

[753]OECD Principles of Corporate Governance of 2004, p 63.
[754]UK Combined Code 2006, para A.2.2.
[755]Sec (a) UK Corporate Governance Code 2012.
[756]Lipton, M. and Lorsch, J., 'A Modest Proposal for Improved Corporate Governance' (1992) The Business Lawyer, vol 48, pp 59-76.
[757]ibid.
[758]G. F. Maassen, *An International Comparison of Corporate Governance Models* (Spencer Stuart, Third Edition, 2002) 106.

contravenes the principle A.2 of the UK Corporate Governance Code.[759] There was an outcry from the shareholders who argued that his appointment contravened the provisions of the Code. Importantly, this appointment coincided with the profits warning, which saw the company's shares plummet by 30% plus.[760] Although the company maintained the role would be split again following Sir Stuart's retirement in 2011. A resolution was tabled at the 2009 AGM, which saw 38% of voting shareholders calling for an early appointment of an independent chairman. Sadly, 62% backed the board which saw Sir Stuart retaining his dual position as the chairman and the CEO. Despite this controversy, a new CEO was appointed in early 2010 and the roles were once again separated.[761] However, the new study on the Development of Corporate Governance and Stewardship in the UK showed that only ten firms in the FTSE 360 had combined between the function of chairman and CEO during 2014.[762]

5.2.2.2 The Board Duties

The UK legal system relies mainly on a common law model in interpreting the duties of a director as it believes that the director should act as a fiduciary.[763] The fiduciary duty is defined as 'a duty to act for someone else's benefit, while subordinating one's personal interests to that of the other person'.[764]

In fact, it is a relationship of trust which places a duty on company directors to act within the best interests of the company and to meet the highest standards of good faith and honesty when doing so.[765] The faith and trust are key elements that should define the personality of board members as well as their decisions. In the UK, the management of shareholders' interests has emerged from the theory of Adam Smith 1776. As a result, the UK model has applied the philosophy of defining the directors' duties to prevent agency conflict of interests. The principle of good faith requires a director to manage the company's affairs with honesty and to be held responsible for achieving the company's objectives equitably.

The negative implications arising from the agency theory problem have forced the UK's legislator to change the approach of fiduciary duty and replace it with the introduction of

[759]UK Corporate Governance Code "The role of the board, chairman and non-executive directors". It is available at: http://www.out-law.com/page-8215.
[760]"List of Public Companies Worldwide, Letter – Businessweek – Businessweek". Investing.businessweek.com. (accessed10 March 2014).
[761]Business Today, *Irish Times* (9 July 2008) 9.
[762]Developments in Corporate Governance and Stewardship 2014, p 12.
[763]W. R. Hinnant, 'Fiduciaries duties of directors: How far do they Go?' (1988) Wake Forest Law Review, vol 23.
[764]Black's Law Dictionary 625 (6th ed. 1990).
[765]Overview of Key Directors' Duties for UK companies. Available at: http://www.gannons.co.uk/services/corporate/company-law/directors/overview-of-key-directors-duties-for-uk-companies/.

statutory duties of the board of directors.[766] Importantly, unless the director can demonstrate that he/she has acted under due diligence, then he/she should be subjected to appropriate sanctions and penalties if they fail to implement their statutory duties and engage in any act that will damage the interests of the company, or that of its shareholders. The UK Corporate Governance Code asserted that the main principle that defines the role of the board is that each corporation must be run by an effective board, which should be responsible for the long-term success and growth of the corporation.[767] Specifically, the UK Company Act of 2006 stipulated that directors of the company must exercise reasonable care, skill and diligence. A director should possess general knowledge, experience and skills required of a person performing vital functions associated with the interests of the company.[768] Moreover, to support the stability of the securities market and the protection of shareholders' interests, the UK Company Act 2006[769] has set out seven duties of directors as follows:

1) Acting within powers granted by the company's constitution[770]
2) Reinforcing the success of the firm and achieving all its objectives[771]
3) Exercising their powers independently[772]
4) Exercising appropriate care, skill and diligence to fulfil the company's interests[773]
5) Avoiding conflicts of interest[774]
6) Not to accept benefits or interests from third parties[775]
7) Notifying about any proposed or arrangement transaction.[776]

In fact, the concept of trust is highly emphasized in the UK's legal system, since it provides that 'directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable discharge of their duties as directors properly.[777]

Furthermore, the concept of duty of loyalty simply means that the decision of the company's directors should be made in such a way that it promotes the interests of the corporation rather

[766]Institute of Directors, *The duties, responsibilities and liabilities of directors* (London, U.K, 2010) 3.
[767]Sec (a-1) U.K Corporate Governance Code 2012.
[768]Sec 174 (1&2) UK Companies Act 2006.
[769]Part 10, Chapter (2) UK Company Act 2006.
[770]ibid, para 171.
[771]ibid, para 172.
[772]ibid, para 173.
[773]ibid, para 174.
[774]ibid, para 175.
[775]ibid, para 176.
[776]ibid, para 177.
[777]J. Davies, *A guide to directors' responsibilities under the Companies Act 2006* (Certified Accountants Educational Trust, 2007) 37.

than their own interests. The board of directors should act or deal fairly in their service to the company even if they have a conflict of interests with the corporation.[778] The term *duty of loyalty* means that the board of directors should prevent a potential conflict of interests and insider trading within the company.[779] The best way of ensuring that duty of loyalty is carried out efficiently is for the directors of the company to avoid entering into any transaction that may likely create a conflict of interests.[780] In other words, they should not enter into any form of dealings or transactions that satisfy their own, selfish interest, although they are allowed to conduct transactions or deals that satisfy their interests, as long as such deals or transactions are not connected with the interest of the company. As a result of this conflict of interest, the self-dealing transactions must be approved by non-interested directors.[781]

In the UK, the basic rule regarding conflict of interests between directors and the company has been applied many times over the years, particularly in those cases involving directors who benefitted from their company's opportunities. For example, in the case of *Aberdeen Railway Co v Blaikie Bros of 1854,* the court ruled that it is not permissible for anyone to enter into any transaction that promotes self-interest and damage the interest of those whom he is obliged to protect.[782] Similarly, in the case of *Bray v. Ford of 1896,* the court affirmed the principle that discouraged the conflict of interests of the corporation by saying:

> It is an inflexible rule of a court of equity that a person in a fiduciary position … is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict.[783]

Section 175 of the UK Company Act of 2006 has also strongly endorsed the concept of avoiding a conflict of interests within the company.[784] This Act requires a company's directors to exercise a duty of loyalty in all situations and circumstances. In accordance with the Act, the company's directors must try to avoid any situation (including direct or indirect

[778]M. A. Eisenberg, 'The Divergence of Standard of Conduct and Standards of Review in Corporate Law' (1994) Fordham Law Review, vol 62, pp 437-450.
[779]N. Beveridge, 'The Corporate Directors' Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transition (1991) DePaul Law Review, vol 41, p 688.
[780]B. S. Black, *The Principal Fiduciary Duties of Boards of Directors", Presentation at Third Asian Roundtable on Corporate Governance Singapore* (Stanford Law School, 2001) 2-12.
[781]M. A. Eisenberg, 'The Divergence of Standard of Conduct and Standards of Review in Corporate Law' (1994) Fordham Law Review, vol 62, p 452.
[782]*Aberdeen Railway Co v. Blaikie Bros* (1854) 1 Macq, 461.
[783]*Bray v. Ford* (1896) AC, 44.
[784]Chapter 2 (175) UK Company Act 2006.

interest) that conflict, or may conflict with the interests of the corporation.[785] In addition to that, Section 175 affirmed that a director must not only avoid situations where there is clearly a conflict with the company but also avoid those that 'possibly may conflict' with the duty of loyalty to the company.[786] As a result, the director is not only obliged to consider whether his insider interests conflict with those of the company but to also make sure that his outsider interests are not in conflict with the company either.[787]

Nonetheless, it is important to note that a self-dealing transaction has never been outlawed under the UK law. The verdict issued in the case of *Aberdeen Railway v. Blaikie of 1854* has never been more than a default rule. Thus, directors' transactions can be accepted whether through charter provision or via approval and attestation of stakeholders.[788] As a general rule, the self-dealing transaction does not necessarily cause damage to the corporation and it is not prohibited unless it is unfair. As a result, shareholders are the only ones who decide whether to challenge a self-interested transaction.[789] More importantly, the UK Company Act of 2006 has asserted that the duty to avoid conflicts of interests is not a breach if the situation does not give the impression that there is a conflict of interest or if the matter has been approved by the directors.[790]

The third substantial duty of the company's directors is the duty of disclosure. This crucial duty is required for publicly listed corporations in the long-term, particularly in common law countries. The importance of duty of disclosure has been aptly emphasized in the work of *Berle and Means* who saw it as a legal tool of addressing the problem of managerial opportunism via self-interested transactions. Indeed, the duty of disclosure plays a fundamental role in protecting minority shareholders' rights. Therefore, it has been argued that without adequate disclosure, the shareholders will not vote sufficiently and their rights may not be protected adequately. Another justification is that full disclosure of conflict of interest transactions before shareholders will permit shareholders to sue directors who violate the duty of loyalty. Also, sufficient disclosure will contribute largely to limiting the conflict

[785]ibid.
[786]ibid.
[787]ibid.
[788]L. Enriques, 'The Law on Company Directors' Self-Dealing: A Comparative Analysis' (2009) International and Comparative Corporate Law Journal, Kluwer Law International, vol 2, no 3, p 8.
[789]K. B. Davis Jr, 'Judicial Review of Fiduciary Decisionmaking – Some Theoretical Perspectives' (1985) North-western University Law Review, vol 80, 1 p 50; H. G. Henn and J. R. Alexander, *Laws of Corporations* (3rd edn, 1983) 1035–1044.
[790]Chapter 2 (175-4) UK Company Act 2006.

of interest emanating from transactions. In reality, there have been certain justifications for requiring the duty of disclosure per se, which are that:

1) It contributes to the effectiveness and development of securities markets[791]
2) It assists to increase the integrity of the company's management considerably[792]
3) It provides shareholders with the useful information they need and it enables them to challenge unfair transactions.[793]

Under the UK legal system, a company's directors must disclose, in the annual report, the transactions entered into by the corporation or its subsidiaries and it should also include any material interest, whether direct or indirect.[794] The disclosure should also refer the nature of self-dealing to other directors of the board.[795] In accordance with Section 237(4) of the UK Company Act 1985, if disclosure is not included in the annual report, 'the auditors shall include in their report, so far as they are reasonably able to do so, a statement giving the required particulars'.[796] Importantly, the UK is different from the rest of the world when it comes to punishing directors who violate the disclosure provision. For instance, the board director, who fails to disclose to the board their interest in a transaction, is punished with a fine, even if the transaction is authorized or ratified at any time, as long as it is unfair to the corporation.[797] Nonetheless, some scholars have raised concern regarding the effectiveness of this penalty and argued that if the penalty would actually serve as a deterrent for future violations 'the possibility of having to pay a fine is an inadequate preventative particularly as it is unlikely that [the director] will be prosecuted'.[798]

5.2.3 Shareholders' Protection Mechanisms

5.2.3.1 Cumulative Voting

The election of board members through cumulative voting is a mechanism that allows minority-shareholders to gain representation on board of directors, because "straight voting" would have made that impossible. Hailed by many as a strong tool for investor's protection,

[791]J. C. Coffee Jr, 'Market Failure and the Economic Case for a Mandatory Disclosure System' (1984) Virginia Law Review, vol 70, p 717.
[792]L. Loss and J. Seligman, 'Securities Regulation' (1989) The Business Lawyer, vol 46, no 4, pp 657–658.
[793]P. G. Mahoney, 'Mandatory Disclosure as a Solution to Agency Problems' (1995) University of Chicago Law Review, vol 62, no 3, pp 1047-1095.
[794]Sec 232, Schedule 6, paras 15–28 UK Company Act 1985; Sec 177(1) UK Company Act 2009.
[795]ibid sec 177(1).
[796]G. Laurence, *Gower's principles of modern company law* (Stevens & Maxwell, 1992) 520 in L. Enriques (2009) p 309.
[797]Sec 317 UK Company Act 1985; The Law Commission and the Scottish Law Commission, Company Directors: *Regulating Conflicts of Interests and Formulating a Statement of Duties* (Consultation Paper No. 153, 1998) 89. Available at: http://www.gtnet.gov.uk/lawcomm.
[798]L.Enriques, 'The Law on Company Directors' Self-Dealing: A Comparative Analysis' (2009) International and Comparative Corporate Law Journal, Kluwer Law International, vol 2, no 3, p 309.

cumulative voting was introduced in the United States during the late nineteenth century as a result of political reforms. Although popular at the beginning of the twentieth century, the application of the system in corporations has steadily declined since 1950s.[799] Cumulative voting allocates one vote for each share of stocks held multiplied by the number of directors to be elected. A shareholder may cumulate his votes and cast all of them in favour of a single candidate, or split them among any combination of candidates. By making it possible to use their cumulated votes to elect at least one board member, cumulative voting is typically seen as a mechanism through which minority shareholders use to secure board representation.

According to the US Securities Exchange Commission:

> Cumulative voting is a type of voting process that helps strengthen the ability of minority shareholders to elect a director. This method allows shareholders to cast all of their votes for a single nominee for the board of directors when the company has multiple openings on its board. In contrast, in "regular" or "statutory" voting, shareholders may not give more than one vote per share to any single nominee.[800]

To further understand cumulative voting, the following example explains the process as follows: if shareholder (A) owns 90 shares while shareholder (B) owns 40 shares in an election for three directors, then shareholder (A) will have 270 votes (90x3) and shareholder (B) will be have 120 votes (40x3). Shareholder (A) wishes to elect A, B and C as directors, whereas shareholder (B) wishes to elect X, Y and Z as directors. Ordinarily, shareholder (A) would be able to elect his nominees A, B and C and no nominee voted for by shareholder (B) would be into board. However, by using the cumulative voting procedure, the above situation would be different. It will distribute shareholder (A) votes equally for A, B and C with each director receiving 90 votes. On the other hand, shareholder (B) will get 120 votes and he will have right to cast all of his shares to one of the directors either X, Y or Z. Therefore, at least one nominee will be elected to the board on behalf of shareholder (B).[801]

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[799]G. Maassen and R. Dragneva, *Cumulative Voting and the Protection of Minority Shareholders in the CIS: Legal Reform and Voluntary Harmonization* (Law in Eastern Europe, no 57, 2007) pp 85-103.
[800]U.S. Securities Exchange Commission (SEC) Definition. It id available at: http://www.sec.gov; Chapter (1-216) of Delaware General Corporation Law.
[801]L. Nilubol, *Legal Framework for Promoting Minority Shareholders' Protection in Thailand* (School of Law, University of Melbourne, Australia, 2012) p 135.

It should be noted that as at 1993, cumulative voting is not broadly prevalent across the world. For instance, it is adopted in certain US States, particularly in California where it is mandatory, but it is optional and rarely used in companies in Japan, and yet unknown in Central and Eastern European countries.[802] Several arguments have been put for and against the use of cumulative voting. Proponents of cumulative voting see it as a fair procedure. They argued that it is only when a shareholder has a substantial interest in the company that he or she will be able to elect a director. Therefore, it is only equitable that stockholders with a large stake in the company have the opportunity to gain representation on the principal governing body, the board of directors and proportion to their holdings.[803] Indeed, without representation on the board, minority shareholders may not be able to get an adequate voice on policy affecting the company. This view is consistent with research findings by Zhao and Brehm, which suggest that cumulative voting is an efficient approach to ease the tension between the board of directors and minority shareholders and can help reduce investors monitoring costs on a corporation.[804] Minority representation on the board can be helpful in protecting or advancing the interests of minority shareholders.[805]

Despite these advantages, critiques, however, argued that cumulative voting may create directors who are partisans to a particular interest group. As a result, the role of a partisan on the board of directors may be inherently inconsistent with the proper function of a director, which is to represent all interest groups in the corporation.[806] A good director should not be captured by any special interest group.[807] There is also issue with regards to confidentiality of information about the company. A director who is not trustworthy may leak such information to harm the company. Other disadvantages include: disharmony could harm the energy of management; and shareholders with narrow, selfish interests could abuse cumulative voting.[808]

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[802]C.W. Gray and R.J. Hanson, *Corporate governance in Central and Eastern Europe: Lessons from advanced market economies. Policy Research Department* (The World Bank, 1993).
[803]C.M. Williams, 'Cumulative voting' (May/June 1955) Harvard Business Review, vol 33, no 3, pp 108-114.
[804]A. Zhao and A.Brehm., 'Cumulative voting and the tension between board and minority shareholders' (2009) Managerial Finance, vol 37 no 5, pp 465-473.
[805]ibid.
[806]C.M. Williams, 'Cumulative voting' (1955 May/June) Harvard Business Review, vol 33, no 3, pp 108-114.
[807]A. Zhao and A. Brehm, 'Cumulative voting and the tension between board and minority shareholders' (2009) Managerial Finance, vol 37 no 5, pp 465-473.
[808]ibid.

In the UK, cumulative voting process is rarely in existence. Firms may adopt it but rarely do so.[809] Legal device that dilute the appointment powers of majority shareholders to benefit minority shareholders are rare compared to devices that enhance the power of minority shareholders. The dilution device that is mostly used is 'vote capping' or imposing restrictions on the control rights of majority shareholders whilst inflating the voting power of minority shareholders. In the UK, the charter provision allows publicly traded corporations to opt into voting caps. However, voting caps are rarely used today in the UK; instead it has been eliminated by listing rules and government cultures. Different classes of shares are permitted in the UK to carry any combination of cash flows and voting rights and UK institutional investors have discouraged the use of dual class shares.[810]

5.2.3.2 Derivative Action Lawsuits

Facilitating the process of litigation before shareholders to file legal action against violators of securities law is an essential requirement for enforcing good corporate governance and ensuring the stability of securities markets.[811] As a result, when shareholders' rights are violated due to mismanagement or misconduct of the executives, they can seek redress by bringing derivative action against the offenders usually a director or corporate officer. Derivative lawsuit means that shareholders can bring legal action against company management and directors on behalf of all aggrieved shareholders, but in the name of and for the benefit of the firm.[812]

The derivative shareholders lawsuit was established to protect the interests of all the shareholders within the company. In many cases, directors breach their commitments concerning protection of shareholders' interests by wasting the resources and capital of the company, cover-up their misdeeds or by awarding failed contracts or projects.[813] Consequently, these dangerous deeds may cause serious damages to the shareholders' interests, thus the derivative action mechanism aims to give aggrieved shareholders the legal right to bring derivative suit against their company itself. Derivative suit is one of the best means of settling conflicts between shareholders and company management. It should be

[809]L. Enriques, H. Hansmann, and R. Kraakman, in R. Kraakman et al. "The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies. The Anatomy of Corporate Law: A Comparative and Functional Perspective", 2009, pp 89-113
[810]J. Franks, C. Mayer, and S. Rossi, Spending Less Time with the Family: The Decline of Family Ownership in the United Kingdom, in R. K. Morck, "A History of Corporate Governance Around the World, 2005, p 581
[811]R. La Porta et al., "What Works in Securities Laws", Journal of Finance, vol. 61, no, 1, 2006, pp 27.
[812]Sec (260-a-b) UK Company Act 2006.
[813]S. Aronson et al. "Shareholder Derivative Action: from Cradle to Grave", O'Melveny & Myers, LLP, Los Angeles, California, 2009, pp 1-3.

noted that this kind of lawsuits has been termed "derivative" to describe the corporate right enjoyed by the shareholders to express their grievances.[814] Specifically, previous research emphasized the importance of derivative action in the following statement:

> The purpose of derivative action is to place in the hands of the individual shareholder a means to protect the interest of the corporation from the misfeasance and malfeasance of faithless directors and managers.[815]

In the U.K, it has been argued that the derivative lawsuit is one of the significant ways to reinforce the position of shareholders, especially minority shareholders in the company. As a chief principle in the common law countries, judicial interference is considered an essential element in the UK's approach to corporate governance.[816] There are restrictions in the application of derivative shareholders suit as can be seen in the famous case of *Foss v Harbottle*.[817] According to this rule, individuals' shareholders were not authorized to bring a legal action on behalf of the company against directors who breached their duties.[818]

The applicable rule in the U.K states that minority shareholders were not capable of filing a legal action against the offending directors unless their claim was ratified by a majority of shareholders at the general meeting.[819] Thus, the derivative suit by minority shareholders will not take place if the majority shareholders at the general meeting decided not to sue the offending directors. In fact, the main reason for not empowering minority shareholders to file suit against directors was based on the ruling in *Foss v Harbottle (1843)*case, which provides that individual shareholders have no cause of action in law for any wrongs done to the corporate and that if an action is to be brought in respect of such losses, it must be brought either by the corporate itself (through management) or by way of a derivative action.[820] However, the general rule was criticized as being complex and vague.[821] As a result, the former position of minority shareholders under the U.K statute has entirely changed with the enactment of the new procedure in Part (11) of the U.K Company Act 2006. The Law

[814]W. Freeman, "The Securities Class-and-Derivative Litigation Two-Step", Abtl Report, North California, vol. 13, no, 2, 2004, pp 2.
[815]S. Aronson et al., Shareholder Derivative Actions: From Cradle to Grave", O'Melveny & Myers, LLP, Los Angeles, California, 2009, pp 1-49.
[816]J. Lee, "Shareholders' Derivative Claims under the Companies Act 2006: Market Mechanism or Asymmetric Paternalism?" International Company and Commercial Law Review, vol. 18, 2007, pp 378.
[817]D. Drake et al., "Minority Shareholders: Law, Practice and Procedure", Oxford University Press, 2011, pp 32-35.
[818]Ibid. No.30.
[819]J. Birds et al., "Boyle & Birds' Company Law", Jordans, 2007, p 674.
[820]S. Watkins, "The Common Law Derivative Action: An Outmoded Relic", Cambrian Law Review, vol. 30, 1999, pp 40.
[821]ibid.

Commission, which submitted the proposal for the new rule of derivative actions, commented on this new procedure by saying:

> In an age of increasing globalization of investment and growing international interest in corporate governance, greater transparency in the requirements for a derivative action is in our view highly desirable.[822]

In the final report referred to as *"Shareholders Remedies No, 246 in 1997",* the Law Commission made fundamental suggestions for the adjustment of the law regarding the derivative action. This Commission advised that the old derivative suit should be replaced by:

> a new derivative procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue an action.[823]

According to the Company Act of 2006, the derivative action can be brought if the cause of action was arising from a proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company.[824] In addition, the claim can be brought before the court whether the cause of action was against a director or against another person.[825]

The process of the application of this new principle requires that plaintiffs who wish to file legal action against directors have to seek first the approval of the court to continue the suit as a derivative action.[826] However, there are certain circumstances in which the court might refuse the continuation of the claim, that is, 'where the actual breach of duty has been authorised or ratified by the company, or where the proposed breach of duty has been ratified by it (Companies Act 2006, sections 263 (2) (b) and (c) and 268 (1) (b) and (c) (applicable to Scotland)'.[827] In addition, the decision of the court to refuse the claim is also applicable where a person acting in accordance with his duty to encourage the interests of the corporation would not seek to continue it.[828] In fact, the court has to be satisfied of the latter state, and does not show bound by the views of the shareholder who initiates measures.[829] If these requirements are met, the court would then take further considerations into account

[822]Law Commission Report, (1997), "Shareholders Remedies", No, 246, Para, 6.9.
[823]ibid No. 35, Para 6.15.
[824]Sec (260-3), of the UK Company Act of 2006.
[825]Ibid
[826]Sec (262-2) of the UK Company Act of 2006.
[827]F. Wooldridge and L. Davies, 'Derivative claims under UK company law and some related provisions of German law' (Summer 2012) Amicus Curiae, no 90, p 6.
[828]Sec (263-3-2-a) and (268-1-a) of the UK Company Act of 2006.
[829]F. Wooldridge and L. Davies, 'Derivative claims under UK company law and some related provisions of German law' (Summer 2012) Amicus Curiae, no 90, p 6.

before deciding whether to authorize the derivative action to continue.[830] The importance that a person acting in accordance with section 172 (duty to promote success of the company) would attach to continuing the action must also be considered by the court including whether the shareholder seeking to continue the action is acting in good faith. The issue of shareholder acting in good faith is not new as earlier jurisprudence on derivative actions has usually not allowed such an action to continue where there is proof that the claim was brought for a hidden reason.[831] Also, the court has earlier failed to authorize an action where there is satisfactory remedy such as placing the company in liquidation.[832] For instance, the presence of an alternative reform under section 994 of the Companies Act 2006 was a significant element in the court's decision to refuse permission to continue a derivative action in the case of Franbar Holdings v Patel[833] and this has been mentioned in a set of following decisions including the view of Lord Glennie in the petition of A M Wishart[834] given in the Outer House of the Scottish Court of Session, as well as in certain English cases. Other considerations that the court has to take into account involve:

1) Whether the act or omission which forms the break of duty could be or in the circumstances would be likely to be ratified by the company;[835]
2) Whether the violation of duty is possible to be attested by the firm, and not merely whether it is ratifiable;[836]
3) Whether the attestation has hindered a complainant from bringing a claim on behalf of the firm;[837]
4) Whether the company has decided not to pursue the claim through the medium of a board resolution or a resolution of the shareholders;[838]
5) Whether the act or omission in respect of which the claim is filed gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company.[839]

[830]Sec (263-3) UK Company Act 2006.
[831]Barrett v Duckett [1995] 1 BCLC 243 and Portfolios of Distinction v Laird [2004] 2 BCLC 741.
[832]F. Wooldridge and L. Davies, 'Derivative claims under UK company law and some related provisions of German law' (Summer 2012) Amicus Curiae, no 90, p 6.
[833]Franbar Holdings v Patel (2009) 1 BCLC I.
[834]A M Wishart [2009] CSOH 20.
[835]Sec (263-3-d) UK Company Act 2006.
[836]F. Wooldridge and L. Davies, 'Derivative claims under UK company law and some related provisions of German law' (Summer 2012) Amicus Curiae, no 90, p 7.
[837]ibid.
[838]Sec (236-3-e) UK Company Act 2006.
[839]Ibid Sec (236-3-f).

Furthermore, there are situations whereby special types of derivative actions may apply. For instance, when those who are empowered to initiate litigation on behalf of the company fear that a derivative claim may be brought against it, they may endeavour to prevent this by initiating a claim on behalf of the company which they have no intention of seriously pursuing. In such situation, sections 262 (2) of the Companies Act 2006, allows a shareholder in the company to apply to the court for permission to continue the proceedings as a derivative claim. This is done when the following factors are present:[840]

(a) The manner in which the company commenced or continued the proceedings amounts to an abuse of the process of the court;
(b) The company has failed to prosecute the claim diligently;
(c) It is appropriate for the member to continue the claim as a derivative claim.

When an application is made to continue an initial derivative claim[841] and the court is persuaded that the application and evidence filed by the applicant in support of it does not disclose a prima facie case for giving permission or leave, the court is then required by section 262 (3) to dismiss the application and make any consequential order it thinks appropriate. Sections 264 and 269 of the Companies Act 2006 provide for a shareholder to apply to take over an existing derivative claim. These provisions are intended 'to prevent directors from frustrating litigation by inducing a sympathetic shareholder to commence a derivative claim, which he will not pursue effectively'.[842]

Despite the fact that the court no longer follows the provisions of the rule in *Foss v Harbottle* in reaching its decision, however, it is interesting to note that some provisions of this rule still applies if it is in the interests of the company.[843] The rationale behind the introduction of statutory derivative action is that it would help to turn things around and perhaps give shareholders a fair chance of bringing the culprits to book. However, concerns have been raised as to whether these reforms would lead to a dramatic increase in the incidence of shareholder litigation[844] For instance, following the introduction of the statutory derivative

[840]Sec (262-2-a-b-c) UK Company Act 2006.
[841]ibid Sec (261-2).
[842]F. Wooldridge and L. Davies, 'Derivative claims under UK company law and some related provisions of German law' (Summer 2012) Amicus Curiae, no 90, p 8.
[843]P.L. Davies and S. Worthington, "Gower and Davies: Principles of Modern Company Law", 8th ed, Sweet and Maxwell, 2008, pp 615, cited in F. Wooldridge and L. Davies, "Derivative claims under UK company law and some related provisions of German law", Amicus Curiae, Issue 90, 2012, p 2.
[844]Lord Eldon stated, in a case that pre-dated Foss v Harbottle, that: [t]his Court is not to be required on every Occasion to take the Management of every Playhouse and Brewhouse in the Kingdom": *Carlen v Drury* (1812) 1 Ves & Bea 154 at 157; 35 ER 61 at 62.

action in the Company Act, only 16 cases has sought for authorization,[845] thus representing an average of 3.2 cases per annum.[846]

In addition to the right of minority shareholders to bring a derivative suit against the defaulting directors, the U.K Company Act of 2006 has given the minority shareholders further statutory protection against the abuse of majority shareholders. This action is known as *"Unfair Prejudice"*. As a result, a minority shareholder has the right to apply to the court by petition on the basis that the corporation's affairs are being or have been conducted in a way which is unfairly prejudicial to the interests of its shareholders generally or some of them (including at least the applicant himself), or that any actual or proposed act or omission of the corporation would be so prejudicial to the applicant.[847] This has been beneficial to the shareholders on occasions when it has been established that the directors have breached their duties to the company. Critiques have argued, however, that the action is being brought by the shareholder to benefit himself of herself, and not the company (as with a derivative action).[848]

There are certain conditions that have to be met before an individual can bring an action based on unfair prejudice. First, an action can be brought by a shareholder of the company one complains against[849], or a number of members as long as they do not together hold a majority of votes.[850] However, if they did hold a majority of votes, then they would be able to control the company and should not be relying on court to sort out their problems. Second, an action may be brought by shareholder nominees, those "transmitted" shares by operation of law (s.994 (2)), those transferred shares without yet having been registered as members and the Secretary of State (s.995). Third, shareholders may assert perform was unfairly prejudicial even if it was before they joined the corporation[851] and they can bring a legal action against a violator who has already sold their shares.[852] Nonetheless, when a

[845]J. Armour, "Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment," April 2008, and accessible at : http://ssrn.com/abstract=1133542.
[846]A.R. Keay, 'The Public Enforcement of Directors' Duties (January 16, 2013). It is available at SSRN: http://ssrn.com/abstract=2201598 or http://dx.doi.org/10.2139/ssrn.2201598 .
[847]Sec (994-1-a-b) UK Company Act 2006.
[848]A.R. Keay, 'The Public Enforcement of Directors' Duties (January 16, 2013). It is available at SSRN: http://ssrn.com/abstract=2201598 or http://dx.doi.org/10.2139/ssrn.2201598.
[849]Sec (112) UK Company Act 2006.
[850]Re Legal Costs Negotiators Ltd [1999] 2 BCLC 171.
[851]Lloyd v. Casey [2002] 1 BCLC 454.
[852]Re A Company [1986] 1 WLR 281, 284, per Hoffmann J.

shareholder has already sold his personal shares and is no longer a member of the company, no claim may be brought.[853]

In the UK, the unfair prejudice has generated an enormous body of cases. The examples of the unfair prejudice litigation under the UK Company Act 2006 are diverse, but the most significant of them can be seen in cases of infringement of shareholders convention or articles of association, failure to provide accurate accounting information, breach of quasi-partnership principles, management misbehaviours, breach of fiduciary duty, the appointment of incompetent member of a controlling family to take charge of the company despite opposition from the minority shareholders or breach of an equitable agreement or understanding.[854] In terms of breaches of directors' fiduciary duties, the case of O'Donnell v Shanahan[855] provides a good example. During the ruling, the trial judge observes (at para. [212]):

> Whilst the authorities make clear that, if a breach of the no conflict rule (and also the no-profit rule) is made out, it does not matter if the company (or trust or partnership) could not of itself have proceeded with the transaction, it does appear to me permissible to take into account when determining the scope of the directors' duties and in deciding whether 'there is a real sensible possibility of conflict' the inherent likelihood in fact of the company extending its existing scope of business into areas of business which might give rise to a conflict.[856]

If the minority shareholders petition is convincing, the court has broad powers to compensate the damages incurred by the minority shareholders as a result of the unfair prejudice. The court can exercise any of the following actions:[857]

1) *Regulating the company's affairs and its behaviours in the future;*
2) *Requiring the company to do or refrain from doing any act;*
3) *Approving for filing civil proceedings on behalf of the company;*

[853]Re A Company [1986] 1 WLR 281.
[854]J. Sykes, "Minority shareholders and their rights", Charles Russell, 2009, pp.1-3. Also, see the IoD Directors' Advisory Service, "Protection for Minority Shareholders", Institute of Directors, 2014, pp 1-3.
[855]O'Donnell v Shanahan [2008] EWHC 1973 (Ch).
[856]Corporate Law and Governance (August 2008) UK: England and Wales: unfair prejudice and directors' fiduciary duties. It is available at: http://corporatelawandgovernance.blogspot.co.uk/2008/08/uk-england-and-wales-unfair-prejudice.html.
[857]Sec (996-1-2) UK Company Act 2006.

4) *Authorizing for buying the shares of any shareholder by other shareholders or by the company itself;*

5) *Requiring the company not to do any amendments in its articles without the approval of the court.*

In this regard, it should be noted that the U.K Company Act of 2006 also give individual shareholders the right to bring legal action against the company or majority shareholders, and this legal action can only be filed to the court when the shareholder is dissatisfied with the new amendment to the Articles of Association or Memorandum or when there is harmful transactions that may lead to variation of class rights.[858] Furthermore, minority shareholders can require the court to wind up the company on the on the ground of *"Just and Equitable"* in the situation of insolvency of the company.[859] However, in some instances the shareholders may experience difficulties in seeking to establish the existence of equitable considerations affecting the manner in which legal rights are exercised. For instance, in the case of McKillen v Misland (Cyprus) Investments Ltd & Ors[860], a shareholder's petition for unfair prejudice, under section 994 of the Companies Act 2006, was unsuccessful and other claims were also dismissed.

In terms of awarding remedies, section 996 of the Companies Act gives the court the powers to award remedies based on the following:[861]

1- If the court is satisfied that a petition under this Part is well founded, it may make such order as it thinks fit for giving relief in respect of the matters complained of.[862]
2- Without prejudice to the generality of subsection (1), the court's order may:[863] (a) Regulate the conduct of the company's affairs in the future; (b) Require the company:

(i) to refrain from doing or continuing an act complained of, or

(ii) to do an act that the petitioner has complained it has omitted to do;

(c) Authorise civil proceedings to be brought in the name and on behalf of the company by such person or persons and on such terms as the court may direct;

(d) Require the company not to make any, or any specified, alterations in its articles without the leave of the court;

[858]A.R. Keay, 'The Public Enforcement of Directors' Duties (January 16, 2013). Available at SSRN: http://ssrn.com/abstract=2201598 or http://dx.doi.org/10.2139/ssrn.2201598 .
[859]Sec (122-1-g) UK Insolvency Act 1986.
[860]McKillen v Misland (Cyprus) Investments Ltd & Ors [2012] EWHC 2343 (Ch)
[861]Sec (996) UK Company Act 2006.
[862]ibid Sec (996-1).
[863]ibid Sec (996-2-a-b-c-e).

(e) Provide for the purchase of the shares of any members of the company by other members or by the company itself and, in the case of a purchase by the company itself, the reduction of the company's capital accordingly.

The current section has discussed the derivative action and unfair prejudice in the UK. In terms of Saudi Arabia, the derivative action lawsuit is recognised under the Saudi Company Law of 1965. Both articles 77 and 78 are relevant at this point. For instance, Article 77 of the Saudi Company Law (SCL) states that:

> '1) The Company may institute an action against (its) directors for wrongful acts that prejudice to the body of shareholders, 2) The resolution to institute this action shall be made by regular general meeting, which shall appoint a person (or persons) to pursue the case on behalf of the company'.[864]

Similarly, Articles 78 of the SCL states that:

> 'every stockholder shall have the right to file a liability claim against the members of the board of directors on behalf of the company if the wrongful act committed by them is of a nature to cause him personal prejudice. However, the stockholder may file such claim only if the company's right to file such claim is still valid and after notifying the company of his intention to do so. If a stockholder files such claim, he shall be adjudged compensation only to the extent of the prejudice caused to him'.[865]

Despite the above provisions, the SCL is not explicit about what the procedure is if the general meeting (GM) fails to issue a decision to sue the wrongdoers or whether the shareholders have the right to bring a derivative action on behalf of the company or not. As a result, it is unclear whether minority shareholders have the power to commence any action on behalf of the company. According to Al-Ibrahim, there are no liability claims that have been brought by minority shareholders under the name of company; instead they can request the Ministry of Commerce and Industry (MOCI) to launch an investigation on the affairs of the company.[866] A closer examination of Article 78 indicates that certain conditions have to be met before the minority shareholders are able to exercise their right to file a suit against the board of directors:

[864]Art (77) of Saudi CL of 1965.
[865]ibid Art (78).
[866]Mansour S. T. Al Anazi, 'Minority shareholders: improving their protection to attract foreign Investment in the Kingdom of Saudi Arabia', LLM. 2008. P 49.

1. The shareholder is entitled to raise his claim if the directors caused harm to his personal interests.
2. The shareholder cannot initiate the lawsuit unless the company has the right to litigation.
3. The shareholder must inform the company of its intention to raise the lawsuit.

Further discussion on this topic of litigation under the Saudi legal system would be provided in section 5.3.7 of this thesis.

5.2.4 The Role of Shareholders' Institutions

The significant growth in institutional shareholders in UK corporations has broad implications for corporate governance. Since the early 1960s, ownership of the UK equity market has become steadily institutionalised and been dominated largely by occupational pension funds and insurance companies.[867] This significant trend has seen individual share ownership plummet from over 50% of the market to fewer than 20%, suggesting that institutions have acquired a large share of the UK capital market.[868] Specifically, this shift in equity ownership is characterized by a rapid expansion of foreign ownership interests in UK-listed companies, to the extent that overseas investors today, own a considerably greater proportion of UK equities than domestic investors.[869] Indeed, institutional shareholders are seen as guardians of public investment as well as a means of dealing with corporate governance related issues. Their main aim is to diversify risks and gain steady returns.[870] In fact, 'institutional saving offers some risk pooling as individual investment is collectively invested with that of others under the direction of specialist managers'.[871] The importance of their role in emphasized by the International Corporate Governance Network (ICGN), which states that:

> Millions of households worldwide depend on growth in long-term value of investments made by institutional shareholders, be it for the saving schemes, life insurance, retirement provisions or otherwise. As trustees of these

[867]M.T. Moore, 'United Kingdom: The scope and dynamics of corporate governance regulation', in A.M. Fleckner and K.J. Hopt (Eds.) *Comparative Corporate Governance: A Functional and International Analysis* (Cambridge: Cambridge University Press, 2013) 913-956.
[868]A. Zhao and A. Brehm, 'Cumulative voting and the tension between board and minority shareholders' (2009) Managerial Finance, vol 37 no 5, pp 465-473.
[869]M.T. Moore, 'United Kingdom: The scope and dynamics of corporate governance regulation', in A.M. Fleckner and K.J. Hopt (Eds.) *Comparative Corporate Governance: a Functional and International Analysis* (Cambridge: Cambridge University Press, 2013) 913-956.
[870]A. Zhao and A. Brehm, 'Cumulative voting and the tension between board and minority shareholders' (2009) Managerial Finance, vol 37 no 5, pp 465-473.
[871]Institutional Investment in the United Kingdom: A Review (Myners Report, 2001), Global Governance Codes & Regulation. Available at: https://www.governance.co.uk/resources/itemlist/category/63-global-governance-codes-and-best-practice.p.27.

> investments, which may include shares in listed companies, institutional shareholders have a general responsibility to use best efforts to preserve and increase this value. Improving the corporate governance of companies is increasingly understood as an important means of enhancing the long-term value of equity investments. As a result, many institutional shareholders, along with the ICGN itself, have taken steps to outline best practices for the governance of such companies. However, institutional shareholders as a class have an equal responsibility to address their own role as fiduciaries and owners of equity on behalf of savers.[872]

In the UK, the strength of institutional investment cannot be underestimated. According to the 2001 Myners Report on institutional investment in the UK,

> The strong presence of large and sophisticated institutions has been one of the factors ensuring that UK capital markets are among the deepest and most liquid in the world, enabling firms to raise capital efficiently through share and debt offerings. Secondly, millions of savers and pension scheme members have benefited from UK institutions' willingness to make substantial equity investments over the past thirty years. Between 1963 and 1998, pension funds achieved average annual returns of 12.1 per cent compared with inflation of 7.2 per cent over the same period.[873]

Institutional shareholders in the UK are seen as important corporate governance mechanisms to improve managerial accountability. Indeed, given that minority shareholders have less power over top managers and executives due to 'free rider' problems, it is expected that UK corporate share ownership (institutional investment) will mitigate such problems when they work collectively and show active involvement in the company's affairs.[874] However, institutional shareholders (such as pension funds) have been driven mainly by short-term strategies.[875] According to Hutton, the consequence of tax arrangements has been a flood of institutional savings, acute demands for dividends and a foreshortening of the investment

[872]ICGN Statement on Institutional Shareholders Responsibilities, International Corporate Governance Network (2003).
[873]Institutional Investment in the United Kingdom: A Review (Myners Report, 2001), Global Governance Codes & Regulation. Available at https://www.governance.co.uk/resources/itemlist/category/63-global-governance-codes-and-best-practice, p. 28
[874]H. Short and K. Keasey, 'Institutional Shareholders and Corporate Governance', in K. Keasey, S. Thompson and M. Wright, (eds., John Wiley & Sons Ltd, West Sussex, 2005) 71-80.
[875]W. Hutton, *The State We're In. Vintage* (London, 1996) pp 305-306.

time horizons.[876] For instance, pension fund investments are free of capital gains tax, contributions to pensions are made out of pre-tax income and life insurance has in the past benefited from tax privileges.[877]

In keeping with the UK Company Law provision and regulation (the FSA), institutional investors owe a duty of care to individuals who invest in retail funds. The 2001 Review Committee by Paul Myners recommends that the UK should adopt an ERISA-style approach to formalizing shareholders' responsibilities. Following this recommendation, the Financial Reporting Council (FRC) published the UK stewardship code setting out good practice guidelines for institutional investors when engaging with the UK listed companies, in which they invest. The stewardship code covers the responsibilities of institutional investors and was published in 2009 by the Institutional Shareholders' Committee (ISC). There are currently four prominent groups in the UK, which constitute the Institutional Shareholders' Committee (ISC). These include: the Association of British Insurers (ABI), the Association of Investment Trust Companies (AITC), the National Association of Pension Funds (NAPF) and the Investment Management Association (IMA).[878] The ISC outlines seven principles, which require institutional investors to:

1. Publicly disclose their policy on how they will discharge their stewardship responsibilities
2. Have a robust policy on managing conflicts of interests in relation to stewardship (and this policy should be publicly disclosed)
3. Monitor their investee companies
4. Establish clear guidelines on when and how they will escalate their activities, as a method of enhancing and protecting shareholder value
5. Be willing to act collectively with other investors, where appropriate
6. Have a clear policy on voting and a disclosure of voting activity
7. Report periodically on the stewardship and voting and activities.[879]

[876]ibid.
[877]Institutional Investment in the United Kingdom: A Review (Myners Report, 2001), Global Governance Codes & Regulation. Available at: https://www.governance.co.uk/resources/itemlist/category/63-global-governance-codes-and-best-practice.
[878]ICGN Statement on Institutional Shareholders Responsibilities, International Corporate Governance Network (2003).
[879]New UK Stewardship Code for Institutional Investors, (2010). Available at: http://www.freshfields.com/uploadedFiles/SiteWide/Knowledge/New%20UK%20Stewardship%20Code%20for%20institutional%20investors.pdf.

In 2003, the UK Combined Code on Corporate Governance urged shareholders to follow the ISC principles. As a result, they made the following recommendations:

1. Institutional shareholders should enter into a dialogue with the companies based on a mutual understanding of objectives;
2. When evaluating companies governance arrangements, particularly those relating to board structure and composition, institutional shareholders should give due weight to all relevant factors drawn to their attention;
3. Institutional shareholders have a responsibility to make considered use of their votes.[880]

To ensure compliance with the ISC principles, the UK National Association of Pension Funds conducted a survey in 2004 of its members. The results showed that 97% of its members were fully aware of the ISC principles, with 60% incorporating these principles in their investment manager's contract. The survey also revealed that less than 80% of pension funds had corporate governance policies in place. The number of pension funds, which received regular reports from managers on voting and their engagement with companies, was 88%.[881]

Despite the benefits associated with institutional investment in the UK, especially their willingness to intervene in companies' affairs and hold management to account, they face many obstacles. One main problem is known as 'the motivation factor', which Proctor and Miles have described as follows:

> There is a disincentive for single institutional shareholders to expend time, effort and resources correcting what they perceive as bad management if other fellow institutional shareholders do not also support this action. Institutional shareholders have different priorities and agendas at any one time. It may be difficult to pool resources to tackle together what to some institutional shareholders may not be a problem at all.[882]

[880]Institute of Chartered Accountants in England and Wales, *Shareholders responsibilities and the investing public: Exercising ownership rights through engagement* (2006).
[881]*Pension Funds: Engagement with Companies* (Research Report No. 2, National Association of Pension Funds, 2004).
[882]G. Proctor and L. Miles, *Corporate governance* (Cavendish, London, 2002) 45.

However, compared to their peers in other countries such as the US, the UK, institutional shareholders' contributions to the improvement of corporate governance practice in listed companies have received some encomium. Importantly, they are seen to be very effective when it comes to monitoring the executives and involving themselves in company affairs for social and regulatory reasons.[883] Furthermore, their engagement with the companies has been characterised as positive, they work behind closed doors rather than going public and their actions are characterised by gentle persuasion rather than being dictated under public scrutiny.[884]

5.2.5 The Principle of Comply or Explain

In principle, the principle of comply or explain has been used widely as an international benchmark for good corporate governance practice. This approach means that listed corporations must declare to their shareholders how they have applied corporate governance rules or why they have not applied corporate governance rules and they have to explain the reasons, in case they have not done so already.[885] In fact, the principle of comply or explain helps shareholders and foreign investors to make their investment decisions wisely. It also assists them to decide which company they wish to invest in. It is important to note that over the last two decades, several countries have developed corporate governance codes.[886] Specifically, as previous research has shown, there are cultural, regional and organisational differences in terms of how far the codes are implemented and complied with.[887]

For instance, in some countries, including the UK[888] and Saudi Arabia (to be described later), compliance with the CGCs is voluntary 'comply or explain', whereas in a few countries such as the US, compliance is mandatory ('comply or else').[889] Over the years, research has been conducted to measure the level of compliance among firms in different countries. In the UK, Pass found that 35% of UK firms complied fully with the 2003 UK Combined Code of Corporate Governance.[890] The study also found that 45% made efforts to comply or gave an

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[883]B. Black and J. Coffee, 'Hail Britannia?: Institutional Investor Behaviour under Limited Regulation' (1994) Michigan Law Review 92, pp 2078-2080.
[884]M. Georgen and L. Renneboog, 'Prediction of Control Concentration in German and UK Initial Offerings', in J. McCahery, P. Moerland, T. Raaijmakers and L. Renneboog (Eds.) *Corporate Governance Regimes: Convergence and Diversity* (Oxford University Press, New York, 2002) 252-277.
[885]A. Sridhar et al., *Corporate Governance in the UK: is the Comply-or-Explain Approach Working?* (Corporate Governance at LSE Discussion Paper Series. No 001, 2005) 1-13.
[886]ECGI (2013). European Corporate Governance Institute. Available at: http://www.ecgi.org/, accessed on 21 May 2010.
[887] L. Bebchuk and M. Weisbach, 'The State of Corporate Governance Research' (2010) The Review of Financial Studies, vol 23, no 3, pp 939-961.
[888]Cadbury Committee, Report of the Committee on the Financial Aspects of Corporate Governance: the Code of Best Practice (Gee Professional Publishing, London, UK, 1992).
[889]Sarbanes-Oxley, Sarbanes-Oxley Act, Washington DC, United States (2002).
[890]C. Pass, 'The Revised Combined Code and Corporate Governance An Empirical Survey of 50 large UK Companies' (2006) Managerial Law, vol 48, no 5, pp 467-478.

acceptable explanation for non-compliance. In a recent study of 130 UK listed non-financial firms, Hussainey and Al-Najir found a high level of compliance with the Corporate Governance Quotient (CGQ) index among the firms. The findings suggest that there is high level of compliance among UK firms with the UK Combined Code, which has positive implications for voluntary disclosure and governance practices.[891] Results from other countries, particularly Turkey, revealed a weak level of compliance with corporate governance codes.[892] Specifically, the authors highlighted the reasons for poor compliance to include weak supervision and enforcement by the regulatory authorities.[893]

The flexibility of the principle of comply or explain means that corporate governance codes will create a kind of competitive situation among corporations and thus will put corporations under pressure to improve their standards more quickly. Previous studies show that this rule is considered more effectively for companies than the strict codes which corporations must comply with promptly.[894] The advantage of comply or explain is that this approach is a complementary rule. It does not displace or replace the basic laws or codes. However, the aim of this principle is to ensure that corporations maintain higher and more typical standards that will make them more transparent and protect the long-term interests of their shareholders or stakeholders. This principle has become the trademark of corporate governance in many countries and has been broadly admired and imitated globally.

In Saudi Arabia, some studies have investigated the level of compliance with the Saudi Corporate Governance Code (SCGC).[895] Results from these studies suggest that there is relative improvement in the level of compliance with the code, following the corporate governance reforms. In terms of voluntary disclosure, Alaseed found a 30% level of compliance with voluntary disclosure.[896] Other studies have also looked at the extent to which information about good corporate governance is reported on the firms' websites. Specifically, Hussainey and Al-Nodel found variations between sectors in terms of the level of online reporting of corporate governance. Among the sectors studied, banks were found to

[891]K. Hussainey and B. Al-Najjar, 'Understanding the Determinants of Risk Metrics/ISS Ratings of the Quality of UK Companies' Corporate Governance Practice'(2012) Canadian Journal of Administrative Sciences, vol 29, no 4, pp 366-377.
[892]M. Ararat and M. Ugur, 'Corporate Governance in Turkey: An Overview and Some Policy Recommendations' (2003) Corporate Governance: An International Review, vol 3, no 1, pp 58-75.
[893]ibid.
[894]Padraig Cronin and Frances Murphy, Slaughter and May, *Corporate Governance for Main Market and AIM Companies* (White Page Ltd, 2012) 8.
[895]K. Alsaeed, K, 'The Association between Firm–Specific Characteristics and Disclosure: The Case of Saudi Arabia' (2006) Managerial Auditing Journal, vol 21, no 5, pp 476-496; E. Al-Moataz and F. Lakhal, *Corporate Governance Disclosure and Corporate Governance Mechanisms: the Case e of Saudi Listed Companies* (Conference Paper, Saudi Accounting Association, Riyadh, Saudi Arabia, 2012); Y. Al-Janadi et al., 'Corporate Governance Mechanisms and Voluntary Disclosure in Saudi Arabia' (2013) Research Journal of Finance and Accounting, vol 4, no 4, pp 25-35.
[896]K. Alsaeed, K, 'The Association between Firm–Specific Characteristics and Disclosure: The Case of Saudi Arabia' (2006) Managerial Auditing Journal, vol 21, no 5, pp 476-496.

provide the highest level of disclosure regarding their corporate governance practices.[897] In fact, results from these studies suggest that Saudi listed firms have demonstrated some level of compliance with the SCGC, although the level of compliance may not reflect good corporate governance practices among all listed corporations.

The UK's corporate governance principles are based on reinforcing the principle of comply or explain among listed companies. It is considered a notable landmark in the UK market, and thus all corporations should comply with this rule and ensure that this principle remains an active alternative to a rule-based system. Accordingly, all listed corporations must show in their annual report their ability or inability to comply with corporate governance standards, or inability to comply with, and explain to the shareholders the major reasons that hindered the application of corporate governance effectively.[898] Importantly, a good disclosure system assists minority shareholders to access reliable information in sufficient detail and appraise the performance of management and the board of directors.[899] Therefore, it can be said that without credible transparency and disclosure, shareholders will not be able to exercise their rights efficiently.[900]According to the Winter Report, 'disclosure can be a powerful regulatory tool; it creates an incentive to comply with best practice and allows members and third parties to take necessary actions. Disclosure requirements can be more efficient, more flexible and easier to enforce'.

In the international context, the OECD Principles of Corporate Governance assert that a corporate governance system should ensure that timely and accurate financial information is made on all material matters concerning the company.[901] Given the importance of disclosure requirements in the stability of a financial system in any state, the UK regulator has given this subject great attention so that corporate governance disclosure requirements are reflected in their capital market regulations (the Financial Conduct Authority (FCA), Disclosure and Transparency Rules (DTR), the FSA Listing Rules, the UK Corporate Governance Code and the Financial Services and Markets Act 2000).[902] For instance, the FCA is responsible for

[897]K. Hussainey and A. Al-Nodel, 'Corporate Governance Online Reporting by Saudi Listed Companies' (2008) Corporate Governance in Less Developed and Emerging Economies, vol 8, pp 39-64
[898]Association of the British Insurers, *Comply or Explain: Investor Expectations and Current Practices* (2012) 6-16.
[899]G.K. Meek et al., 'Factors influencing voluntary annual report disclosures by U.S., U.K. and Continental Europe multinational corporations' (1995) Journal of International Business Studies, vol 26, no 3, pp 555-572.
[900]F. Kahn, 'Transparency and Accountability: Rethinking Corporate Fiduciary Law's Relevance to Corporate Disclosure' (2000) Georgia Law Review, vol 34, pp 512.
[901]OECD Principles of Corporate Governance of 2004, Principle No (v).
[902]Schedule (B) UK CGC 2012.

reviewing and approving prospectuses and declarations, identifying eligibility for listing, maintaining the official list and monitoring the UK stock exchange and market abuse.[903]

In addition, the FCA also monitors the compliance of issuers and major shareholders via periodic disclosures required under disclosure and transparency and listing rules.[904] Sections 84 and 87 of the FSMA contain the main provisions related to prospectus requirements. These provisions state that issuers must obtain an approval from the FCA before offering prospectuses to the public. Disclosure and transparency rules regulate all disclosure requirements, including those that must be incorporated in the prospectus.

According to the prospectus rules, the prospectus must include the following information: issuer information; managers', suppliers' and advisers' information; financial information; investment information; policy and strategy information; hazard factors; institutional structure and management information.[905] The UK Prospectus Rules were implemented in 2005 and the FSA's Disclosure and Transparency Rules (DTR) were issued in February 2010. In fact, the UK disclosure system is characterized by great recognition of the rule of *reasonable investor,* which helps the stock market to act efficiently and fairly and to serve as a point of reference to guide investment decisions. To reinforce the disclosure requirements, the UK FSMA stipulated that quarterly and annual financial reports must be submitted to the FCA. It is important to note that Article 12 of the Saudi Listing Rules contains similar conditions specified in the UK Prospectus Rules. For example, the Prospectus Rules in Saudi Arabia must contain all information which enable an investor to make an assessment of the activities, assets and liabilities, financial position, management and prospects of the issuer, its profits and losses and must also include information in relation to the obligations, rights, powers and privileges attached to the relevant securities.[906]

According to the new developments in UK corporate governance, it is important that companies that do not follow the rule of "Comply or Explain", should provid their shareholders with explaination so that thay can evalute whether they are satisfied with the governance arrangements that the corpoarion has put in place.[907] Importantly, the 2014 edition of the Code involves a set of characteristics of what the FRC considers to be

[903]The U.K Financial Conduct Authority An overview of 2013, p 7.
[904]ibid.
[905]FCA Disclosure and Transparency Rules. It is available at: http://fshandbook.info/FS/html/FCA/DTR.
[906]Art (12-a) Saudi Listing Rules 2004.
[907]Financial Reporting Council of 2013 on Corporate Governance, p 15.

significant explanations, to grant a standard for corporations when providing explanations and shareholders when evaluting them.[908] These include: 'that the explanation should set out the background, provide a clear rationale for the action it is taking, and describe any mitigating actions taken; and that where movement away from a particular provision is intended to be limited in time, the explanation should indicate when the company expects to conform to the provision'.[909] By implication, a company may choose not to comply with a specific provision; nonetheless, it needs to provide a reasonable explanation in its corporate governance report.[910]

5.3 The Saudi Arabian Experience

5.3.1 Introduction

The internal mechanisms of corporate governance: equities ownership structure and key players, the board of directors, transparency and disclosure requirements and the basic rights of minority shareholders in Saudi Arabia, are provided in the sections below. As previously mentioned in Chapter 1, one of the main rationales for comparative study between UK law and Saudi law is that if the research intends to explain Saudi law to English speakers, so much would be lost in translation and many concepts that English speakers would take for granted would not be translatable from the Arabic language to the English language. Thus, to avoid the risk of mistranslation and misunderstanding, the sections above have provided an overview and analysis of corporate governance mechanisms, including capital market laws and regulations under the UK legal system. This approach is necessary so that it will provide a solid basis for a comparative understanding of laws and certain technical terms that are common to both jurisdictions. Specifically, one of the reasons for choosing a comparative law method[911] is to find out if there is a possibility of transplanting some of the UK best practices of corporate governance to improve the situation in Saudi Arabia. Therefore, by analysing the internal mechanisms of Saudi corporate governance, a comparison has been made between the UK and Saudi Arabian corporate governance mechanisms. This has implications for transplantation of some UK practices to Saudi Arabia.

[908]Developments in Corporate Governance and Stewardship, 2014, p 12.
[909]Developments in Corporate Governance. The impact and implementation of the UK Corporate Governance and Stewardship Codes. The Financial Reporting Council Limited, 2013, p.15. Also see Developments in Corporate Governance and Stewardship, 2014, p 12.
[910]Corporate governance Developments in the UK, 2012, p 5.
[911]Chapter 1.7 on research methodology.

5.3.2 Ownership Structure

In Saudi Arabia, the Corporate Governance Regulations (CGRs) have partially been influenced by the US Law principles, particularly in terms of the formation and duties of the board of directors, the rights of shareholders and transparency proceedings. Nonetheless, the German model of corporate governance is strongly present in the Saudi legal system. The proof of this orientation is that the CGRs have adopted a wider view as a method of interpreting the concept of corporate governance.[912] Specifically, German and Saudi corporate governance systems are built on the stakeholders' theory. As a result, the corporation ownership in the Saudi securities market is characterised by concentrated ownership.[913] In fact, the dominance of ownership concentration in the Saudi market is attributed to many factors, with political and legal factors as the dominant ones. Saudi Arabia is characterized by absolute monarchy and the nature of the political system has a large impact on the life of its trade and economy.[914]

The Saudi legal system is also considerably influenced by the civil law model, in particular the French legal system. Since the outset, most Saudi laws have been influenced by the principles of the civil law model, more than the common law model, particularly in relation to commercial and administrative laws.[915] In Saudi Arabia, banks still play a vital role in the Saudi securities market. They work as stockbrokers and prefer to deal with large investors instead of smaller ones.[916] It is important to note that Saudi banks contributed to the crisis that hit the Saudi securities market at the end of 2006, which led to huge losses (such as investment portfolios) by the shareholders, particularly the minority shareholders.

Unlike the UK securities market, the Saudi market works under the control and dominance of two types of investors, namely family-owned corporations and government-owned corporations. Family ownership has been defined in the literature as:

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[912]Art (1) Saudi CGR.
[913] For more insight, see Chapter 1.4.1 of the present thesis.
[914]P. Gourevitch and J. Shinn, 'Political Power and Corporate Control: the New Global Politics of Corporate Governance' (Princeton University Press, Princeton, 2007) pp 80-81, in F. Almajid, *A Conceptual Framework of Reforming the Corporate Governance of Saudi Publicly Held Companies: Comparative and Analytical Study from a Legal Perspective* (School of Law, University of Manchester, 2008) 208.
[915] M. Hanson, 'The Influence of French Law on the Legal Development of Saudi Arabia' (1987) Arab Law Quarterly, vol 2, pp 283-291.
[916]A. Awwad, *Legal Regulation of the Saudi Stock Market: Evaluation and Prospect for Reforms* (University of Warwick, 2000) 200, in supra 30. (F. Almajid, 2008).

> Those controlled by a family having at least one of the following characteristics: three or more family members involved in the business; or two or more generations of the family having control in the business; or the current owning family intends to pass on ownership to its future generations.[917]

Other scholars have also offered their definition as: 'a family enterprise is a proprietorship, partnership, corporation or any form of business association where the voting control is in the hands of a given family'.[918]

In Saudi Arabia, as in other civil law countries, the majority shareholders, who own a greater number of equities, usually exercise their power and influence upon the company's management and its board of directors. This situation often weakens the rights of minority shareholders, especially their right of involvement in the company's decisions-making and the election of the board of directors. Previous research has shown that concentrated ownership structure empowers the controlling shareholders to expropriate minority shareholders' rights.[919] In fact, concentrated ownership and control in the hands of single families in Saudi Arabia has resulted, in many cases, in the failure of some family corporations. A recent example is the Saudi Arabian construction company Mohammed Al-Mojil Groups (MMG), which was hit by heavy losses and accumulated debts amounting to $107 million in November 2012. Importantly, the collapse of the Al-Mojil Group was attributed to the mismanagement and misuse of power by the board of directors.[920] Some Saudi scholars commented that the failure of MMG suggests that most family-owned businesses that have recently moved to a joint-stock company in the Saudi securities market do not exercise a positive role, either to the Saudi economy in general or to the Saudi community in particular.[921]

La Porta et al have earlier stated that wealthy families in the insider system (civil law model) usually desire to hold fundamental shareholdings in their corporations, even if these

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[917] D. Kenyon-Rouvinez, and J.L. Ward (Eds.) *Family business key issues* (New York: Palgrave MacMillan, 2005) 1-16.
[918]F. Neubauer and A.G. Lank, *The Family Business: Its Governance for Sustainability* (Hampshire: MacMillian Press LTD, 1998).
[919]R. La Porta et al., 'Investor protection and corporate Governance' (2000) Journal of Financial Economic*s*, vol 58, pp 3-27.
[920]The Saudi Arabian Construction Company Mohammed Al-Mojil Group is participated in building part of Aramco's Wasit gas program, as well as the Aramco-Sinopec refinery in Yanbu, among others. Also, this family company has branch in the United Arab Emirates. MMG has been put up 30% of its shares for the public offering and gained the approval of the Saudi Capital Market Authority (CMA) on 03/05/2008 but it also has been hinged its traded shares by the decision of the Saudi Capital Authority on 22/07/2012 because its financial troubled and faltering projects revenues. This information has taken from some local Saudi newspapers, such as aleqtisadiah newspaper, issued on 01/10/2012, by no, 6930.
[921]This information has taken form the Journalistic investigation made by the Saudi newspaper (*aleqtisadiah*) on 01/10/2012 with some Saudi legal scholars.

companies are registered in the securities market.[922] Subsequently, evidence shows that some of the Saudi family listed corporations transferred to joint-stock companies so as to enhance and build up their wealth, at the expense of the minority shareholders. They also added that the transfer of the Saudi family enterprises to joint-stock companies is just an illusion and deceptive strategy, as evident in the cases of the Al-Mojil Group and the Bisha Agricultural Development Company.[923]

The power of the Saudi wealthy families in Saudi Arabia is reflected through their presence in all sectors of the economy, in particular agriculture, finance, banks, cement, petrochemicals, energy and transportation. In reality, there are multiple examples that indicate the dominance of Saudi, rich families on most of the listed corporations. For instance, Kingdom Holding is owned by one owner with only 5% of its equities available for trading.[924] Another example is the Al-Rajhi family, which owns more than 20% of equities in at least three listed companies.[925] The Al-Zamil family owns more than 10% of stocks in 4 public firms.[926] In addition, Al-Abdullatif, Al-Drees, Al-Othaim, Al-Babtain, Al-Hokair and others among the companies listed on the Saudi securities market, are still mostly owned by a single family and afford its name. The ownership of shares in these companies exceeds almost 40% of total shareholdings.[927] Furthermore, in the Saudi securities market, there are more than 22 corporations in which 20% of their total shares are still owned by a single family or by majority shareholders.[928]

The above statistics show that a concentration of ownership in the hands of wealthy families is high in the Saudi securities market, which also empowers these families to boost both their wealth and their control in the company's decision-making. In addition, the highly-concentrated ownership enables the Saudi founders or families to interfere in the decision-making of the company's board and to exercise their power to select the board members. The

[922]R. La Porta et al., 'Investor protection and corporate Governance', (2000) Journal of Financial Economic*s*, vol 58, pp 3-27.
[923]Bisha Agricultural Development Company has been suspended from trading since 2007. The realized losses amounted to 3.7 million riyals by the end of 2011, increasing about 95% percent compared with the losses recorded during 2010, which amounting to about 1.9 million riyals.
[924]The owner of the Kingdom Holding is prince Alwaleed Bin Talal Al-Saud, who is one of a famous global businessman.
[925]Al Rajhi family members own a large number of shares in Yanbu Cement Company. Therefore, they own about 29.10% of the shares. For more insight see Tadawul website.
[926]The proportion of shares that are owned by Al-Zamil family, 1- Al-Zamil Industrial Investment company "owns 19.9% of shares", 2- Sipchem company "10.20 % of the shares", 3- Chemanol company "11.20% of the shares" and in Sahara company they own "7% of the shares". This information is existed at Tadawul website.
[927]For more information see Saudi Tadawul. Available at: http://www.tadawul.com.sa.
[928]ibid.

literature shows that 1/3 of Saudi listed corporations have at least two directors from the same family and 20% per cent of the board members also belong to the same family.[929]

It should be noted that the government-owned corporations represent a crucial element in ownership structure in the Saudi securities market. The Saudi government owns extensive equities in most corporations listed in the securities market. Through its large investment funds, the Saudi government plays a substantial influence on the ownership of shares and it owns approximately 44% of equities traded in the Saudi securities market.[930] The influence of the Saudi government on the securities market is visible in that most chairmen and CEOs of government-listed corporations are appointed based on the decisions of the government. Also, the election and dismissal of board members are only subjected to the government.[931] According to Al-Moataz and Hussainey, State ownership in those emerging countries where there is high-concentrated ownership has a significant impact on influencing corporate governance disclosure.[932] Importantly, with such large State ownership, agency problems might likely manifest.[933] Besides, Konijn et al have earlier argued that State or government ownership often results in government intervention in the running of corporations, which has a negative impact on corporate governance practices.[934] For instance, the State influence or power can reflect in the appointment of the CEO and board directors, who may lack the requisite skills and experience.[935] Therefore, the effective application of corporate governance in the Saudi stock market requires a free market that will mitigate the government ownership in the Saudi stock market because, as previously mentioned in Chapter 1 of this thesis, one of the problems that affects the exercise of minority shareholders' rights is a high concentration of ownership in the hands of the government and rich families.

The Saudi government invests in the securities market through spreading its investments amongst three large national funds managed by its agencies, namely the General Organisation for Social Insurance (GOSI), the Public Investment Fund (PIF) and the Public Pension Fund (PPF). Official statistics showed that altogether these investment funds hold about £8.8

[929]G. James, 'Learning from Family Failures' (2010) MEED: Commercial Banking, vol 54, 25, pp 34-37.
[930]Tadawul, 'Statistical Report – First Nine Months 2008', in *Saudi Stock Exchange* (Riyadh, 2008) 25.
[931]F. Almajid, *A Conceptual Framework of Reforming the Corporate Governance of Saudi Publicly Held Companies: Comparative and Analytical Study from a Legal Perspective* (School of Law, University of Manchester, 2008) 213.
[932]E. Al-Moataz and K. Hussainey, 'Determinants of Corporate Governance Disclosure in Saudi Arabia' (2012) Journal of Economics and Management, King Abdulaziz University.
[933]L. Eng and Y. Mak, 'Corporate Governance and Voluntary Disclosure' (2003) Journal of Accounting and Public Policy, vol 22, no 4, pp 325-345.
[934]S. Konijn et al., 'Blockholder Dispersion and Firm Value' (2011) Journal of Corporate Finance, vol 17, no 5, pp 1330-1339.
[935]M. Cornett et al., 'The Impact of State Ownership on Performance Differences in Privately-Owned Versus State-Owned Banks: An International Comparison' (2010) Journal of Financial Intermediation, vol 19, no 1, pp 74-94.

billion shares with a market capitalisation of 584.7 billion riyals, which is equivalent to $155.92 billion.[936]

5.3.3 Board of Directors

As with the Anglo-Saxon model (the UK as an example), the composition of the board within the Saudi listed corporations is characterized by a single-tier. It is right to say that the major objective of the Saudi listed corporations is to increase profits for its founders and shareholders.[937] In fact, the idea about concentration of ownership and control in the hands of owners and controlling shareholders still dominates the Saudi regulator mentality and its desires. Consequently, electing members of the board by controlling shareholders is still a common practice in the Saudi securities market.[938] The Company Law stated that each company must be managed by a board of directors and it must not have less than three members.[939] The CL gives the company's bylaw to specify the size of the board.[940] Indeed, board size plays a role in effective corporate governance[941], especially in relation to protection of minority shareholders' rights. For instance, previous research has shown that the effectiveness of cumulative voting as a mechanism that allows minority shareholders to elect their representative onto the board, will depend on the board size, that is, the number of members being elected and the number of voting shares that the minority holds.[942] Furthermore, previous research also suggests that the effect of board size can be traced to three main sources: (a) increased communication and coordination problems, (b) the board's decreased ability to control management, and (c) the cost of poor decision-making spread among a larger group of firms.[943]

The CL requires a director who wants to nominate himself to the board to own a number of shares to the value of at least 10,000 SR.[944] In reality, most of these provisions have been reinforced by applying the new securities regulations under the Saudi Corporate Governance Regulations (CGRs) of 2006, which state that the Articles of association should determine the number of board members, provided that the board size is not less than three and not

[936]This information took from a Journalist Report issued by alriyadh newspaper entitled: Insurance, Pension and Public Investments Funds reveal their Ownership of Shares in Joint Stock Companies in the Greater Disclosure Process in Saudi Securities Market. For further details see that at: http://www.alriyadh.com/330988.
[937]M. H. Al-Jeber, 'The Saudi Commercial Law', King Fahad National Library, *Riyadh* (1996) 235 [Arabic Edition].
[938]ibid.
[939]Art (66) Saudi CL.
[940]ibid.
[941]M. Santiago and C. J. Brown, 'An empirical analysis of Latin American board of directors and minority shareholders' rights' (2009) FORUM Empresarial, vol 14, no 2, pp 1-18
[942]International Finance Corporation, *Korporativno upravljanje Priručnik za firme u Bosni i Hercegovini*, IFC Sarajevo, Sarajevo (2009).
[943]T. Eisenberg et al., 'Large board size and decreasing firm value in small firms' (1998) Journal of Financial Economics, vol 48, no 1, pp 35-54.
[944]ibid no 68.

exceeding eleven members.[945] Importantly, the Saudi government and the Saudi wealthy families are basic shareholders in many listed corporations. Most of the Saudi listed corporate boards are dominated by members, who are selected by the State or rich families. The influence of the State and rich families is visibly present and prevalent in Saudi Arabia. Consequently, many chairmen of listed corporations are appointed by the decisions of the State or rich families, without following the legal procedures as set out in related legislations.

Evidence suggests that the number of the government's representatives accounts for about two out of six in boards of listed corporations. For instance, a high percentage of members of the boards of the State-controlled corporations in the Saudi securities market, such as SABIC, STC, the Alinma Bank, the Riyadh Bank, SAFCO, the Electricity Company, MAADEN Company, the Petro Rabigh Company and others, are selected by the Saudi government.[946] Similarly, the boards of most large Saudi family-owned corporations wield considerable influence on businesses or social relationships.[947]

Figure 2: Criteria for appointment in the boardroom[948]

Figure 3: Performance of board members[949]

[945]Art (12) Saudi CGRs.
[946]Tadawul website. Available at: http://www.tadawul.com.sa.
[947]W. Alajlan, *Corporate Governance in Saudi Arabia: the Roles and Responsibilities of the Board of Directors in the Banking Industry* (University of Nottingham, 2005) pp.363-366.
[948]*Saudi Riyadh* newspaper (2007). For more insight see K. I. Falgi, *Corporate Governance in Saudi Arabia: A stakeholder Perspective* (University of Dundee, U K, 2009).
[949]ibid.

It is important to note that the appointment of board members in Saudi Arabia is based on favouritism and nepotism. Likewise, the performance of the board of directors in some of the listed corporations is characterized by weakness. In fact, the presence and influence of wealthy families is not only experienced in their firms' boardrooms but also in other corporations, due to strong social ties. The recent empirical evidence shows that 'the power of selecting the boards' members in these (quoted) firms is almost entirely in the hands of a few large shareholders'.[950] The Council of Minister's Resolution (no.80, dated 1985) affirmed that it is unlawful for board members to sit as board members in more than three listed corporations. However, in many listed corporations, individuals still sit in more than three boards as members. Lately, the CGRs have allowed an individual to serve 'as a member of board of directors of more than five joint-stock companies at the same time'.[951] Indeed, this contravenes the provisions of the Council of Ministers Resolution. Hence, potential conflict between the decision of the Council of Ministers and the CGRs is inevitable.

5.3.3.1 Board Duties

The main role of the board is to direct the business or operations of the corporation collectively, in a manner that will ensure the success of the company, whilst also safeguarding the interests of its shareholders and/or stakeholders. The board of directors perform multiple roles inside the company, such as defining the corporate objectives, developing plans and strategies, monitoring the company's management and reviewing financial statements of the company that contribute to improving and consolidating on the company's performance. After the scandals that led to the collapse of the Enron Company, the WorldCom Company, the Parmalat enterprise and others, the board of directors have dominated the topic for debate on the reform of listed corporations over the world.[952] Given the different roots and approaches of the board of directors, the next section focuses on examining and analysing the duties of the board (duty of care and good faith, duty of loyalty, and duty of disclosure) under the Saudi legal system and then compares these duties with the UK experience.

[950]W. Alajlan, *Corporate Governance in Saudi Arabia: The Roles and Responsibilities of the Board of Directors in the Banking Industry* (University of Nottingham, 2005) 363-366.
[951]Art (12-h) Saudi CGRs.
[952]R.B. Adams et al., *the Role of Boards of Directors in Corporate Governance: A Conceptual Framework & Survey* (National Bureau of Economic Research, Massachusetts Avenue, Cambridge, 2008) 1-2.

5.3.3.1.1 Duty of Care and Good Faith

The duty of the board is to ensure harmony and consistency between the top company's management utilities and the shareholders' interests. The managers usually make the plans and decisions and the board duties are to ensure that these decisions are implemented in accordance with the shareholders' interests.[953] Similar to the UK system, the duty of care in listed corporations' boards is defined by Saudi law. The Corporate Governance Regulations (CGRs) of 2003 state that the board of directors must, in the conduct of their business, carry out their duties in a responsible manner, in good faith and with due diligence.[954] To protect the company's interests and its shareholders' rights, these regulations stipulate that the board of directors shall be given all the essential powers to manage the company. In fact, the ultimate responsibility for the company should situate on the board, even if it establishes committees or delegates some of its powers to a third party.[955]

Each member of the board of directors shall represent all shareholders and do their best, in the interests of the company and its shareholders, rather than the interests of the group that he represents or that he voted for, in favour of his appointment to the board of directors.[956] Furthermore, the powers of the executive management should be defined by the board of directors and the executive management should submit a periodic financial report to the board of directors.[957] The board of directors is responsible for ensuring that accurate information about the firm is available to all board members in general, and to the non-executive members in particular.[958]

It is important to note that the scope of the duty of care under the Saudi statutes is considerably restricted. Importantly, section one of the Saudi Company Law of 1965 identified the general provisions that relate to the board of directors' actions, obligations, appointments and their liability for damages sustained by the shareholders.[959] However, the Company Law of 1965 did not define the duties of the board of directors clearly as it is with the UK laws, which define their duties clearly, as seen above.

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[953]S. Lane et al., 'Guidelines for Family Business Boards of Directors' (2006) Family Business Review, vol 19, no 2, pp 147-167, in M.M. Angel and S. Kamil, *Corporate Governance in Family-Controlled Firms* (Master's Thesis in Business Administration, Jonkoping International Business School, 2008) 28.
[954]Art (11-c) Saudi CGRs.
[955]ibid 11-a.
[956]ibid 11-d.
[957]ibid 11-e.
[958]ibid 11-g
[959]Art (66&82) Saudi CL.

In accordance with the duties of the company's boards which appeared in the Saudi Corporate Governance Regulations (CGRs), it can be said that these regulations have some ambiguities and restraints that may impede the effectiveness of the board of directors to implement the duty of care efficiently. One of the major defects under these regulations is that the company's board decision, to carry out its duties in good faith and with due diligence, must be based on information provided to them from the executive management or from other sources.[960] In addition to this, the provisions of the duty of care have not been interpreted by the Saudi courts. No case related to the duties of the board of directors has been brought before the Saudi judicial authority.

For instance, the Saudi Arabian Construction Company Mohammed Al-Mojil Group, the Bisha Agricultural Company and other corporations were sued by the Saudi aggrieved shareholders. The plaintiffs alleged that the directors of those corporations were responsible for the damages inflicted on them and that they should bear such damages jointly. Nonetheless, their cases are still pending in the Saudi courts.

5.3.3.1.2 Duty of Loyalty

In Saudi Arabia, prior to 2003, the concept of the duty of loyalty was recognized by the Company Law of 1965, since the conflict of interests was regulated by certain clauses of the Company Law. As a general principle, the Law clearly prohibits company directors from competing with the company's businesses or engaging in any form of commercial activities run by the company,[961] unless they seek approval at the general meeting.[962] The director is also required to inform the company's board of any transaction or personal interest made on behalf of the corporation.[963]

It should be noted that the provisions for a conflict of interests, under the new Saudi securities market regulations, were taken from the Company Law provision of 1965 with no amendment. As a result, in accordance with the CGRs, the director shall notify the board of any personal interest he or she may have in the transactions or contracts made on behalf of the company. Such notifications should be recorded in the minutes of both the company's general meeting and the board meeting.[964] Furthermore, the Saudi listing rules have also

[960]Saudi CGRs 2006.
[961]Art (69&70) Saudi CL.
[962]ibid.
[963]ibid.
[964]Art (18-a) Saudi CGRs.

emphasized prevention of conflict of interests between the director and the company as they state: 'the directors of a company should exercise their powers and carry out their duties in such a way as to serve the interests of the company'.[965]

In reality, the concept of the duty of loyalty is much better developed in the Saudi securities regulations. An example of a legal case of conflict of interest can be seen in the famous case of the Saudi Chemical Company, in which the board members purchased 15% of the equities of one of the subsidiaries of the company, without informing it at the general meeting or announcing this transaction either on its website or on the stock exchange website. Consequently, the Board of the Capital Market Authority imposed a penalty fine of 50,000 SR, which is equivalent to $13,333, to the board chairman and each board member, for breaching Article 28 of the listing rules.[966]

Nevertheless, there are some criticisms associated with the enforcement of the duty of loyalty principle at the judicial level. This is because the sanctions imposed on violators are seen to be relatively weak and soft. A good example is the case of the Saudi chemical chairman and board members (the plaintiffs) who filed a lawsuit against the CMA's decision before the Appeal Committee for the Resolution of Securities Conflicts (ACRSC). The ACRSC withdrew the decision of the CMA to impose the above penalty (fine) on the above company's board members, despite the fact that their violation was clear.[967]

5.3.3.1.3 Duty of Disclosure

Specifically, the duty of disclosure under the Saudi securities regulations is similar to those provisions mentioned in the UK system. Perhaps the only difference might be that as a developed country, the UK has a strong legal and economic system that helps to establish good corporate governance practices. Therefore, the level of disclosure in such a country may likely be higher compared with the level of disclosure obtained in Saudi Arabia. Previous research has shown that the level of compliance with corporate governance standards is high in developed compared to developing countries and this is attributed to the strength of legal and economic systems.[968] In relation to duty of disclosure in Saudi Arabia, transactions

[965] Art (28) Saudi LRs.
[966] The Decision of the Board Capital Market Authority (BCMA) issued against the Saudi Chemical Company on 18 October 2009. For more insight see http://www.argaam.com/article/articledetail/127502/.
[967] This decision has announced on the website of the Saudi Stock Exchange (Tadawul). For more information see http://www.tadawul.com.sa/wps/portal/!ut/p/c0/04_SB8K8xLLM9MSSzPy8xBz9CP0os3g_A.
[968] E. Salterio et al., 'Canadian Evidence of Adherence to 'Comply or Explain' Corporate Governance Codes: An International Comparison' (2013) Accounting Perspectives, vol 12, no 1, pp 23-51.

should be made by way of public bidding unless the director has submitted the best offer for the company.[969] Nonetheless, the director shall announce to the company's board any self-interest he or she may have in the transactions or contracts made on behalf of the firm. Such declarations should be entered in the minutes of the company's general meeting.[970] Importantly, the interested board member may not be allowed to vote on the resolution adopted in this respect, either in the general meeting or the board meeting. In addition, the board chairman must inform, at the ordinary general meeting, of any self-interest transactions and contracts made by any member of the board. Furthermore, such communication must be accompanied by a special report prepared by the company's auditor.[971]

5.3.3.2 Types of Directors

As previously mentioned, the UK's board system is characterised by a single-board or unitary system composed of non-executive directors and executive directors. In Saudi Arabia, the board structure is quite similar to the single-board model that operates in the UK system. The boardrooms of the Saudi listed corporations consist of both independent non-executive directors and executive directors. In effect, non-executive directors have lately become one of the most important foundations of the sound corporate governance practice in any State.[972] The significance of this development is attributed to two reasons: (1) the outside directors are becoming an essential element to ensure that decision-making processes are not left under the control and influence of individuals, and (2) outside directors can make a positive contribution to the development and improvement of a company. It is important to note that non-executive directors play a vital role in preventing abuse of executive directors, as well as contributing effectively to the protection of shareholders' interests. Therefore, outside directors can be described as a chain-linking management, the executive directors and shareholders.

The importance of separating the duties of non-executive directors and executive directors is increasingly being recognised as a crucial factor in reforming listed corporations in many jurisdictions. Importantly, the need to restore public confidence and trust in the global financial system, following the global financial crisis, led many States and international bodies to propose the inclusion of independent non-executive directors to sit in the board of

[969] Art (18-a) Saudi CGRs.
[970] ibid.
[971] ibid.
[972] J. Cotter and M. Silvester, *Board and Monitoring Committee Independence* (University of Southern Queensland, 2000) 1-31.

companies. The importance of this proposal is reflected in the OECD Principles of Corporate Governance (2004), which state that:

> Independent board members can contribute significantly to the decision-making of the board. They can bring an objective view to the evaluation of the performance of the board and management. In addition, they can play an important role in areas where the interests of management, the company and its shareholders may diverge such as executive remuneration, succession planning, changes of corporate control, take-over defences, large acquisition and the audit function.[973]

The UK regulator has realized the importance of non-executive directors, especially independent non-executive directors, in stabilizing their listed corporations and restoring investors' confidence in the financial system. As a result, the UK Combined Code of Corporate Governance (2006) provides that:

> Non-executive directors should constructively challenge and help develop proposals on strategy. Non-executive directors should scrutinize the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible.[974]

Similarly, the Cadbury Report acknowledged that the existence of non-executive members is particularly relevant in applying and implementing the standards of corporate governance.[975] The Hampel Committee in 1998 recommended the creation of two types of boards of directors: the executive and non-executive directors. It also recommended that the non-executive directors should form at least 1/3 of the board otherwise the board is considered to be weak.[976] Indeed, the importance of the non-executive directors in protecting shareholders' rights, and the company's interests in general, has been stated clearly in the UK Corporate Governance Code of 2012.

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[973]OECD Principles of Corporate Governance (1999) 64.
[974]Para, A.1.U.K Combined Code of 2006.
[975]The Cadbury Report on the Financial Aspects of Corporate Governance, (1992) para, 4.10. For more insight see Mallin, C.A., *Corporate Governance* (Oxford University Press, 2006) 132.
[976]R. Hampel, *Report of the Committee on Corporate Governance Gee* (London, 1998) 27. Available at: www.fsa.gov.uk/ukla.

This Code provides that the board should consist of executive and non-executive directors, particularly independent non-executive directors. The main objective is to deter individuals or small groups of individuals from dominating the board's decision-making.[977] Furthermore, the Code provides that the board appointment should be made through a nomination committee, the majority of which are independent non-executive directors.[978] In accordance with the UK Corporate Governance Code, non-executive directors should examine the company's management and monitor their performance reports. Also, they should oversee the transparency and integrity of financial information.[979] Non-executive directors are responsible for identifying the appropriate compensation of executive directors and they also have an absolute power to appoint and fire executive directors.[980]

In the UK corporations, the board should appoint one of the non-executive directors to work as a senior independent director in order: 1) to provide a sounding board for the chairman; 2) to serve as an intermediary for other directors; and 3) to serve shareholders if they have concerns regarding their interests.[981] Furthermore, in order to increase the performance of non-executive directors, the chairman should hold meetings with the non-executive directors without the executives present. On the other hand, the non-executive directors should hold meetings with executives without the chairman present, at least once a year to assess the chairman's performance.[982]

In Saudi Arabia, the Company Law of 1965 did not give room for division of board members. Indeed, this represents a problem in good corporate governance because according to the agency theory, the presence of independent directors can reduce information asymmetry,[983] mitigate the conflict of interest between agents and principals[984] and improve board decisions.[985] Therefore, by not giving room for a division of board members, many Saudi firms will be saddled with agency problems, which may adversely affect the protection of minority shareholders' rights. However, following the enactment of the CGRs in 2006, the

[977]Sec (b-1) U.K Corporate Governance Code 2012.
[978]ibid Sec (b-2-1).
[979]ibid.
[980]ibid .
[981]ibid Sec (a-4-1).
[982]ibid.
[983] M. Allegrini and G. Greco, 'Corporate Boards, Audit Committees and Voluntary Disclosure: Evidence from Italian Listed Companies' (2013) Journal of Management and Governance, vol 17, no 1, pp 187-216.
[984]L. Bebchuk and M. Weisbach, 'The State of Corporate Governance Research' (2010) The Review of Financial Studies, vol 23, no 3, pp 939-961.
[985]S. Chen et al., 'Government Intervention and Investment Efficiency: Evidence from China' (2011) Journal of Corporate Finance, vol 17, no 2, pp 259-271.

need to divide the board into three categories was emphasized. Consequently, the CGRs defined three types of the board members as follows: executive members, independent members and non-executive members. The executive director is a person who works in a full-time capacity with the company and obtains a monthly wage.[986] The non-executive member is a director who does not hold a full-time management position in the firm, or receive a monthly or yearly salary. To increase the effectiveness of the non-executive directors, the CGRs require all listed corporations to ensure that the majority of board members are appointed as non-executive directors.[987]

Furthermore, the CGRs emphasized the need to appoint independent non-executive members of the board who should enjoy complete independence. The independent director is not allowed to:[988]

1) Hold 5% or more of the company's stock or any of its group
2) Act as a representative for a controlling shareholder who owns 5% or more of the company's equity or any of its group;
3) Act during the previous two years as a senior executive of the corporation or of any other its subsidiaries
4) Be a first-degree relative of either any board member of the corporate or its group, or any of the senior executives of that company or its group
5) Be a nominee in the company board or in any subsidiaries branches of that company
6) Act during the previous two years in the company, or its group as external auditors or main suppliers or have a controlling interest in any such party.

Despite the huge similarity between the Saudi law and the UK legal system, especially in terms of the types of directors and their duties however, there is an ambiguity regarding the function of the independent director and the non-executive director in Saudi law. For instance, it is very uncertain that non-executive members and executive members would not challenge the strategies and decisions made by the chief executive officer (CEO).[989] Perhaps this is not an exception in Saudi Arabia. To comply with sound corporate governance standards, the contract of the executive director should run for three years, which can only be

[986]Art (2) Saudi CGRs.
[987]Ibid art (12-c).
[988]Ibid art (2).
[989]J. Westphal and E. Zajac, 'The Symbolic Management of Stockholders: Corporate Governance Reforms and Shareholders Reactions' (1998) Administrative Science Quarterly, vol 43, no 1, pp 134.

renewed following endorsement of shareholders. Furthermore, the executive members' income should be subjected to full transparency and disclosure.[990] However, the CGRs in Saudi Arabia have not provided this in the legislation, thus there is a need for amendment in the legislation to accommodate this requirement.

In fact, the number of non-executive directors in the Saudi listed firms is based on the type and nature of the company. Therefore, in most of the Saudi banks, the non-executive directors are composed of a large percentage of the board members.[991] For instance, the board members of the Aljazeera Bank are consisting largely of non-executive directors. In the Saudi SAMBA Bank board, 8/10 members are non-executive directors. All the 9 board members of the Saudi Investment Bank are non-executive directors and for Saudi Hollandi Bank, 9/12 members are non-executive directors.[992]

However, it should be noted that the percentage of non-executive directors in the Saudi family-owned corporations is still small. Previous research suggests this is due to an increased concentration of ownership in listed companies.[993] In fact, there is no specific formula for identifying the number of the company directors, though in certain companies, laws have placed a minimum or maximum number of directors.

For example, the management board of Tesco Plc in the UK, which is considered as one of the largest multinational supermarket enterprises, involves 13 directors.[994] The UK Corporate Governance Code has a good procedure in place, which requires that the appointment of board members and the selection of independent non-executive directors be made following a recommendation by the nomination committee.[995]

Under the Saudi system, the CGRs stipulate that the board of directors, including non-executive directors, must be appointed by the general assembly.[996] In addition, the CGRs also provide that the nomination committee should recommend all appointments for the membership of the board, to the board of directors in accordance with the approved policies

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[990]A. Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance* (1992) 58.
[991]F. Al Majed, *A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: a Comparative and Analytical Study from a Legal Perspective* (School of Law, Manchester University, 2008) 254.
[992]ibid.
[993]ibid.
[994]For more insight about the board of Tesco Plc visit: https://www.google.co.uk/#q=Tesco+plc.
[995]Sec (b-2-1) UK Corporate Governance Code 2012.
[996]Art (12-b) Saudi CGRs 2006.

and standards.[997] The non-executive directors are appointed and dismissed by the nomination committee under the UK law but in Saudi Arabia, the appointments and dismissals are done at the discretion of the general assembly.[998] As a result, non-executive members may act under the influence of controlling shareholders or majority shareholders and this may weaken their status of independence.

5.3.3.3 The Chairman and the CEO

As mentioned, the duties of the chairman and the CEO are sometimes combined as one, suggesting that one person can serve as the chairman of the board as well as the chief executive officer of the company.[999] It has been argued that the function of the chairman and the CEO should be separated and should not be filled by only one person. Unlike the UK system, the Company Law of 1965 in Saudi Arabia did not encourage separation of the two functions.[1000] Importantly, it advocated that the role of the chairman and that of the CEO should be inseparable. Nevertheless, this view has since changed following the enactment of the CGRs in 2006. This new regulation has recognized the importance of separation between the functions of the chairman and the CEO. Consequently, the CGRs not only recommended that the functions of the chairman and the CEO in listed corporations should be separated but that it should also be considered a serious offence if any corporation violates this provision.[1001]

Despite the fact that the Saudi regulator recommends the separation of the two functions, most listed corporations, particularly the State and the family-owned corporations, do not apply this rule (such as the Samba Bank). In fact, it is not a surprise that some corporations fail to implement the Saudi security laws when it comes to separation of the office of the chairman and the CEO. This is because the Company Law of 1965 granted the board members the right to elect the chairman and the CEO.[1002]As a result, the State and rich families exert considerable influence in the selection of the chairman and the CEO of their companies. For instance, the chairman of the SABAC Company is appointed by the Saudi

[997]Ibid art (15-c).
[998]Ibid art (12-f).
[999]Art (79) Saudi CL.
[1000]Ibid art (79).
[1001]Art (12-d) Saudi CGRs 2006.
[1002]Art (79) Saudi CL.

State and the post of the chairman and the CEO of the Al Rajhi Bank are held by a single individual, who in this case is the son of Suleiman Al Rajhi.[1003]

In fact, most obstacles facing the effectiveness of corporate governance in the Saudi securities market are that there is clear duplication between the rules of the Company Law and the Corporate Governance Regulations (CGRs), as well as the appointment of the chairman and the CEO being subject to social ties and business relationships. Thus, the appointments of most chairmen and CEOs in the Saudi listed corporations are largely based on friendship ties rather than on skills, qualifications and experiences.

5.3.3.4 Board Sub-Committees

The boards' committees are becoming a fundamental prerequisite for the effective application of corporate governance practice worldwide. They are seen as crucial tools that help the company's boards to achieve their goals and objectives efficiently. Specifically, the importance of the boards' committees has gained wide recognition across the globe. Consequently, boards may establish various sub-committees and delegate their authority to some of those committees. At the same time, the boards of directors remain responsible for sub-committees' activities.[1004]

The board committees differ in terms of the nature and size of the corporation. However, establishing a good corporate governance system requires at least three major sub-committees. In the UK experience, the Higgs Review suggested that most public companies should have two types of sub-committees, namely the audit committee and the remuneration committee.[1005] Similarly, the Cadbury Report recommended that the board of directors should have two official committees: the audit committee and the remuneration committee.[1006] The Cadbury Report also stated that the nomination committee is a very important device to ensure the board of directors' designation process is made more explicit.[1007] Therefore, it can be said that a formal governance structure is made up of three main committees, namely the audit committee, the remuneration committee and the nomination committee. Moreover, the board of directors may create further committees, such as a risk committee and an executive

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[1003]Mr. Abdullah bin Suleiman Al Rajhi Chairman, Board of Directors - Non-executive member. He assumed a number of leading positions most noted are his tenures as Managing Director and Chief Executive Officer of Al Rajhi Bank. For more information visit: http://www.alrajhibank.com.sa/en/about-us/pages/board-of-directors.aspx.
[1004]C.A. Mallin, *Corporate Governance* (Oxford University Press, 2007) 121-136
[1005]R. Hampel, *Report of the Committee on Corporate Governance Gee* (London, 1998) 27. Available at: www.fsa.gov.uk/ukla.
[1006]Cadbury Report of the Committee on the Financial Aspects of Corporate Governance (Gee Publications, December 1992). Available at: http://www.ecgn.org/ecgn/docs/codes/cadbury.pdf.
[1007]C.A. Mallin, *Corporate Governance* (Oxford University Press, 2007) 128.

committee, as per the company's condition. The following sections examine these committees and their implications for protecting minority shareholders' rights in two jurisdictions.

5.3.3.4.1 Audit Committee

The audit committee is the most significant board committee that oversees the internal and external audit process of the company. Basically, the objective of an audit committee is to review the company's financial data and ensure that the corporation has efficient internal controls, suitable accounting standards and external auditors who can prevent scams, manipulation and enhance the company's quality. The audit committee plays a crucial role in providing the board of directors with all relevant issues associated with its actions. Therefore, it connects the internal and external auditors and the board of directors. The importance of audit committees in protecting minority shareholders' rights is captioned explicitly in the Smith Review Report as follows:

> While all directors have a duty to act in the interests of the company, the audit committee has a particular role, acting independently form the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control.[1008]

Previous research suggests that the key role of the audit committee is to help the board in monitoring and ensuring the efficient implementation of the internal control mechanisms, overseeing and concentrating on all aspects of risk management, especially financial risk.[1009] Some analysts suggest that the main objective of the audit committee is to protect the shareholders' interests and ensure that managers implement their duties in accordance with their contracts. They summarized the significance of the audit committee in three points as follows:[1010] (1) to help the board of directors in performing their duties in terms of internal control and financial reporting, (2) to make sure that management acts in the right way and enforces the best practices and procedures, and (3) to address the issues of management and corporation objectively. As a result of the importance of this committee, the UK Combined Code (2006) states that:

[1008]R. Smith, *Audit Committee Combined Code Guidance* (The Financial Reporting Council Limited, 2003) 1-47.
[1009]W. Willekens and P. Sercu, *Corporate Governance at the Crossroads* (Intersentia, Oxford, 2005) 35.
[1010]H. Haron et al., 'Audit Committee Compliance with Kuala Lumpur Stock Exchange Listing Requirements' (2005) International Journal of Auditing, vol 9, no 3, pp 187-200.

> The board should establish an audit committee of at least three, or in the case of smaller companies, two, members, who should all be independent non executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.[1011]

The audit committee should include independent outside directors in order to monitor and assist and to give assurance that the audit committee is working correctly.[1012] In fact, the UK and Saudi systems have adopted these recommendations that establish audit committees as fundamental elements of their corporate governance systems. Consequently, both of these systems emphasized the importance of the audit committee, remuneration committee and nomination committee in their listed corporations.

Many of the features of good corporate governance in the UK developed through the Cadbury Report in 1992, which recommended the separation of the functions of the chairman and the CEO and the establishment of independent audit committees.[1013] The company's board should establish the audit committee with at least three members including two independent non-executive directors.[1014] Under the Saudi legislation, the audit committee has constituted a paradigm shift in the field of transparency and disclosure in the Saudi stock market, particularly in the wake of enacting the CGRs in 2006. The new regulations strongly recommend that each board of directors in listed corporations set up an audit committee.[1015] Its members should not be less than three, involving professional persons in the domains of financial and accounting matters.[1016] Furthermore, the CGRs recommended that the members of the audit committee should be selected from non-executive directors.[1017] Importantly, the general assembly of shareholders should make specific rules regarding the appointment of the members of the audit committee.[1018]

[1011]Para, C.3.1 U.K Combined Code 2006.
[1012]L.F. Spira, *The Audit Committee: Performing Corporate Governance* (Kluwer, 2002); W. Willekens and P. Sercu, *Corporate Governance at the Crossroads* (Intersentia, Oxford, 2005) 35.
[1013]London Stock Exchange, *Corporate Governance for Main Market and AIM Companies* (White Page Ltd, 2012) 9.
[1014]Sec (c-3) U.K CGC 2012.
[1015]Art (14) Saudi CGRs 2006.
[1016]ibid art (14-a).
[1017]ibid.
[1018]ibid art (14-b).

In accordance with the CGRs, it is not acceptable to appoint the executive directors to sit on the audit committee.[1019] To ensure integrity and neutrality, the audit committee should not have any direct or indirect engagement in any interest linked to the company's dealings or transactions. The supervision on the company's internal control systems, particularly the activities of internal auditing and the actions of the external auditors, is a major duty of this committee.[1020] Another duty is reviewing the interim and annual financial reports and conducting suitable recommendations prior to presentation to the board of directors.[1021] Moreover, this committee is charged with reviewing the accounting policies and making recommendations to the board of directors.[1022] It should also make recommendations to the board of directors concerning the appointment, dismissal and the remuneration of external auditors.[1023]

In spite of the Saudi regulator's efforts in this regard, evidence suggests that most Saudi listed corporations have a cynical disregard of the activities of this committee and thus some of them have failed to comply with the provisions of the CGRs. The main problem emerges when the board of the listed corporations nominate the audit committee members without seeking approval from the general meeting of shareholders. For instance, the Basic Chemicals Industries Company recently paid a fine of $13,333 due to the failure of the company's board to seek approval of the general assembly when selecting the members of the audit committee.[1024] In addition, Tabuk Cement Company also received the same penalty because it breached the provisions of Article 14b) of the CGRs.[1025]

5.3.3.4.2 Remuneration Committee

The compensation committee (remuneration) remains a contentious topic in the field of corporate governance. It plays a vital role in preventing potential conflicts of interests between managers and shareholders, as executive directors may set up private remunerations for their personality interests. According to the Greenbury Report (2005):

> To avoid potential conflicts of interests, board of directors should set up remuneration committees of non-executive directors to determine on their

[1019] ibid
[1020] ibid art (14-c).
[1021] ibid.
[1022] ibid.
[1023] ibid.
[1024] Decision of the Capital Market Authority Board, No. 7-1-2012 (1 January 2012).
[1025] Decision of the Capital Market Authority Board, No. 8-1-2012 (1 January 2012).

> behalf, and on the behalf of the shareholders, within agreed terms of reference the company's policy on executive remuneration and specific remuneration packages for each of the executive directors, including pension rights and any compensation payments.[1026]

It should be noted that the Greenbury Report has tried to strike a balance between executive directors and shareholders through the creation of the remuneration committee, which should consist of non-executive directors who act on behalf of the board of directors and shareholders. Hence, the main purpose of this report is to create a balance between the salaries and the performance of directors.[1027] The members of the compensation committee should be identified by the chairman and the executive directors and these should also be outlined in the annual report.

This committee has taken an advanced position under UK legislation as it was one of the issues that led to the agency theory problem. Therefore, it has received special attention in UK legislative reform. The UK CGC of 2012 states that the level of directors' remuneration should be sufficient in order to attract, keep and encourage the professional directors to run the firm efficiently but that a corporation should avoid paying more than is necessary for this objective.[1028] The levels of remuneration of executive directors should be determined by non-executive directors.[1029]

The UK Combined Code (2006) provided that: 'the remuneration committee should consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive directors. The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration'.[1030] In fact, the provisions governing the remuneration committee are similar to those provisions regulating the audit committee under the UK legal system, and thus the company's board should appoint at least three members of independent non-executive directors in this committee.[1031]

[1026] Greenbury Report, *Greenbury Recommendations* (2005) para (A-1).
[1027] J.Solomon, *Corporate Governance and Accountability* (Chichester, West Sussex, UK, 2010).
[1028] Sec (d) U.K CGC 2012.
[1029] Ibid Sec (a-4).
[1030] UK Combined Code 2006, para B.2.1.
[1031] Sec (d-2-1) UK CGC 2012.

In Saudi Arabia, the board of directors is a single authority that holds the right to manage the business of the company including the audit committee, remuneration and nomination committees. Hence, the company's board should form a committee, known as the 'nomination and remuneration committee'.[1032] Based on the board's recommendations, the general assembly should issue rules concerning the appointment of the members of the nomination and remuneration committees.[1033]

The main duties and responsibilities of these committees include:[1034] 1) recommending members to the board of directors; 2) making an annual review of the requirements of appropriate skills for membership of the board; 3) reviewing the board's structure and recommending required modifications; 4) identifying the levels of strength and weakness in the board and issuing recommended remedies that are consistent with the company's interests; and 5) ensuring that the independence of the independent members is respected by the board.

Despite the similarity between the Saudi Corporate Governance Regulation (CGRs) and the UK regulations concerning the work of the remuneration committee, the truth remains that this committee and other board committees cannot replace the board of directors' responsibilities, which has the absolute power to manage the company with the appropriate method. Therefore, the CGRs are very obvious when they state that: '… the ultimate responsibility for the company rests with the board, even if it sets up committees or delegates, some of its powers to a third party'.[1035]

Furthermore, previous research has argued that controlling shareholders can abuse the company and the rest of shareholders by approving high remuneration for themselves.[1036] This has a negative impact on minority shareholders, especially if we take into account that the controlling shareholders hold an executive position in most listed corporations in the Saudi securities market.

[1032]Art (15-a) Saudi CGRs 2006.
[1033]ibid art (15-b).
[1034]ibid art (15-c).
[1035]ibid art (11-a).
[1036]S. Johnson et al., 'Tunnelling' (2000) T he American Economic Review, vol 90, no 22, pp 22.

5.3.3.4.3 Nomination Committee

The nomination committee focuses on the appraisal of the board of directors of its respective company and ensures that the skills and attributes of directors match the specifications required to serve on the company's board. Indeed, directors have been commonly designated according to personal relationships, without due consideration of requisite competencies. However, this typically provides firms with inefficient directors. Previous research had earlier shown that companies that have nomination committees provide good protection for stakeholders' interests, as opposed to those without such committees. Thus, the presence of a nomination committee should limit or prevent the appointment of ineffective directors.[1037]

Some reports and codes support the necessity of strict, formal and transparent designation of new directors. For instance, the UK Combined Code (2006) states: 'there should be a nomination committee which should lead the process for board appointments and make recommendations to the board. A majority of members of the nomination committee should be independent non-executive directors'.[1038]

The nomination committee should make sure that there is the right balance of qualifications, knowledge, skills and experience between the members of a company's board. Under the Saudi regulations, the nomination committee has recently been recognised as one of the most significant of the board committees. The regulations also encouraged all Saudi listed corporations to establish this committee as part of their board. However, it should be noted that the nomination committee was established alongside the remuneration committees and carried the same provisions. Thus, it would indeed be beneficial if the Saudi regulator split this committee and set out its responsibilities clearly.

5.3.4 The Basic Rights of Minority Shareholders

In the introductory section, reference was made to Berle and Means' study, which assumed that the basis of the agency theory problem was that individual shareholders have no control over the company's decision-making.[1039] Similarly, in a concentrated ownership model, controlling shareholders dominate the decision-making and minority shareholders have no power to exercise their rights.[1040] Corporate governance came into existence to establish

[1037]B.D. Baysinger and H.N. Butler, 'Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition' (1985) Journal of Law, Economics, & Organization, vol1, no 1, pp 101-124.
[1038]Para, A.4.1 U.K Combined Code 2006.
[1039]A. Berle and G. Means, *The Modern Corporation and Private Property* (Harcourt, Brace & World, 1932).
[1040]R. La Porta et al., 'Corporate Ownership around the World' (1999) The Journal of Finance, vol 54, no 2, p 471.

sufficient minority shareholders' protection through restoring a balance between conflicting interests and offering appropriate remedies to shareholders' disputes. Since the advent of corporate governance, shareholders' rights were represented as an essential element of the internal structure of corporate governance.

In the Saudi legislations, the minority shareholders' rights have been integrated within the general rights of shareholders under Article 3 of the Corporate Governance Regulations (CGRs) of 2006.[1041] These regulations have provided a bundle of basic rights for the treatment of shareholders in general, and minority shareholders in particular. As a result, the recent report issued by the World Bank has ranked Saudi Arabia as 70th out of 183 countries with adequate protection of shareholders, particularly minority shareholders.[1042] In line with global standards of corporate governance, the Saudi regulator has outlined several rights of shareholders. In the section that follows, the basic rights of shareholders under the UK and Saudi legal systems, such as management rights, financial rights, property rights and judicial rights, are provided.

5.3.5 Management Rights

Given the importance of management rights in the field of protecting minority shareholders rights, the law should provide a bundle of administrative rights for all shareholders, especially minority shareholders. In this regard, this research has focused on examining the rights of minority shareholders to attend general meetings, voting rights exercised chiefly in the case of absence, the rights of participation in deciding the company's agenda and fundamental changes, participation in the election and rejection of board members, as well as the right to obtain information on a timely and regular basis.

5.3.5.1 The Right to Attendance in Shareholders' General Meetings

First of all, a general assembly is a substantial element in the internal structure of corporate governance. It is a main headquarter where all shareholders can vote and participate in the fundamental decisions and significant issues affecting the company. Attendance and engagement at the general meetings is seen as a fundamental factor in the course of protecting minority shareholders' rights. Therefore, the OECD Principles of Corporate Governance emphasized the importance of this meeting by saying that 'shareholders should

[1041] Art (3) Saudi CGRs.
[1042] Report on the Observance of Standards and Codes (ROSC), *Corporate Governance Country Assessment: Kingdom of Saudi Arabia* (The World Bank, 2009) 1-15.

have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures that govern general shareholder meetings'.[1043]

According to this principle, protecting minority shareholders' rights should form the definition of a good corporate governance framework and this should involve a set of elements of regulations, self-regulation, and mechanisms of forced enforcement of laws, voluntary commitment to obligations, capital market conditions, business practices and levels of institutions' development.[1044] Protecting minority shareholders should be supported by legal system, either company law, securities law or others. The quality of laws and their enforcement by the regulatory bodies and courts are substantial factors, needed to ensure sound corporate governance and financial systems in any State. When these laws and regulations do not provide good protection of minority shareholders however, corporate governance does not act efficiently. As a result, Jensen and Meckling asserted the above argument by saying that:

> This view of the company points up the important role which the legal system and the law play in social organisations, especially, the organisation of economic activity. Statutory laws set bounds on the kind of contracts into which individuals and organisations may enter without risking criminal prosecution. The police powers of the State are available and used to enforce performance of contracts or to enforce the collection of damages for non-performance. The courts adjudicate conflicts between contracting parties and establish precedents which form the body of common law. All of these government activities affect both the kind of contracts executed and the extent to which contracting is relied upon.[1045]

In fact, shareholders usually obtain a bundle of rights by buying shares. Thus, the main reasons that induce shareholders to buy stocks are dividends, control and to gain capital.[1046] The widely-held view is that minority shareholders' control is gained by participating effectively at general meetings. It can be said that attendance and participation at the general

[1043]OECD Principles of Corporate Governance of 2004, Principle No (II-a-4).
[1044]K. Dulic and Kuzman, T. 'Protection of Rights of Minority Shareholders: Legal Framework and Enforcement' (2012) Quarterly Monitor, vol 30, p 87.
[1045]M. Jensenand W. Meckling, 'Theory of the firm: managerial behaviour, agency costs, and ownership structure' (1976) Journal of Financial Economics, vol 3, p 311.
[1046]IFC, *Corporate Governance* (Rulebook, revised edition, Belgrade, 2011).

assembly is the legal means for shareholders and their representatives to influence the company's policies and decisions.

On the other hand, the OECD Principles assert the significance of providing shareholders with sufficient and timely information regarding the location, date and agenda of general meetings as they frankly stipulate that 'shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting'.

However, in practice, evidence shows that different procedures may be used to decrease the effectiveness of shareholders' participation in general meetings, such as holding the shareholders' general meeting in a difficult location, voting by raising hands without the right to demand a poll, delaying the provision of basic information, allowing a limited number for attendance at the general meetings, giving a period of notice that is below the legal minimum, and so on.[1047] The main issue that minority shareholders may face is that the company's management may only display issues that they want and disregard other significant matters. This problem is very common in those systems characterised by concentrated ownership, since the controlling shareholders may likely use the general assembly to pass only decisions that satisfy their selfish interests. As a result, the corporate governance system emerged to encourage listed companies to remove all artificial barriers that will prevent shareholders from exercising their rights in general meetings.

Accordingly, the Saudi legislations have paid considerable attention to shareholders' right to attend and exercise their rights via general meetings. Specifically, the Saudi Company Law has recognized the shareholders' right to attend the general meeting by stating that '…every stockholder who holds 20 shares shall have the right to attend, even if the bylaws of the company provide otherwise'.[1048]

Generally, the CL has contained a set of rules that regulate the shareholders' rights to attend and participate effectively in the general assembly. Similar to the UK system, the CL gives shareholders the right to attendance and participation in both the ordinary and extraordinary

[1047]Technical Committee of the International Organisation of Securities Commissions Report, *Protection of Minority Shareholders in Listed Issuers* (2009) 21.
[1048]Art (83) Saudi CL.

meetings.[1049] Article 61 stated that the general meeting will not be valid unless the number of attendees represents at least half of the company's capital.[1050] In fact, the CL has included a bundle of provisions, which to a large extent, reflect international standards of good corporate governance. However, it has been discovered that the right of shareholders, especially minority shareholders with regards to general meetings, is poor and non-existent. This is because the company management, especially the CEO and the controlling shareholders use all the proportions and the number of shares they hold to dominate all of the company's affairs.[1051] Therefore, the Corporate Governance Regulations (CGRs) in 2006 and listing rules (LRs) were enacted in 2006 to mitigate those existing shortcomings of the SCL.

The CGRs clearly stipulate that shareholders should be empowered to exercise their rights, especially: their right to a share of the corporation's assets upon liquidation; a share in the distribution of net profits; the right to attend the general meeting and vote on fundamental issues; the right to oversee the board's activities; the right to file claims against violations of board members and the right to obtain sufficient information.[1052] In accordance with the UK Company Act of 2006, a shareholder should obtain a set of rights in the firm and these rights may be different depending on the type of shares held.[1053]

As per the UK Company Act of 2006, shareholders' rights in any company should be laid down the provisions of the Company Act of 2006, the Articles of association and any shareholder's agreement. The major rights related to shares are diverse, but the right to attend general meetings and vote is substantial in the UK Company Act.[1054] Therefore, shareholders, who own at least 10% of the paid-up capital of the company, have the right to require the director to convene a general meeting.[1055] Specifically, the Act provides that 'every public company must hold a general meeting as its annual general meeting in each period of 6 months beginning with the day following its accounting reference date (in addition to any

[1049]The ordinary general meeting should be convened to discuss all matters related to appoint and re-appoint board members, to approve the company's net profits and dividends and the date of their circulation, and to agree on the board's annual report, and to agree whether to an increase or a decrease in the company's capital. On the other hand, the extraordinary general meeting hold in order to argue the urgently matters, chiefly if the company has lost half of its capital or faces potential liquidation and bankruptcy. It can be also held to change the company's articles of association, modify the company's main purpose, transfer its headquarters to another country or change the company's nationality.
[1050]Art (61) Saudi CL.
[1051]M. Al Jaber, *The Saudi Commercial Law"* (King Fahad National Library, Riyadh, 2007) 202 [Arabic edition]. For more information see Articles (84&85) Saudi Company Law 1965.
[1052]Art (3) Saudi CGRs.
[1053]Johnathan Korchak, 'what rights do shareholders have?', (2014), Online Company Records Management. It is available at: www.informdirect.co.uk/shares-shareholders-rights-guide.
[1054]Part 22-Sec 803 (2) UK Company Act 2006.
[1055]Ibid Sec (803).

other meetings held during that period)'.[1056] In addition, Article E-2 of the UK Corporate Governance Code of 2012 stated that 'the board should use the AGM to communicate with investors and also to encourage their participation'.[1057]

Similarly, the Saudi CGRs stipulate that a general meeting should be held once a year at least within the six months of the end of the company's fiscal year.[1058] The board of directors should be called for at a general meeting following a request of either the auditor or a number of shareholders, whose shares represent at least 5% percent of the company's shares capital.[1059] Despite the considrable similarity between the UK and Saudi systems, especially in terms of the right of shareholders to attend and vote at the annual general meeting (AGM). Yet, it should be noted that the CGRs in Saudi Arabia are in compliance with global standards of corporate governance more than the provisions of the UK Company Act of 2006, as it requested shareholders to hold at least 10% percent of paid-up capital of the company before they can request the director to convene at ordinary or extraordinary meetings.

In fact, the required percentage (which is 5% of the equity share capital) under the Saudi CGRs to convene at ordinary and extraordinary meetings, is considerably recognized in many advanced legal systems over the world. Specifically, the European Union requests all member countries to reduce the percentage of requesting for extraordinary meeting to 5%. Following this recommendation, the UK Company Act of 2006 has changed the percentage of paid-up capital from 10% to 5%,[1060] although the CGRs are in line with international practices of corporate governance, particularly in terms of the percentage of the extraordinary meeting. Nonetheless, Article 5b) of the CGRs conflicts with the provisions of the CL, since the latter has given the shareholders, who own at least 20 shares, to attend and participate in the general assembly.[1061] In this regard therefore, it should be noted that the provisions of the CL may provide good protection of minority shareholders against the abuse of company management and its board of directors. On the other hand, there is no determined clause under the OECD Principles of Corporate Governance concerning 5%, as a condition for the shareholders to exercise their rights in the general meetings.

[1056]Ibid Chapter 4-Sec (336-1).
[1057]Section E-2 of UK Corporate Governance Code of 2012.
[1058]Art (5-a) Saudi CL.
[1059]Ibid Art (5-a).
[1060]Section 303(2-a) UK Companies Act 2006, s. 303 (2-A) has been modified by the EU Directive in 2009. For more insight see European Community Directive on Shareholders' Rights, URN 08-1362.
[1061]Art (83) Saudi CL.

Hence, this percentage may hinder the rights of shareholders to engage in general meetings and raise their opinions. In addition, this percentage may oppose the effective application of sound corporate governance in the Saudi securities market. As a result, it is wise that the CMA amend this clause to enhance the opportunity of minority shareholders to efficiently participate at AGM. Theoretically, the Saudi regulator has exerted huge efforts in enhancing shareholders' rights through attendance and participation in general meetings. In practice however, there is a cultural dilemma related to the attendance at the general meeting as the Saudi company's directors believe that the general meeting is just mere formality organ and that the attendance is not important. In turn, the culture of political and popular participation in Saudi Arabia is rather modest and the Saudi people are not familiar with participation in public encounters.[1062]

5.3.5.2 The Right to Participate in Proposing an Agenda

The main difficulties encountered by shareholders in most listed corporations is that the company's management always propose issues that would be discussed in general meetings and shareholders are only allowed to vote on matters presented by the management. This problem emerged clearly, as previously mentioned through the study of Berle and Means, which argued that the influence of shareholders on the board's decisions was poor. As a result, some countries proposed some laws as support that would enable shareholders to control the management and participate in the company's decisions-making.[1063]

Specifically, the US Exchange Act gives the shareholders, who own equities with the value of at least $2000 or at least hold 1% of the shares, the right to file proposals. This right must be exercised at least once a year and the equities must be held by shareholders at the date of the general meeting.[1064] Contrarily, in the UK governance rules, there is no text that provides shareholders with the right to discuss the company's agenda. However, in general, shareholders must enjoy all rights to exercise their legal rights efficiently. In accordance with PIRC Shareholders Voting Guidelines, shareholders should be notified of substantial decisions and allowed to vote and participate in all substantive matters. Moreover, the notice

[1062]Fahad M, Almajid, (2011), "A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: a Comparative and Analytical Study from a Legal Perspective", PhD Thesis, School of Law, University of Manchester.
[1063]D. E. Lazaroff., 'Promoting Corporate Democracy and Social Responsibility: The Need to Reform Proxy Rules on Shareholders Proposals' (1998) Rutgers Law Review, vol 50, pp 33-36.
[1064]Art 14 (a-8) U.S Securities Exchange Ac 1934.

of the general meeting must be submitted to the company at least 20 working days prior to the meeting.[1065]

The Cadbury Report recommended that shareholders should be given the opportunity to express their views on such matters in the annual general meeting.[1066] The report further suggested that shareholders can play a significant practical governance role by influencing on-board resolutions, through making the details of board resolutions subject to their vote.[1067] All new long-term incentive schemes of the company should be approved by shareholders. To motivate shareholders to participate effectively in the general meeting agenda, the Combined Code stipulated that the company board should use the general meeting to connect with shareholders and stimulate their participation.[1068]

In Saudi Arabia, the right of participation in proposing the agenda in the general meeting is restricted only to shareholders who hold 5% of shares capital of the company. The CGRs have stated frankly that:

> In preparing the general assembly's agenda, the board of directors shall take into consideration matters shareholders require to be listed in that agenda; shareholders holding not less than 5% of the company's shares are entitled to add one or more items to the agenda upon its preparation.[1069]

As a result, this percentage constitutes a significant factor that can have a negative effect on the protection of minority shareholders' rights. In fact, the OECD Principles of Corporate Governance have not mentioned the 5% criteria in its document. Consequently, this percentage is indeed, inconsistent with the sound practice of good corporate governance and should be disregarded by the Capital Market Authority Board. In addition, these two jurisdictions (the UK and Saudi Arabia) have included similar conditions regarding proposed agendas in the general meetings and this point still needs to be developed and improved in these systems.

[1065]Pensions Investment Research Consultants Limited (PIRC), Shareholder Voting Guidelines issued in 1994 and revised in March 2001.
[1066]Cadbury Report, 'The Financial Aspects of Corporate Governance, United Kingdom Shareholders Association' (1992) in H. J. Gregory, *Comparative Matrix of Corporate Governance Codes Relevant to the European Union and its Member States*" (Weil, Gotshal&Manges LLP, 2001) 359.
[1067]ibid.
[1068]The Combined Code (2000), "The Combined Code Principles of Good Governance and Code of Best Practice", Derived by the Committee on Corporate Governance from the Committee's Final Report and from the Cadbury and Greenbury Reports.
[1069]Art (5-f) Saudi CGRs.

5.3.5.3 The Right to Vote in the Case of Absence

It should be noted that there are some legal systems around the world which allow the management or controlling shareholders to reduce the influence of minority shareholders on the company by banning proxy voting and requiring personal attendance at general meetings to vote, including attaching vote fees.[1070] The OECD Principles of Corporate Governance affirmed that '... shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia'.[1071]

In order to ensure the voting rights for all shareholders, the law should include a bundle of tools that can reinforce participation of shareholders in general meetings even when they are far away or unable to attend. In fact, most international legal systems have changed their financial legislations to be compatible with the global standards of corporate governance. The Saudi Company Law gave shareholders all the statutory rights to attend the general meetings or give proxy to other stockholders, except for directors to attend the general meetings on their behalf.[1072] The CGRs endorsed this clause with a slight difference, as they stipulated that 'a shareholder may, in writing, appoint any other shareholder who is not a board member and who is not an employee of the company to attend the general assembly on his behalf'.[1073]

Although the CGRs have recognized that voting is a substantial right of a shareholder, it should not, in any way, be denied. As such, corporations are obliged to avoid taking any action which might prevent shareholders exercising their voting right.[1074] However, the main problem is that these provisions have not explained or shown the form of a proxy, particularly in the case of absentee shareholders. In addition, these regulations have not mentioned the use of any distance communications or new technology tools in voting processes. This is in sharp contrast with the UK Company Act, which gives shareholders an absolute right to appoint another person as a proxy to attend, speak and vote at a general meeting on his behalf.[1075] Furthermore, it also allows the shareholders to send all documents relating to the general meeting by using electronic forms, as well as giving the shareholders the right to use

[1070]S. Nestor and F. Jesover, *OECD Principles of Corporate Governance on Shareholders rights and Equitable Treatment: Their Relevance to the Russian Federation* (2000) 5.
[1071]OECD Principles of Corporate Governance of 2004, Principle No, (II-a-4).
[1072]Art (83) Saudi CL.
[1073]Art (6-c) Saudi CGRs.
[1074]ibid.
[1075]Sec 324 (1) UK Company Act 2006.

electronic tools to send documents relating to the appointment of a proxy in meetings, without the need to attendance.[1076]

The use of electronic communication between corporate management and shareholders has been endorsed by many judicial systems in the developed nations. For instance, the U.S Security Act and Delawar Corporate Act have promoted electronic corporate-shareholders communication.[1077] The SEC recognized the importance of electronic tools in the relationship between the company and its shareholders.[1078] In Germany, the Stock Corporation Act gave the company and shareholders the right to use e-mail for meeting declaration.[1079] Under the UK system, the Department of Trade and Industry issued a Statutory Instrument Order to encourage the use of electronic communication between the company and shareholders. Thus, companies can provide information to their shareholders via e-mail and other modern technical means.[1080]

Proxy voting remains an important issue in protecting minority shareholders' rights. The advantage of this idea is to vote without attending the general meeting and increasing savings in terms of time, effort and money.[1081] Therefore, preventing minority shareholders from casting their votes by using proxy or technological means may weaken the protection of minority shareholders' rights in the Saudi securities market. Consequently, the recommendation here is that using proxy voting and technology tools, including electronic voting, will definitely lead to wider shareholder participation and strengthen their position in the market, as well as mitigating conflict of interests between minority shareholders and controlling shareholders.

5.3.5.4 The Right to participate in Decision-Making Related to Fundamental Corporate Changes

Participating in any decision concerning making amendments to the company's structure, is extremely important for minority shareholders and is considered an essential aspect of good

[1076]Ibid Sec (333).
[1077]Bayo Atte, 'Enhancing shareholders participation in company meetings in Nigeria through application of information technology', Journal of Humanities and Social Science, vol 20, issue 9, p.64.
[1078]SEC Guidance on Use of Electronic Media. Release Nos. 33-7856, 34-42728, IC-24426; File No. S7-11-00. It is available at: https://www.sec.gov/rules/interp/34-42728.htm.
[1079]OECD, 'General Meetings in Listed Companies-New Challenges and Opportunites 2000'.
[1080]The Draft of the Companies Act 1995 'Electronic Counication' Order 2000. It is available at: www.ligeslation.hmso.gov.uk.
[1081]U. C. Braendle, 'Shareholder Protection in the USA and Germany - "Law and Finance" Revisited' (2006) German Law Journal, vol 7, no 3, p 267.

corporate governance. The OECD Principles have spelt out what fundamental corporate changes represent, as they state that:

> Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as: 1) amendments to the statutes, or Articles of incorporation or similar governing documents of the company; 2) the authorisation of additional shares; and 3) extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company.[1082]

In effect, the rights of minority shareholders to be involved in modifying the corporate charter, or any essential developments in the company's position, are weak in most markets as the minority shareholders are usually oppressed by the controlling shareholders, especially when those amendments are being deliberated upon. The problem often occurs when the new controlling shareholders and management release new policies and strategies that contradict the existing ones significantly. These changes may have a negative impact on the minority shareholders' rights and interests. For example, these changes may push minority shareholders to sell their equities in the company but at an unfavourable price because the new management and strategy may lead to a decline in share prices. Furthermore, a pre-emptive right, as referred to above, is considered one of the most significant elements that may assist the minority shareholders in preserving their rights during amendments in company structure or position.

However, in many countries, pre-emptive rights are not well recognised or applicable due to the powerful influence of controlling shareholders. One good example is the case of the YUKOS Oil Company in Russia, where the right of minority shareholders to participate in increasing the company capital was disregarded by controlling shareholders.[1083] In addition, some corporations issue shares without the general meeting's approval and some of them fail to notify shareholders to exercise their pre-emptive rights, and they are not subjected to any sanctions of the law in case of failure to notify. The general principle is that shareholders' authorisation is required in any fundamental corporate changes. According to the OECD Principles of Corporate Governance, the corporate governance framework in any country

[1082]OECD Principles of Corporate Governance 2004. Principle No, (II-b).
[1083]S. Nestor and F. Jesover, *OECD Principles of Corporate Governance on Shareholders rights and Equitable Treatment: Their Relevance to the Russian Federation*" (2000) 4.

should give either exclusive power to the shareholders' meetings or require the board to obtain shareholders' authorisation in the case of extraordinary changes on the status of the company.[1084]

In fact, there are various ways used by management or controlling shareholders to mitigate the power of minority shareholders into the company. Therefore, the issuance of additional shares may be considered the best way in the hands of controlling shareholders and management, to reduce the power of minority shareholders. Simplistically, the majority shareholders may find themselves unable to make a decision to amend the company system or merge the company into another company because of the power of minority shareholders and their influence on decision-making. As a result, management or controlling shareholders think that the best way to force the minority shareholders to accept their decisions is to increase the capital of the company. In fact, this action entitles them to execute their decisions, concerning changing the status of the company, without consulting the minority shareholders. The increase of the capital of the company usually results in a decrease in the real value of the original shares, which makes the value of the new shares unlawful. The case of *Clemens v. Clemens Bros. Ltd* in 1976 was one of the most significant, famous legal cases in this regard.

The plaintiff (A) held 45% of the shares capital of the company. The remaining shares (about 55%) were held by the defendant (B) who was director in the company board. She suggested that increasing the capital of the firm, by establishing additional equities, should be allocated to the directors. The impact of this new arrangement was not proportional on existing shareholding, and this saw minority shareholding plummeted from 45% to 25%, thus enabling the majority shareholder (B) to pass a special resolution at an extraordinary meeting to approve it. (A) Brought legal action against the corporation and against (B), she claimed that this decision was oppressive and aimed to put her aside. This scheme was aimed to put the defendant and her fellow directors in complete control of the company. The court held that the issuance of new shares was unnecessary and thus, revered the resolution. During the ruling, the presiding judge, Judge Foster J said that:

[1084]OECD Principles of Corporate Governance 2004. Principle No, (II-b-3).

> ...this was so but, regretfully, he refused himself to produce a principle because "the circumstances of each case are in-finitely varied". He also said that legal rights are "subject.... to equitable considerations which may make it unjust.... to exercise them in a particular way... such considerations were present in this case and were sufficient to enable "a court of equity" to prevent the defendant from using her right in the way that she had.[1085]

As a result of this ruling, the defendant (B) was unable to use majority votes to participate in decision-making. It should be noted that the increase of the company's capital is considered as a legal right for a general assembly as it has jurisdiction through its extraordinary meeting to enhance the company's capital. In effect, the CL stipulated that 'the extraordinary general assembly may decide to increase the company's capital once or several times, provided that the original capital is paid in full'.[1086]

Although the CL has made the above provision in relation to increase in company's capital, it has failed to stipulate sanctions or penalties against anyone who violates this provision. The Saudi listing rules have asserted that the issuer must not issue new shares of the same class as the shares that are listed for a period of not less than six months, following the date of admission of the shares to the official list. Also, the rule asserts that the issuer must notify the Capital Market Authority (CMA) about further securities and must not issue further securities unless an approval is obtained from the CMA.[1087]

In fact, the UK Company Act of 2006 has addressed this issue better than the Saudi legal system. The UK Act prevents directors from issuing new shares to anyone unless they are given the approval to do so either by the company's Articles of association or by the shareholders.[1088] Also, a company is obliged to offer new stocks first to its existing shareholders in the same proportions they previously held.[1089] As a result, this clause protects shareholders' rights from dilution.

[1085]N. Hawke, 'Recent Developments' (1977) The Law Teacher, vol 10, no 3, p 158.
[1086]Art (134) Saudi CL.
[1087]Art (37-a-b) Saudi LRs.
[1088]Sec 549 UK Company Act 2006.
[1089]ibid sec 561.

5.3.5.5 The Right to Elect and Dismiss Board of Directors

The board of directors is charged with running the day-to-day affairs of the corporation and making decisions about the efficient running of the company's business, as permitted by the law. As it is well known, shareholders have no power to reject the board's decisions. Therefore, appointing and rejecting board members are genuine rights given to minority shareholders in order to protect their interests against the abuse of controlling shareholders and directors. Given the importance of minority shareholders participating in electing and rejecting the board's members, the OECD Principles of Corporate Governance have stated this right explicitly by saying '… that effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated'.[1090]

The participation of shareholders in nominating and dismissing the board of directors contributes largely in making the board of directors more accountable to the shareholders.[1091] In order to make the election process more effective, shareholders should be encouraged to participate in the nomination of board members and vote on individual nominees or on various lists of candidates.

As a result, laws and regulations should create several mechanisms that ensure full participation of minority shareholders in electing and dismissing board members. As is known, the power of controlling shareholders allows them to elect and dismiss the board of directors. Minority shareholders should also be given the chance to participate in the election process. Consequently, cumulative voting (as previously mentioned) is the best way that facilitates minority shareholders to cast all their votes in the election process smoothly. They can cast all their vots for an individual nominee or distribute their vots among various nominees in the election process.[1092] The justification of using cumulative voting is to ensure that minority shareholders would participate through certain representatives on the board of directors. Previous studies suggested that under non-cumulative voting, controlling shareholders could control and domainate the process of electing the board members.[1093]

[1090]OECD Principles of Corporate Governance 2004. Principle No (II-c-3).
[1091]Davies, P., *The Board of Directors: Composition, Structure, Duties and Powers, Company Law Reform in OECD Countries: A Comparative Outlook of Current Trends* (Stockholm, Sweden 2000) 7.
[1092]Theodor, Baums and Johann, Wolfgang, 'General Meeting in Listed Companies-New Challenges and Opporetunities' (2000) Stockholm-Sweden, p 12.
[1093]Ibid.

However, it should be noted that cumulative voting is not common practice across the world. It is present in some countries and absent in others. The use of cumulative voting is still optional in most countries instead of mandatory.[1094]

In certain countries, the mechanism of cumulative voting is biding for all listed corporations, for instance, in some U.S States, such as California, Arizona and Nebraska listed companies must adher by cumulative voting, but in other States cumulative voting is still permissible and defulte rule.[1095] On the other hand, shareholders in some countries cannot use cumulative voting to elect the boards of management. For instance, some evidence in the German system indicates that cumulative voting is unknown in the German Company Code.[1096] In addition to that cumulative voting in UK legal system may be still allowable, yet it seems not to be in use.[1097]

In Saudi Arabia, the CGRs asserted the right of shareholders to participate in the election of the board of directors as it provides that '...voting is deemed to be a fundamental right of a shareholder, which shall not, in any way, be denied'.[1098] With respect to cumulative voting, the CGRs have recognized the principle of cumulative voting as an original principle, which can support and give the minority shareholders the opportunities to elect their representatives on the companies' boards. It provides that 'in voting in the general assembly for the nomination to the board members, the accumulative voting method shall be applied".[1099]

However, it should be noted that despite this, the Saudi laws and regulations have affirmed the rights of shareholders, especially in relation to their involvement in the electoral process and there are certain obstacles that may hinder shareholders from exercising their rights lawfully. Firstly, the application of cumulative voting under the Saudi regulations is still optional rather than obligatory. Thus, as previous research suggests, this mechanism is not a compulsory tool, particularly in publicly-listed companies.[1100] Secondly, concentrated ownership in the hands of controlling shareholders, especially in family-listed corporations,

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[1094]J. Gordon, *What is Relational Investing and How Cumulative Voting Can Play a Role* (Working Paper No.97, Centre for Law and Economic Studies, School of Law, University of Columbia, 1993).
[1095]Sec (301,708-a-b) of Colifornia Corporations Code of 2004. Sec (10-728) of Arizona State Legislature of 2004. Art (12), Sec (1 and 12) of Nebraska State Constitiution of 2006.
[1096]R. Kraakman et al., *Anatomy of Corporate Law: A Comparative and Functional Approach* (2004) 55.
[1097]Theodor, Baums and Johann, Wolfgang, 'General Meeting in Listed Companies-New Challenges and Opporetunities' (2000) Stockholm-Sweden, p 12.
[1098]Art (6/a) Saudi CGRs.
[1099]Ibid Art (6-b).
[1100]A. R. Pinto and D. M. Branson, *Understanding corporate law* (LexisNexis Matthew Bender, 2004) 165.

may be one of the key reasons that prevent minority shareholders from participating effectively in the election of the boards of directors. As previously mentioned, in Saudi Arabia, most boards of family-listed companies are controlled and dominated by the same family members. Hence, the right to appoint and dismiss directors is subject to their decisions and discretions. A good example is the Al Khodari Company, which is a family-owned company (with about 60% share ownership) with its chairman and other board members (2/6) belonging to the same family.[1101]

To further improve the directors' election process and participation of shareholders in this election, the OECD Principle has also recommended full disclosure of experiences and qualifications of the candidates for the board during the election process in order to give the shareholders the opportunity to assess the abilities and suitability of each nominee.[1102] Moreover, many countries have established nomination committees to ensure proper compliance with nomination procedures and to facilitate the search for qualified candidates.
In addition, the removal of the board members represents a fundamental element in the course of sound corporate governance. Therefore, both the Saudi CGRs and the UK Company Act have asserted the right of the general assembly to remove all or any of the members of the board, even though the Articles of association provide otherwise.[1103] Therefore, shareholders participation in the directors' dismissal process is a genuine right, which the CL explicitly stipulates '…but the regular general meeting may, at any time, remove all or some of the directors even if the company's bylaws provide otherwise'.[1104]

5.3.5.6 The Right to Access Information on a Timely and Regular Basis

Financial crises that have hit the global economy and the collapses of many giant corporations around the world have been attributed to weaknesses and ambiguities of transparency and disclosure. Indeed, the significance of access to company information related to its transactions and financial situation have been acknowledged in the OECD Principles of Corporate Governance, which state 'the corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding

[1101]Abdullah Al *Khodari* Company. Available at: http://www.alkhodari.com/organizational.html, accessed 8 October 2013.
[1102]OECD Principles of Corporate Governance 2004, pp 34.
[1103]Art (12-f) Saudi CGRs 2006; Sec (168-1) UK Company Act 2006.
[1104]Art (66) Saudi CL.

the corporation, including the financial situation, performance, ownership and governance of the company'.[1105]

It observes that a disclosure system that encourages transparency is becoming an integral element of shareholders' rights to enable them to exercise their legal rights on an informed basis.[1106] Evidence reveals that disclosure can be a powerful instrument for assessing the performance of companies and protecting minority shareholders.[1107] Disclosure assists investors to judge the company which they intend to invest their funds in and empowers them to measure the extent of the company's integrity and eligibility. This principle is considered as the spirit of the stock market and a basic hallmark of its continuation and thrives.[1108]

In order to guarantee easy access to company information and to reinforce the principles of disclosure in listed corporations, adequate regulations are needed to ensure that companies make the financial information accessible and publicly disclose all the material transactions or dealings affecting the shareholders (including the value of their outstanding shares), on a timely basis. Consequently, the issuer is required to present a financial statement disclosing the: annual financial statement, interim financial statement, audited statement and electronic distribution and related party transactions, on a timely basis.[1109]

It should be noted that the Saudi Arabian regulations have indeed, affirmed transparency and disclosure as fundamental principles in its stock market. Therefore, the CGRs and the CML confirm that all the joint-stock companies must comply with the policies, procedures and supervisory rules related to disclosure.[1110] The LRs have explained the procedures required to attain sufficient information before traders in the Saudi stock market. In this regard, the CGRs affirm that shareholders should be clearly informed about the location, date and agenda of the general meeting. Shareholders should be invited to the meeting by publishing the invitation on the company's website, two local newspapers and with using the new technical tools to communicate with shareholders.[1111] Furthermore, shareholders should be notified by the rules governing the meeting and the voting procedures, they must be empowered to raise

[1105]OECD Principles of Corprate Governance of 2004, Principle No (v).
[1106]Technical Committee of the International Organization of Securities Commissions, 'Protection of Minority Shareholders in Listed Issuers', (2009), p 15.
[1107]ibid.
[1108]OECD Principle of Corporate Governance of 2004, Principle No (v).
[1109]Technical Committee of the International Organisation of Securities Commissions Report, *Protection of Minority Shareholders in Listed Issuers* (2009) 16.
[1110]Art (40-48) Saudi CML; Art (8-9) Saudi CGRs.
[1111]Art (5-c) Saudi CGRs.

any questions to the board or to the external editor and their questions should be answered.[1112] Although this article gave shareholders the right to rise any question in general meeting. However, it dose not give them the right to place an agenda as previously mentioned in section of 5.3.5.2.

5.3.6 Property Rights of Minority Shareholders

It is logical to say that shareholders invest their funds in companies because they need to increase their returns and profits. Property rights are not less important than the management rights in the course of protecting minority shareholders. This section focuses on discussing dividend rights and preserving shareholders' ownership as essential elements of corporate governance mechanisms in both the UK and the Saudi Arabian system.

5.3.6.1 Dividend Rights

The main objective of investing in securities markets is to maximize the value of the shares and increase revenue in the form of dividends. Dividend policy was a crucial factor that led to the agency theory problem or the so-called conflict of interests between owners and managers. Thus, placing a good policy to distribute revenues and dividends fairly is deemed a fundamental element in effective application of corporate governance. Generally, corporate dividend policy always depends on the discretion of the company's board of directors, unless the Articles of association state otherwise.[1113] According to the OECD Principles of Corporate Governance, the right of shareholders to share in the profits of the company is a basic shareholder's right.[1114] Some countries, such as the UK, believe that shareholders should not decide on profit distribution policy[1115] and that this is the duty of the board of directors. As a result, in the UK, shareholders solely have the right to agree on the proposals of the board. Shareholders can participate to reduce the dividends proposed but they cannot increase it or insist on a distribution if the company management decides to retain profits for investments.[1116] Under the UK system, there is no commitment on the directors to announce dividends even if the company is profitable.[1117]

[1112]Ibid art (5-d-e-g).
[1113]Sec (170-a) U.S Delaware General Corporation Law.
[1114]OECD Principle of Corporate Governance of 2004.
[1115]O. Fremond and M. Capaul, *The State of Corporate Governance: Experience from Country Assessments* (World Bank Policy Research Working Paper 2858, 2002) 28.
[1116]ibid.
[1117]Johnathan Korchak, 'what rights do shareholders have?', (2014), Online Company Records Management. It is available at: www.informdirect.co.uk/shares-shareholders-rights-guide.

In fact, the right of dividends is an economic right and should be subjected exclusively to the resolution of the company's management. By contrast, the above situation is different in other countries. For instance, in some European countries such as Germany and France, the shareholders' general meeting is to declare a dividend distribution and impose it on the board of directors, based on the company's annual financial report.[1118] This declaration should include the amount of dividend distribution to shareholders, the amount of profit reserves and any amount of profits that would be carried forward.[1119]

In Saudi Arabia, the CGRs have clearly stated that shareholders should be accorded all the rights attached to the share, including their right to a share of the distributable profits or dividends.[1120] Under the Saudi law, both the board of directors and the general assembly are allowed to distribute dividends.[1121] The board of directors is responsible for setting out a clear policy concerning the distribution of dividends, in a way that will promote the interests of the shareholders and the firm. The shareholders should be informed regarding the dividends policy at the general meeting.[1122] Thereafter, the general assembly should approve the dividends and the specified date of distribution. The dividends are considered a genuine right to shareholders listed in the depositary centre and thus must be divided among the shareholders, whether in cash or bonus shares.[1123]

The above discussion concerns protecting shareholders' rights concerning the right for dividends and it has shown that the law has addressed this issue in different ways. However, the treatment of the right of minority shareholders in this regard is still vague. As is well-known, minority shareholders are not able to control the board of directors or the general meeting and the controlling shareholders or majority shareholders will pass decisions that serve and benefit their own interests. As a result, it has been argued that the Saudi CGRs would do better for minority shareholders if they regulated and placed a clear way for the distribution of dividends to the shareholders.[1124]

[1118]Sec 119(2) German Stock Corporation Act of 2009.
[1119]ibid sec 175(2).
[1120]Art (3) Saudi CGRs.
[1121]Ibid art (7-a-b).
[1122]ibid.
[1123]ibid.
[1124]S. Yahya, *The Summary of the Saudi Arabian Commercial System* (Arabic edition, The Bureau of Modern Arab, Alexandria, 2004) 255.

5.3.6.2 The Right to Safeguard Shareholdings' Ownership Registration

Among the problems facing minority shareholders, is ownership registration in joint-stock companies. Thus, in many cases, shareholders have found that either their shares had not been registered or they noticed that the numbers of shares issued by the company exceeded the total shares registered in shareholders' records, due to defects in the system that may have led to double booking by brokers.[1125] According to the OECD Principles, listed companies that operate in stock markets should register the records of shareholders either by themselves or through agents (custodies and intermediaries), and therefore all listed companies and their agents are responsible to register such shares in the shareholders' records.

Property rights protection starts with assuring all shareholders that their equities are registered in the company's book. According to this principle, security laws should spell out the listing rules, whereas the company law should require all joint-stock corporations to maintain a register of their shareholders. In fact, the OECD Principles of Corporate Governance have emphasized the importance of shares registration because there have been many cases of illegal changing of share registration, from common to preferred, so as to prohibit shareholders exercising their voting rights.[1126]

Given the importance of this principle, the Saudi Capital Authority (CMA) has affirmed this standard within its regulations in order to reinforce confidence in the stock market, and the Saudi economy in general. The CML allows for the creation of the Securities Depository Centre to carry out the transactions of deposits, transfers, settlements and clearing and registering of the ownership of securities traded on the stock exchange.[1127] Furthermore, the Saudi regulator has issued the listing rules which are responsible for setting out the rules of share ownership registration.

5.3.7 Judicial Rights and Civil Litigation under the Saudi Legal System

Enabling minority shareholders to file lawsuits against directors' misconduct is not only useful to the company itself but also helps to improve the application of corporate governance by preventing potential violations. From the outset, the OECD Principles of Corporate Governance have clearly stated that 'minority shareholders should be protected from abusive

[1125]OECD Principles, *Methodology for Assessing the Implementation of the OECD Principles of Corporate Governance* (OECD, 2007) p 36.
[1126]S. Nestor and F. Jesover, *OECD Principles of Corporate Governance on Shareholders rights and Equitable Treatment: Their Relevance to the Russian Federation* (2000) 4.
[1127]Art (26-27) Saudi CML.

actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress'.[1128]

Giving minority shareholders the opportunity to litigate the board of directors is seen as a substantial remedy and one of the most significant rights of shareholders. Nonetheless, the efficiency and merit of prosecuting tools have been questioned. Romano affirmed that shareholders' lawsuits in listed corporations occur frequently but these litigations are always resolved by agreement with no monetary compensations.[1129] As previously indicated, the derivative action lawsuit is prevalent in the UK legal system. To empower shareholders to claim and protect their rights, this tool gives shareholders the right to challenge the board members before the courts 'expropriation in the courts'.[1130] A derivative lawsuit is usually brought by a group of shareholders on behalf of the company, to hold the company board liable for their wrongdoings. Derivative action incurs high costs and may take a long time and effort. Besides, there is no proof that derivative action can prevent the violations of the board members.[1131] Nevertheless, derivative action is considered a significant weapon used by the minority shareholders to exercise their judicial right against abuse of board members and controlling shareholders.

In fact, derivative action lawsuits are not commonly recognized under the litigation system in Saudi Arabia in general, and in the securities market particular. However, the Company Law (CL) and the Capital Market Law (CML) have included certain provisions which are quite similar to the provisions of derivative action under the UK legal system. Under the provisions of civil liability, the Saudi laws grant the aggrieved shareholder the right to bring legal action against offending directors whose actions have damage his interests. The right of shareholders to litigate the board members has to pass two main stages.

The first stage is associated with the SCL as it asserts that every shareholder shall have the right to bring an action in liability cases against the board members, on behalf of the company when their interests are harmed by directors' wrongful acts.[1132] However, the main issue is that the right of shareholder to exercise his or her right in litigation of the board members, is restricted to specific circumstances, namely 1) shareholders cannot file such

[1128]OECD Principles of Corporate Governance, *The Equitable Treatment of Shareholders* (2004) Principle III-A-2.
[1129]R. Romano, 'The Shareholders Suit: Litigation without Foundation' (1991) The Journal of Law, Economic and Organization, vol 7, no 1, pp 55-84.
[1130]S. Djankov et al., 'The Law and Economics of Self-Dealing' (2008) Journal of Financial Economics, vol 88, p 430.
[1131]R. Romano, "The Shareholders Suit: Litigation without Foundation", (1991) The Journal of Law, Economic and Organization, vol. 7, no. 1, pp.55-84.
[1132]Art (78) Saudi CL.

legal action unless the company's right is still valid and after notifying the company by his/her intention to do so; 2) a violation of directors should damage shareholders' interests precisely; 3) aggrieved shareholders are not allowed to bring claims against directors if the company intends to prosecute wrongs made by the directors.[1133] In reality, analyzing Article 78 of the SCL has shown that the fate of minority shareholders' rights depends on the majority shareholders' decisions, who dominate the general assembly. The meaning of this Article suggests that the controlling shareholders legally act as judges in their own cases. The current Saudi Company Law, instead of providing legal assistance, directives, and guidance for protection of minority shareholders, has indeed, made things difficult for minority shareholders and supported the dominance of majority shareholders in the company's affairs. It has been argued that this law has not identified appropriate remedies for minority shareholders when their rights have been damaged or expropriated due to mismanagement or abuse of majority shareholders.[1134]

The second stage came into force following the enactment of the Capital Market Law in 2003. In order to strengthen the position of shareholders and protect their rights in the Saudi securities market, the CML clearly established the Committees for the Resolution of Securities Disputes as a private competent court, on the issues of the stock market.[1135] Importantly, the CML has given these committees the power to prevent the abuse of directors and controlling shareholders. As a result, when board members plead guilty, the CRSD has jurisdiction to impose a bundle of punishments against violators, including sanctions, imprisonment, expropriating property, issuing travel bans and suspending the board member(s) from dealings with the companies for a specific period of time.[1136] Indeed, the Saudi regulator has enacted a bundle of proceedings that endeavour to ensure equitable remedy is provided on all shareholders' issues. However, there are some obstacles that may contribute considerably to impeding minority shareholders to sue the board members. Among others, the SCL has given majority shareholders the right to relieve the members of boards from liability suits.[1137] Legally, the general assembly has the right to terminate civil liability against the board members, with the exception of the case of fraud.[1138]

[1133]ibid.
[1134] M. H. Almadani, *The Reform of Minority Shareholder Protection in Saudi Arabia and Dubai in Private Companies* (The University of Leeds, School of Law, 2011) 109.
[1135]Art (25) Saudi CML.
[1136]ibid art (59-a).
[1137]ibid art (76).
[1138]ibid.

Consequently, the SCL gives majority shareholders an absolute right to relieve the directors of their accountability. However, this rule is not justified and perhaps may contain some form of oppression and abuse against the protection of minority shareholders' rights. The reason is that the resolution of exemption of the directors may build upon the courtesy or the mutual interests of the controlling shareholders and the board of directors, especially in family-listed companies which are characterized by an overlap between ownership, management and the boards of directors. Furthermore, there is a disagreement between the provisions of the SCL and the CML concerning the period of time for hearing a complaint against the board members. For instance, the SCL states that any claim made against directors should not be heard after a lapse of three years, from the date of detection of the harmful act.[1139] In contrast, the CML stipulates that:

> A suit under Articles 55, 56 and 57 of this Law shall not be heard if the complaint is filed with the authority after the lapse of one year from the date when the claimant should reasonably have been aware of facts causing him to believe he had been the victim of a violation, and in no case may such complaint be heard by the Committee after five years from the occurrence of the violation subject of the claim.[1140]

The above clause affirmed that the CML has placed further obstacles before minority shareholders to litigate directors, as the period of time to hear the shareholders' complaint is limited to one year from the date of commission of the act. Therefore, this period is shorter than that provided under the SCL.

In addition, one of the most significant differences between the CML and the SCL is that the latter stated that the company's shares should be deposited in one of the banks selected by the Ministry of Commerce and Industry (MOCI), within 30 days following the appointment of the board members. They should be placed aside until all pending lawsuits against the board member have been heard, or judgement reached on the matter.[1141] Nonetheless, the problem is that this requirement is no longer included in the provisions made by the CML and the Corporate Governance Regulations (CGRs).

As far as the Saudi judicial system is concerned, there are controversies regarding which judicial authority has jurisdiction to handle disputes between minority shareholders and the

[1139] ibid.
[1140] ibid art (58).
[1141] Art (68) Saudi CL.

company executives or management. In fact, ambiguities and unclear judicial procedures have been identified as major problems facing minority shareholders in the Saudi stock market. The SCL and the CGRs made provisions for the rights of shareholders to file a claim against violators but did not specify which court has the jurisdiction to hear such claims.[1142] A good example is the case of the Mohammed Al-Mojil Group (MAG) in which the Saudi legal scholars and lawyers were not able to determine the competent court. Some of them argued that the Board of Grievances (BG) was the competent body to deal with the case, while others argued that the Committee for Resolution of Securities Disputes (CRSD) was the appropriate body to adjudicate in that case.[1143]

5.4 Chapter Summary

Chapter 5 analysed and compared share ownership structures, boards of directors and their duties, transparency and disclosure requirements and the basic rights of shareholders in the UK and the Saudi Arabian capital market. The analysis revealed that even though the internal structures of corporate governance are fundamentally distinct in these two jurisdictions, they share some similarities in some aspects. These similarities and differences have important implications for possible legal transplants, proposed in the next chapter. Specifically, Saudi Arabian corporate governance has partially been influenced by the common law model (the UK and the US experience), particularly in terms of the formation of boards of directors, the rights of shareholders and disclosure requirements. In terms of ownership structure, the analysis revealed differences across the two jurisdictions. Specifically, the ownership structure in the UK is assumed to be dispersed. In other words, the market is characterised by a diversification of shareholders and an enhancing role of the board of directors. Similarly, the gradual disappearance of controlling family ownership has seen a surge in institutional ownership, which has characterised the UK capital market to date. In Saudi Arabia on the other hand, ownership structure is assumed to be concentrated. Specifically, the Saudi market is working under the control and dominance of two types of investors, namely family and government-owned corporations. Importantly, this concentrated ownership has a grave impact on the Saudi capital market, especially as the wealthy families continue to boost their investment and dominate the decision-making processes of corporations, thus creating room for expropriation of the rights of the minority shareholders, who are prone to threat.

[1142]For more insight review Art (77&78) Company Law of 1965 and Art (3) Corporate Governance Regulations 2006.
[1143]M. Garoub, *Al-Mojil's Shareholders have the Right to Sue the Company's Board of Directors* (Aleqtisadiah. No, 6930 on 01-10-2012). Available at: http://www.aleqt.com/2012/10/01/article_697652.html.

In terms of board composition, the analysis above showed that the two jurisdictions adopt similar board systems (of one-tier boards), otherwise known as unitary systems. This system is well-developed in the UK accompanied by effective legislations describing board appointments. However, in Saudi Arabia the composition of the board remains a serious issue in the country's capital market. As the analysis revealed, the Saudi government and the Saudi wealthy families are basic shareholders in most listed corporations and most of the boards of some of these corporations are still dominated by members selected by the State or rich families. The influence of the State and rich families in Saudi Arabia cannot be taken for granted. In fact, many chairmen of listed corporations are appointed by the decisions of the State or rich families without following the due process, as set out in the legislations. The impact that this arrangement has on the protection of the rights of minority shareholders however, cannot be underestimated.

Other areas of convergence between the two jurisdictions include duties of the boards (duty of care, loyalty and disclosure), board committees and the structure and types of boards. In terms of the duties of the chairman and the CEO, debate regarding whether the two should be combined or separated remains contentious in both jurisdiction. Although available legislations in both jurisdictions emphasize the need for the two to be separated, evidence suggests that the separation principle does not always work in practice and it has been violated on a number of occasions. Another important area examined in this chapter is the rights of minority shareholders. As can be seen from the analysis, several rights of minority shareholders' protection are recognised in both jurisdictions, thus complying with the framework of good corporate governance suggested by the OECD. With the concentrated ownership model still prevalent in Saudi market, minority shareholders may not have the power to exercise their rights despite provisions of legislation to challenge violations of those rights.

Taken together, it appears that the UK corporate governance system may serve as a good reference point to improve Saudi Arabian corporate governance. Importantly, given the sound legal systems in place to enforce the implementation of internal corporate governance structures, there is a possibility that the Saudi capital market will benefit from legal transplants from the UK. This proposal is discussed in more detail in the next chapter.

Chapter 6

Conclusions

6.1 Introduction

The purpose of the present thesis was to explore the influence of corporate governance on the protection of rights of minority shareholders in UK and Saudi Arabian listed firms. A comparative law approach was used to analyse the differences and similarities in corporate governance and minority shareholders' protection in the UK and Saudi Arabia. Both internal and external resources were also adopted to understand the mechanisms of minority shareholders' protection in both jurisdictions. The results from the analysis revealed three key findings: (1) corporate governance practice in the two countries reflects some elements of universal standards but with slight variations (2) the concentrated pattern of ownership and the predominant influence of the State and family shareholdings in Saudi Arabia has a negative effect on the protection of the rights of minority shareholders (3) the Saudi security market has a legal system that is characterised by weak protection of the rights of minority shareholders. Each of these findings is discussed below, thus furthering our understanding of the influence of corporate governance on the protection of the rights of minority shareholders in Saudi Arabia and UK listed family firms. The implications of the findings, as well as the practical and academic contribution of the present thesis, are provided. The chapter is concluded highlighting the limitations of the study as well as suggestions for future research.

6.2 Key Findings

6.2.1 Evidence for Global Corporate Governance Standards in the UK and Saudi Arabia

Chapter 5 explored the mechanisms of protecting minority shareholders' rights in Saudi Arabia compared with the UK. The analysis revealed that the features of the internal structure of corporate governance in the two jurisdictions reflected some elements of compliance with the global universal standards of corporate governance. As stated in Chapter 2 of this thesis, the OECD Principles of Corporate Governance is recognized as the global standard of 'good corporate governance', which provides that:

> Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate

> governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.[1144]

As revealed in the above provisions, good corporate governance requires adequate provision of internal structures, which determine the means of attaining the objectives of the company and monitoring its performance. Examples of these internal structures include ownership structure, the board of directors, transparency/disclosure requirements and basic shareholders' rights. The evidence provided in Chapter 5 shows that the two jurisdictions have well-defined ownership structures but with slight variations. For instance, the UK corporate governance system is characterised by a dispersed ownership structure (the separation between ownership and control). Specifically, share ownership in the UK is widely-held and dominated by institutional shareholders with limited significance of family ownership.[1145] The widely-held firms provide shareholders with little choice in terms of control structure. Only 4% of firms in the FTSE 100 fall below the de fact control heading and 3% under legal control.[1146] For example, Nenova found that private control benefits in the UK equal to only about 10.6% of market capitalisations of the firms concerned.[1147] Similarly, a survey by Dyck and Zingales revealed a substantially lower control premium of 2%.[1148]

According to the OECD principles of corporate governance, the exercise of ownership rights by all shareholders, including institutional investors should be facilitated.[1149] In keeping with this principle, the UK Cadbury Report provides that 'given the weight of their votes, the way institutional investors use their power is of fundamental importance'.[1150] Similarly, the Greenbury Report of 1995 stated that 'investor institutions should use their power and influence to ensure best practice as set out in the Code'. While, according to the 1998 Hampel Report 'institutional investors have a responsibility to make considered use of their votes'.[1151] The Newbold Inquiry of 1999 recommended 'regular considered voting should be regarded

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[1144]OECD Principle of Corporate Governance 2004, p 11.
[1145]T. Khan, *Company Dividends and Ownership Structure: Evidence from UK Panel Data* (Workshop at Nuffield College, Oxford, 2005) pp 1-8.
[1146]J. Grant and T. Kirchmaier, *Corporate Ownership Structure and Performance in Europe* (CEP Discussion Paper No 631, The Centre for Economic Performance, 2004) 16.
[1147]T. Nenova, 'the value of corporate voting rights and control: A cross-country analysis' (2003) Journal of Financial Economics, vol 68, p 341.
[1148]A. Dyck and L. Zingales, 'Private Benefits of Control: An International Comparison' (2004) Journal of Finance, pp 537-601; J. Grant and T. Kirchmaier, *Corporate Ownership Structure and Performance in Europe* (CEP Discussion Paper No 631, The Centre for Economic Performance, 2004) p 28.
[1149]OECD Principles of Corporate Governance 2007, Principle No, (II-f).
[1150]Cadbury Report of Corporate Governance (1992).
[1151]Hampel Report on Corporate Governance (1998); Greenbury Recommendations of Corporate Governance (1995).

as a fiduciary responsibility' by trustees of pension funds.[1152] The evidence above suggests that the UK corporate governance system reflects global standard of corporate governance.

In terms of board systems, the findings also revealed that the UK corporate governance system is characterised by a one-tier board system. Specifically, the UK Company Act of 2006 recognised the importance of boards of directors to oversee the affairs of the corporation and went on to outline the obligations of directors as follows: 1) to act in accordance with the company's constitution (s.171); 2) to exercise independent judgment (s.173); 3) to exercise reasonable care, skill and diligence (s.174); 4) to avoid conflicts of interest (s.175); 5) to not accept benefits from third parties (s.176); 6) to declare interests in proposed transactions or arrangements (s.177). This again, demonstrates evidence of global standards of corporate governance. According to the OECD principles of corporate governance, the corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board and the board's accountability to the company and the shareholders.[1153] The principle also provides that board members should act on a fully-informed basis, in good faith, with due diligence and care and in the best interests of the company and shareholders.[1154] The UK Company Act of 2006 stipulated that directors of the company must exercise reasonable care, skill and diligence in the discharge of their duties, thus demonstrating compliance with the OECD principle.

Furthermore, the principle states that in order to guarantee good practice, the objective of the board and its independence from management may be strengthened by the separation of the role of the chief executive and the chairman, or, if these roles are combined, by designating a lead non-executive director to convene or chair sessions of the outside directors. The Combined Code of 2006, as well as the Cadbury Report of 1992, also advocated the importance of the separation of the role of chairman and the CEO. In terms of protection of the rights of minority shareholders, there is evidence to suggest that the UK complies with the global standard of corporate governance. According to the OECD, a corporate governance framework should facilitate the exercise of shareholders' rights, including the protection of minority shareholders. This provision is supported by the Company Act 2006 and the UK Corporate Governance Code of 2012. Other mechanisms of protection of minority shareholders (cumulative voting, derivative action and comply or explain) are also recognised by the UK security and capital market regulations. For instance, the 'comply or explain'

[1152]T. Khan, *Company Dividends and Ownership Structure: Evidence from UK Panel Data* (Workshop at Nuffield College, Oxford, 2005) 7.
[1153]OECD Principle of Corporate Governance of 2004, Principle No (vi).
[1154]ibid.

principle is the trademark of corporate governance in the UK, as emphasized in the Corporate Governance Code of 2012. The principle has been in operation since the Code's beginning and is widely admired, imitated and strongly supported by companies and shareholders.

The evidence above suggests that the UK corporate governance practice reflects global standard of good corporate governance, using the OECD principles as a criteria. In terms of Saudi Arabia, the analysis of the internal structures of corporate governance (ownership structure, boards of directors, transparency/disclosure requirements and basic shareholders rights) indicate evidence of a global standard of corporate governance.

Specifically, the Saudi Company Law of 1965 stated that each company must be managed by a board of directors and it must not have less than three members.[1155] The CL also gives the company's a bylaw to specify the size of the board.[1156] Similar to the UK system, the duties of the board are defined by the Saudi law. The Corporate Governance Regulations (CGRs) of 2006 state that the board of directors must, in the conduct of their business, carry out its duties in a responsible manner, in good faith and with due diligence.[1157] In Saudi Arabia, the board structure is quite similar to the single-board model operated in the UK system. The boardrooms of the Saudi listed corporations consist of both independent non-executive directors and executive directors. Specifically, the importance of separating the duties of non-executive directors and executive directors are increasingly being recognised as a crucial factor in reforming listed corporations in many jurisdictions. The importance of this proposal is reflected in the OECD Principles of Corporate Governance, which state that:

> Independent board members can contribute significantly to the decision-making of the board. They can bring an objective view to the evaluation of the performance of the board and management. In addition, they can play an important role in areas where the interests of management, the company and its shareholders may diverge such as executive remuneration, succession planning, changes of corporate control, take-over defences, large acquisition and the audit function.[1158]

[1155]Art (66) Saudi CL.
[1156]ibid.
[1157]Art (11-c) Saudi CGRs.
[1158]OECD Principles of Corporate Governance (1999) 64.

In fact, both UK and Saudi legislations recognise the importance of the above principle. For instance, the UK Combined Code of Corporate Governance 2006 provides that:

> Non-executive directors should constructively challenge and help develop proposal on strategy. Non-executive directors should scrutinize the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible.[1159]

Similarly, the Saudi Arabian Corporate Governance Regulations of 2006 also emphasized the need to appoint independent, non-executive members of the board who should enjoy complete independence. Indeed, it appears that the internal structures of corporate governance in both the UK and Saudi Arabia reflect the global standard of corporate governance. Although as Salacuse posited, the features of the internal structure of corporate governance differed from one country to another due to differences in legal structure, political status and cultural setting.[1160] Specifically, these differences are reflected not just in terms of legal structure, political status and cultural settings but also in terms of enforcement and implementations of the internal corporate governance mechanisms. As previously discussed in Chapter 5, both jurisdictions differ greatly in terms of the strengths and weaknesses of corporate governance legislations. Importantly, analysing these differences provided some insights as to whether the Saudi listed corporations efficiently comply with the corporate governance regulations and also whether the current practice of the corporate governance in the Saudi stock market reflects appropriate protection of minority shareholders' rights.

6.2.2 Evidence for the Influence of Ownership Structure on the Protection of the Rights of Minority Shareholders in Saudi Arabia

As stated in Chapter 5 of this thesis, ownership structure in Saudi Arabia is characterised by concentrated ownership. Specifically, unlike the UK securities market, the Saudi market is working under the control and dominance of two types of investors, namely family-owned corporations and government-owned corporations. The findings revealed that in Saudi

[1159]Para, A.1. U.K Combined Code 2006.
[1160]J. Salacuse, 'Corporate Governance in the New Century' (2004) Company Lawyer, vol 25, pp 76-78.

Arabia, as in other civil law countries, the majority shareholders, who usually own a greater number of equities, exercise their power and influence upon the company's management and its board of directors. This situation often weakens the rights of minority shareholders, especially their right of involvement in the company's decision-making and the election of the board of directors. In fact, the dominance of ownership concentration in the Saudi market is attributed to a number of factors, which are mainly political and legal. Saudi Arabia as a country is characterized by absolute monarchy, and indeed the nature of the political system has a large impact on the life of its trade and economy.[1161]

According to the political perspective, the less democratic a State is weaken minority shareholder protection and is the more likely it is to have concentrated patterns of ownership.[1162] From the perspective of the political economic theory, Gourevitch and Shinn argued that investors' confidence is a function of political transparency and firm-level transparency.[1163] Indeed, it is not a surprise to see a high concentration of shares in the hands of a few powerful individuals particularly in the developing countries. These individuals, especially from small wealthy families, own large percentages of stocks, not just in one company, but in several listed corporations in the stock market. Such a tendency is a ubiquitous phenomenon in the Saudi stock market, characterised by a high ownership of shares by wealthy families, who thus control the market in ways that are detrimental to minority shareholders. Previous research has earlier shown that a concentrated ownership structure empowers the controlling shareholders to expropriate minority shareholders' rights.[1164] The high concentration of ownership in Saudi Arabia is also explained from a legal point of view. According to the law matter theory, the legal origin of a country has a strong influence in shaping the ownership structure of companies, as well as the design of shareholder protection.[1165]

Indeed, the Saudi legal system is considerably influenced by the civil law model, in particular the French legal system. Since the outset, most Saudi laws have been influenced by the principles of the civil law model more than the common law model, particularly in relation to

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[1161]P. Gourevitch and J. Shinn, *Political Power and Corporate Control: the New Global Politics of Corporate Governance* (Princeton University Press, Princeton, 2007) 80-81, in F. Almajid, *A Conceptual Framework of Reforming the Corporate Governance of Saudi Publicly Held Companies: Comparative and Analytical Study from a Legal Perspective* (School of Law, University of Manchester, 2008) 208.
[1162]ibid.
[1163]ibid.
[1164]R. La Porta, et al. 'Investor protection and corporate Governance' (2007) Journal of Financial Economics, vol 58, pp 3-27.
[1165]R. La Porta et al., 'Law and Finance.' (1998) Journal of Political Economy, vol 106, pp 1151-1152.

commercial and administrative laws.[1166] Therefore, if the assumptions of the law matter theory are true, then this would tentatively suggest that expropriation of minority shareholders by the family and state-owned shareholdings in Saudi Arabia is inevitable. However, the legal and political explanations of the divergence of shareholding structures amongst different corporate governance systems have been heavily criticised in the literature. For example, Coffee argued that neither explanation provides sufficient reasons for the different ownership arrangements of corporate governance systems.[1167] He attributed differences in ownership structure between common and civil law countries to the ways in which their financial markets have developed over time, rather than to their legal heritage.[1168]

This explanation is plausible when one looks critically at the situation in the Saudi stock market. Since its establishment in 1984, the market has been characterised as underdeveloped. However, following the introduction of the Electronic Securities Information System (ESIS) in 1990 by the SAMA, the market gradually began to flourish.[1169] Even though the introduction of ESIS was seen by many as a significant landmark in the history of the Saudi market, especially to facilitate the operations of the stock market by making it more attractive to potential investors, the market was greeted with a low turnout.[1170] This in turn, suggests that other factors such as high trading costs for small investors were perhaps responsible for the low turnout.[1171] Importantly, the role of banks during the transformation of the Saudi stock market deserved special mention. They were accused of favouring the big investors to the detriment of the minority investors. Specifically, as the sole stockbrokers, they tended to favour large investors by lowering the executive costs on their trading, which in turn allowed them to own large stakes in the companies they invested in.[1172]

[1166]Hanson, 'The Influence of French Law on the Legal Development of Saudi Arabia' (1987) Arab Law Quarterly, vol 2, pp 283-291.
[1167]J. C. Coffee, 'The Rise of Dispersed Ownership: The Role of Law and the State in the Separation of Ownership and Control' (2001) The Yale Law Journal, vol 111, no 1, pp 4-82.
[1168]ibid.
[1169]F. Almajid, *A Conceptual Framework of Reforming the Corporate Governance of Saudi Publicly Held Companies: Comparative and Analytical Study from a Legal Perspective* (School of Law, University of Manchester, 2008) 216.
[1170]A. Awwad, *Legal Regulation of the Saudi Stock Market: Evaluation and Prospect for Reforms* (University of Warwick, 2000).
[1171]H.Azzam, *The Emerging Arab Capital Markets: Investment Opportunities in Relatively Underplayed Markets* (Kegan Paul International, London, 1997).
[1172]A. Awwad, *Legal Regulation of the Saudi Stock Market: Evaluation and Prospect for Reforms* (University of Warwick, 2000).

The shareholder protection criteria suggested by La Porta et al has also been criticised. Specifically, Baums and Scott criticised the simplicity of the judgment (zero or one).[1173] Coffee also argued that:

> By no means is it here implied that these rights are unimportant, but only that they supply partial and sometimes easily outflanked safeguards, which have little to do with the protection of control and the entitlement to a control premium.[1174]

Cools also raised concern on the way La Porta et al overestimated the differences in shareholder protection, without due consideration to important aspects of company laws and their differences.[1175] He further attributed differences in ownership structures to fundamental distinctions between common and civil law, in the allocation of power in corporations.[1176] Different legal systems provide different methods of shareholder protection, which are hardly recognized in the evaluation of La Porta et al's theory.[1177] Braendle also questioned whether seven criteria are sufficient enough to evaluate shareholder protection. He also emphasized the need to consider different board structures, while judging shareholder protection.[1178] Importantly, common law countries, otherwise known as the Anglo-Saxon countries, apply one-tier or unitary board systems, whereas civil law countries are mainly characterised by two-tier boards, which separate management and supervisory boards. Therefore, it is likely that different board systems will illustrate different allocations of power within corporations.

In fact, the concentration of ownership among State and family-listed corporations in the Saudi capital market has indeed, created an agency problem. However, this agency problem is not in the form of diverged interests between the management of the firms and their shareholders but instead it represents a conflict of interest between the majority shareholders (family and State-owned shareholdings) and minority shareholders (investing public). A demonstration of the way in which majority shareholders can expropriate minority shareholders in Saudi listed firms is illustrated in the two interrelated issues below. The first

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[1173]T. Baums and K. Scott, *Taking Shareholder Protection Seriously?, Corporate Governance in the United States and Germany* (Stan. L. Sch., Working Paper No. 272, 2003).
[1174]J. C. Coffee, 'The Rise of Dispersed Ownership: The Role of Law and the State in the Separation of Ownership and Control' (2001) The Yale Law Journal, vol 111, no 1, p 4.
[1175]S. Cools, *The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers* (Harvard Law & Economics. Discussion Paper No. 490, 2004)).
[1176]ibid.
[1177]U.C. Braendle, Shareholder Protection in the USA and Germany 'Law and Finance' Revisited (2005) German Law Journal, vol 7, no 3.
[1178]ibid.

issue is the close relationship between ownership structure and board appointments. In Saudi Arabia, it is a ubiquitous practice to see a direct presence of controlling individuals in the management of the firm, though not always (but often) as members of the top management team, which gives them considerable power and influence over these corporations. As a result, the main conflict of interest manifests in terms of the expropriation of minority shareholders by the controlling shareholders, rather than the usual conflicts of interest (between managers and shareholders) that characterised the agency theory problem.

Specifically, the highly concentrated ownership enables the Saudi founders or families to interfere in the decision-making of the company's board and to exercise their power in the selection of board members. The literature showed that 1/3 of Saudi listed corporations have at least two directors from the same family, and 20% of the board members also belong to the same family.[1179] Similarly, the analysis from Chapter 5 showed that the influence of the Saudi government on the securities market is visible in that most chairmen and CEOs of government-listed corporations are appointed based on the decisions of the government. Also, the election and dismissal of board members are only subjected to approval of the government.[1180] Indeed, electing members of the board by controlling shareholders is still a common practice in the Saudi securities market[1181] and many chairmen of listed corporations are appointed by the decisions of the State or rich families, without following the due legal procedures, as set out in the capital market laws and regulations. For instance, a high percentage of members of the boards of the State-controlled corporations in the Saudi securities market, such as SABIC, STC, the Alinma Bank, the Riyadh Bank, SAFCO, the Electricity Company, the MAADEN Company, the Petro Rabigh Company and others are selected by the Saudi government.[1182] In fact, the presence/influence of wealthy families is not only experienced in their firms' boardrooms but also in other corporations due to strong social ties.

The evidence above suggests that ownership arrangement in the Saudi stock market, especially in family-listed firms is likely to create agency conflict. Previous research has shown that family firms suffer from agency problems that are generic to other firms,

[1179]G. James, 'Learning from Family Failures' (2010) MEED: Commercial Banking, vol 54, no 25, pp 34-37.
[1180]F. Almajid, *A Conceptual Framework of Reforming the Corporate Governance of Saudi Publicly Held Companies: Comparative and Analytical Study from a Legal Perspective* (School of Law, University of Manchester, 2008) 213.
[1181]ibid.
[1182]Tadawul website. It is available at: http://www.tadawul.com.sa.

especially those that arise from the peculiar nature of the relationship between owners.[1183] The nepotism and favouritism that characterise the appointments of board members in the majority of the Saudi listed, family firms further exacerbate the agency conflict. Schulze et al had earlier demonstrated that altruism, prevalent in family firms, creates a host of agency conflicts that have negative consequences to the family firm.[1184] These agency conflicts can be summarised as follows: agency costs of monitoring agents who are also family members, agency costs of monitoring owners that are also members of the family and configurations of agency threats, where control mechanisms aggravate each other, exacerbating their effect on firm performance.[1185]

The second issue derives from the first issue, being the 'right to elect and dismiss a board of directors'. Appointment and rejection of board members are genuine rights given to minority shareholders in order to protect their interests against the abuse of controlling shareholders and directors. This right is affirmed in the OECD principles of corporate governance, which state that '… effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated'.[1186] This right is also recognised in Saudi Arabia, whereby the CGR provides that '...voting is deemed to be a fundamental right of a shareholder, which shall not, in any way, be denied'.[1187] However, it should be noted that despite the existence of these laws and regulations, there are several obstacles that hinder shareholders from exercising their right lawfully. Specifically, concentrated ownership in the hands of controlling shareholders, especially in family-listed corporations, is one of the key reasons that prevent minority shareholders from participating effectively in the election of boards of directors. This reason seems to fit well with the Saudi context. As previously mentioned, in Saudi Arabia most boards of family-listed companies are controlled and dominated by the same family members. Hence, the right to appoint and dismiss directors are subject to their decisions and discretions. A good example is the Al Khodari Company, which is a family-owned company (with about 60% share ownership) with its chairman and other board members (2/6) belonging to the same family.[1188]

[1183]P.M. De Holan and L.J. Sanz, 'Protected by the family? How closely held family firms protect minority shareholders' (2006) Journal of Business Research, vol 59, no 3, pp 356-259.
[1184]W.S. Schulze et al., 'Agency Relationships in Family Firms: Theory and Evidence' (2001) Organization Science, vol 12, no 2, pp 99-117.
[1185]ibid.
[1186]OECD Principles of Corporate Governance of 2004, Principle No, (II-c-3).
[1187]Art (6/a) Saudi CGRs.
[1188]Abdullah Al *Khodari* Company. Available at: http://www.alkhodari.com/organizational.html, accessed 8 October 2013.

Similarly, there is a problem with insider control. According to Tomasic and Andrews, the appointment of independent directors is viewed as a strong element of corporate governance and a panacea for insider control.[1189] The concentration of ownership in the hands of controlling shareholders (State and families) implies that there is a lack of effective external monitoring of the management of listed firms. In Saudi Arabia, the percentage of non-executive directors in the family-listed corporations is still small. Previous research suggests this is due to increased concentration of ownership in listed companies.[1190] The Capital Market Authority in Saudi Arabia identifies the independent members as 'members who enjoy a complete independence'. By implication, family members who are already acting as board members should not be allowed to act as non-executive directors. However, this is not the case in Saudi Arabia. The main problem lies in the way the Saudi Arabia Corporate Governance Regulations (CGRs) define non-executive directors. For instance, the Code defines the independent director as the director who has no first-degree relatives on the board, where relatives are identified as father, wife or husband and children.[1191] This means that brothers, sisters, uncles and cousins are excluded from this relationship. In a society like Saudi Arabia, the relationships between families are so strong and the firms still look like family businesses.[1192] Evidence showed that some firms in Saudi Arabia have more than two brothers sitting on the board of directors, or in the sub-committees, and they are described as independent members.[1193] From the perspective of the agency theory, a large presence of independent directors on the board can mitigate agency conflicts and thus, enhance board effectiveness and firm performance.[1194]

Indeed, given that members of one family dominate a board and its committees may affect the decision-making processes or perhaps lead to a conflict of interests. Furthermore, since the minority shareholders have the right to information, this could also lead to information asymmetry between the minority shareholders on the one hand, and majority shareholders on the other. Indeed, majority shareholders would have more information regarding the company's situation than their minority counterparts, which could facilitate their expropriation of the firm.

[1189]R. Tomasic and N. Andrews, Minority shareholder protection in China's top 100 listed firms. Available at: http://ssrn.com, 2007.
[1190]Abdullah Al *Khodari* Company. Available at: http://www.alkhodari.com/organizational.html, accessed 8 October 2013.
[1191]M.A. Ghabayen, 'Board characteristics and firm performance: case of Saudi Arabia' (2012) International Journal of Accounting and Financial Reporting, vol 2, no 2, pp 168-200.
[1192]ibid.
[1193]ibid.
[1194]D. Ramdani and V. Witteloosuijn, *Board independence, CEO duality and firm performance: A quintile regression analysis for Indonesia, Malaysia, South Korea and Thailand* (Working Papers 2009-004, University of Antwerp, Faculty of Applied Economics, 2009).

Taken together, the findings from this research showed that the volume of concentrated ownership in Saudi Arabia represents about 70% of the shareholdings structure in the Saudi securities market.[1195] Specifically, most listed corporations on the Saudi securities market are dominated by a relatively small network of prevalent Saudi families and business leaders. Remarkably, 1/3 of Saudi listed companies have more than two directors from the same family, and in other corporations 20% of the board members belong to the same family.[1196] In reality, controlling rich families on most listed companies on the Saudi securities market is a major problem facing minority shareholders. This is because a high concentration of ownership and control allow them to increase not only their wealth but also to exercise control over the management, the board of directors, the chairman and the CEO of the company. As a result, the rights of the minority shareholders would indeed, remain under the control of the majority shareholders, who control all the decisions-making processes of the corporation.

6.2.3 Evidence for Weak Legal Protection of the Rights of Minority Shareholders in Saudi Arabia

One of the research questions posed in Chapter 1 of this thesis is 'What is the role of the Saudi Arabian laws and regulations in protecting minority shareholders' rights?'. This question was examined in Chapter 3, which provided a review of legal and judicial authorities in relation to capital market operation in Saudi Arabia. The findings revealed that the Saudi Arabian government has enacted some laws to regulate the activities of the stock market and in particular, safeguard the rights of minority shareholders. La Porta et al have earlier asserted that one of the factors that affect the development of capital markets is the protection they offer to minority investors and its enforceability and the stability of these rules, or at least of the core of these rules.[1197] This is so because these rules determine, to a large extent, the propensity of outside investors to become minority shareholders in a firm controlled by someone else (or, in Adam Smith´s terms, 'other people´s money'), including families.[1198] Therefore, protecting the interests of minority shareholders is a gesture of good

[1195]W. Al-Ajlan, 'Ownership Patterns and the Saudi Market' (2004) Advances in Financial Economics, vol 9, pp 161-184.
[1196]G. James, 'Learning from Family Failures' (2010) MEED: Commercial Banking, vol 54, no 25, pp 34-37.
[1197]La Porta et al.,'Investor protection and corporate Governance' (2000) Journal of Financial Economics, vol 58, pp 3-27.
[1198]P.M. De Holan and L.J. Sanz, 'Protected by the family? How closely held family firms protect minority shareholders' (2006) Journal of Business Research, vol 59, no 3, pp 356-259.

health of a shareholder democracy and is fundamental in the corporate governance process.[1199]

According to the OECD principles of corporate governance, 'effective corporate governance requires a sound legal, regulatory and institutional framework that market participants can rely on when they establish their private contractual relations'.[1200] The principles also suggest that a sound legal structure should be in place to promote efficient and effective processes of corporate governance. Indeed, as noted in the OECD document, the confidence of minority investors is enhanced when the legal system provides mechanisms for minority shareholders to bring lawsuits when they have reasonable grounds to believe that their rights have been violated. Thus, if a violated right cannot be protected by the shareholder in front of coercive authorities (such as courts and security committees), the shareholder shall not enjoy effective and actual protection, even when he/she is protected by 'the right on the paper'.[1201]

Previous research has shown that the Saudi legal system has the most characteristics of systems with weak protection of shareholders.[1202] This, according to Almajid, is due to a number of factors which include: (1) a concentrated pattern of ownership shareholdings, (2) a strong existence of State and family corporate ownership, (3) an illiquid equity market, (4) debt finance-dominating equity finance.[1203] Almajid argued that the concentrated pattern of ownership and the predominant influence of the State and family shareholdings have resulted in a less liquid and less competitive stock market.[1204] A critical analysis of the rights of minority shareholders showed that these rights exist in theory but their enforcement remains a critical issue. For instance, the Saudi Corporate Governance Regulations (CGRs) recognise the right of minority shareholders to attend shareholders' general meetings. Specifically, the CGRs stipulate that a general meeting should be held once a year at least, within the six months of the end of the company's fiscal year.[1205] The board of directors should call for a general meeting following a request of either the auditor or a number of shareholders whose shares represent at least 5% of the company's shares capital,[1206] (although the CGRs are in line with international practices of corporate governance, particularly in terms of the

[1199]A. Saadouia and Y. Boujelbene, 'The impact of law on the protection of minority shareholders, concentration of ownership and information asymmetry' (2012) African Journal of Hospitality, Tourism and Leisure, vol 2, no 1, p 2.
[1200]OECD Principles of Corporate Governance 2004.
[1201]K. Dulic and T. Kuzman, 'Protection of rights of minority shareholders: legal framework and enforcement' (2012) Quarterly Monitor, no 30, pp 86-96.
[1202]F. Almajid, *A Conceptual Framework of Reforming the Corporate Governance of Saudi Publicly Held Companies: Comparative and Analytical Study from a Legal Perspective*" (School of Law, University of Manchester, 2008) 229.
[1203]ibid.
[1204]ibid.
[1205]Art (5-a) Saudi CL.
[1206]ibid.

percentage of shares required to call for an extraordinary meeting). Nonetheless, Article 5b) of the CGRs conflicts with the provisions of the CL, since the latter has given the shareholders, who own at least 20 shares, the right to attend and participate in the general assembly.[1207] This means that the provisions of the CL may provide good protection of minority shareholders against the abuse of the company's management and its board of directors.

However, there is no determined clause under the OECD Principles of Corporate Governance concerning 5% as a condition for the shareholders to exercise their rights in the general meetings. Specifically, this percentage may hinder the rights of shareholders to engage in general meetings, raise their opinions and perhaps oppose the effective application of sound corporate governance in the Saudi securities market. Article 83 also provides that if a shareholder is unable to attend, he can send an authorised representative to cast his vote at the meeting. The authorised representative, as Article 84 provides, must not be a member of the board of directors. The main problem is that these provisions have not explained or shown the form of a proxy, particularly in the case of absentee shareholders. In addition, there are no provisions regarding means of sending correspondence (especially for those who live in distant locations) or use new technology tools in the voting process. Unlike the UK legal system, which allows a shareholder to mail his proxy vote directly to the corporations without being there in person, shareholders under the Saudi legal system are not permitted. In fact, they are binding to attend in person or authorise someone to represent and vote on their behalf.[1208] Besides, Saudi listed companies are generally controlled by the majority shareholders (State and family) and it is almost impossible for minority shareholders to gain sufficient votes through proxies to overcome the power of the controlling shareholders. This in turn, suggests that the Saudi system makes it difficult for shareholders to vote, rather than encouraging the voting process. Therefore, preventing minority shareholders to cast their votes, either via a proxy or use of technology, weakens the protection of minority shareholders' rights in the Saudi securities market.

Available evidence also showed that different procedures may be used to decrease the effectiveness of shareholders' participation in general meetings, such as holding the shareholders' general meeting in a difficult location, voting by raising hands without the right to demand a poll, delaying the provision of basic information, allowing a limited number to

[1207]Ibid art (83).
[1208]F. Almajid, *A Conceptual Framework of Reforming the Corporate Governance of Saudi Publicly Held Companies: Comparative and Analytical Study from a Legal Perspective* (School of Law, University of Manchester, 2008) 232.

attend the general meetings, giving a period of notice that is below the legal minimum, and so on.[1209] The main issue that minority shareholders may face is that the company's management may display only issues that they want and disregard other significant matters.

Saudi Arabia has also adopted some principles, which derive from US law, including shareholders' rights to file proposals. Specifically, the US Exchange Act gives the shareholders who own equities, with the value of at least $2000 or at least hold 1% of the shares, the right to file proposals. However, whether such adopted rules will function in practice in Saudi Arabia and remains to be determined. For example, the majority of Saudi minority shareholders participate in the share market as speculators, not investors; they have no interest in putting shareholder proposals to a general meeting. Specifically, in Saudi Arabia, the right of participation in proposing the agenda in the general meeting is restricted only to shareholders who hold 5% of shares capital of the company. The CGRs have frankly stated that:

> In preparing the general assembly's agenda, the board of directors shall take into consideration matters, which the shareholders want to be listed in that agenda; shareholders holding not less than 5% of the company's shares are entitled to add one or more items to the agenda upon its preparation.[1210]

Indeed, this percentage is inconsistent with the sound practice of good corporate governance and can have a negative effect on the protection of minority shareholders' rights. In fact, the OECD Principles of Corporate Governance have not mentioned the 5% criteria in its document. Furthermore, the rights of minority shareholders to be involved in modifying the corporate charter, or any essential developments in the company's position, are weak in the Saudi markets. The findings showed that minority shareholders are usually oppressed by the controlling shareholders, especially when those amendments are being deliberated upon. The problem often occurs when the new controlling shareholders and management release new policies and strategies that significantly contradict the existing ones. These changes may have a negative impact on minority shareholders' rights and interests. For example, these changes may push minority shareholders to sell their equities in the company but at an unfavourable price because the new management and strategy may lower the share price.

[1209] Technical Committee of the International Organisation of Securities Commissions Report, *Protection of Minority Shareholders in Listed Issuers* (2009) 21.
[1210] Art (5-f) Saudi CGRs.

Apart from the provision of the rights of minority shareholders, the Saudi legal system also provides different mechanisms of shareholder protection (such as derivative action and cumulative voting). However, the enforcement of these mechanisms in the Saudi market is relatively weak. For instance, the CGRs have recognized the principle of cumulative voting as an original principle, which can support and give minority shareholders the opportunities to elect their representatives on the company's board. However, the findings showed that the cumulative voting process under the Saudi regulations is still optional instead of obligatory. Therefore, as previous research suggests, this mechanism is not a compulsory tool, particularly in publicly-listed companies.[1211] Besides, high ownership concentrations (especially in family-listed corporations) prevent minority shareholders from participating effectively in the election of boards of directors. As previously noted, in Saudi Arabia most boards of family-listed companies are controlled and dominated by the same family members. As a result, the right to appoint and dismiss directors is subject to their decisions and discretions. Similarly, minority shareholders in Saudi Arabia are allowed by law to bring derivative action against directors on behalf of the company, but this does not always work in practice.

The main issue is that the right of a shareholder to exercise his or her right in litigation of the board members is restricted to specific circumstances, namely 1) shareholders cannot file such legal action unless the company's right is still valid and after notifying the company by his/her intention to do so; 2) violation of directors should damage shareholders' interests precisely; 3) aggrieved shareholders are not allowed to bring claims against directors if the company intends to prosecute wrongs made by the directors.[1212] In reality, analyzing Article 78 of the SCL has shown that the fate of minority shareholders' rights will depend on the majority shareholders' decisions, who dominate the general assembly. The meaning of this Article suggests that the controlling shareholders legally act as judges in their own cases. The current SCL, instead of providing legal assistances, directives, guidance and suitable protection of minority shareholders, has indeed, made things difficult for minority shareholders and on the other hand, supported the dominance of majority shareholders in the company's affairs. Furthermore, it has also been argued that this law does not identify

[1211] A. R. Pinto and D. M. Branson, *Understanding corporate law* (LexisNexis Matthew Bender, 2004) p 165.
[1212] ibid.

appropriate remedies for minority shareholders, especially when their rights have been damaged or expropriated, due to mismanagement or abuse of majority shareholders.[1213]

Another important finding from this research is that in Saudi Arabia there is an absence of a specialised, commercial court to deal with security market issues, including those affecting minority shareholders. Currently, the Committee for the Resolution of Securities Disputes (CRSD) and the Appeal Committee for Resolution of Securities Conflicts (ACRSC) are responsible for adjudicating the issues of the securities market. The main challenge facing minority shareholders is that those committees are not subjected to the judicial courts, they are known as quasi-judicial committees, and hence they do not have a binding force to implement their decisions. Furthermore, the CRSD is subjected to the authority of the Capital Market Authority Board (CMAB), thus making it non-autonomous and impartial. Similarly, both the CRSD and the ACRSC are headquartered in Riyadh, which is the capital of Saudi Arabia. There are no branches of these committees in other Saudi Arabian cities. Thus, the lack of other judicial committees in other cities in Saudi Arabia remains a major dilemma for investors in general, particularly minority shareholders.

Taken together, it seems that the Saudi legal system provides some measures aimed at protecting the rights of minority shareholders, thus conforming to the standard of good corporate governance. However, these measures seem to work in theory rather than in practice. Indeed, the findings above seem to be supported by a wealth of anecdotal evidence and some academic research, which showed that whenever a locale does not have comprehensive protection of minority stakeholder rights, their interests tend to not be catered for, as much as they would in minority-friendly locations.[1214] The protection of minority shareholders' rights under the Saudi legal system is poor, ineffective and in need of improvement. As a general norm, shareholders' rights cannot be protected by the rule of 'the right on the paper'. A violated right cannot be protected without effective, judicial protection. Even if it is granted by an advanced legal system, it will remain meaningless. The existence of laws and the quality of their enforcement by regulatory bodies and courts are significant factors of both corporate governance and the financial system of a country.

[1213]M. H. Almadani, *The Reform of Minority Shareholder Protection in Saudi Arabia and Dubai in Private Companies* (The University of Leeds, School of Law, 2011) 109.
[1214]P.M. De Holan and L.J. Sanz, 'Protected by the family? How closely held family firms protect minority shareholders' (2006) Journal of Business Research, vol 59, no 3, pp 356-259.

6.3 Contribution of the Research

Specifically, the present thesis aims to provide insight into the influence of corporate governance on the protection of the rights of minority shareholders in Saudi Arabia, in comparison with the UK corporate governance system. In recent years, the study of corporate governance has become increasingly recognised in the Middle East and North African (MENA) regions. As a result, practitioners from the capital market including banks, private and public sectors and civil society alike, have accepted the need to address corporate governance issues as a means of increasing the investment climate and international competitiveness in the global economy. Indeed, there is a dearth of literature in the MENA region in general and particularly in Saudi Arabia. These developments alongside others, were the primary motive for embarking on this research. Therefore, the findings from this research have important implications for understanding the role of corporate governance in protecting the rights of minority shareholders in Saudi Arabia. Specifically, the findings will contribute to the literature on corporate governance and shed light to understanding the role of concentrated share ownership, especially family owners, in the protection of rights of minority investors.

As corporate governance practice is gradually developing in the Kingdom, the findings from this thesis highlight those internal and external mechanisms of corporate governance, including the barriers facing their successful implementation. By so doing, practitioners and policy makers alike will be fully informed on the ways to improve corporate governance standards in the Kingdom, especially regarding the investment climate, market regulations and shareholder democracy. Furthermore, the findings from this thesis have important implications for legal education, especially in understanding the role of laws and regulations in the protection of the rights of minority shareholders in Saudi Arabia. Importantly, the analysis of the legal structures, capital market laws and corporate governance codes/regulations have theoretical implications for a number of academic debates, including the debate as to whether law matters in economic development as La Porta et al would claim.[1215] Therefore, the present thesis makes a useful contribution to understanding the development of law and policy in Saudi Arabia, especially as it relates to minority shareholders' protection. Perhaps this knowledge may likely benefit future capital market law reforms in Saudi Arabia. Also, the research findings can sereve as a reformative tool for improving the market in the Arab Gulf States GCC.

[1215] R. La Porta et al., 'Law and Finance.' (1998) Journal of Political Economy 106, pp 1151-1152.

6.4 Corporate Governance and Protection of Minority Shareholders Enhancing Saudi Laws

This thesis has chiefly relied on describing and comparing the statutory protection of minority shareholders under the UK and Saudi Arabian legal systems. A comparative and analytical study is a substantial approach in legal studies; it allows countries to benefit from other countries, which have more advanced legal experiences. In fact, the effectiveness of a legal transplant is still a subject of controversy amongst legal researchers. Those in support of legal transplants, particularly Watson, believe that 'transplanting is, in fact, the most fertile source of development. Most changes in most systems are the result of borrowing'.[1216] Friedman endorsed this orientation and assumed that the legal transplant is a beneficial method to reform the local laws. It helps local regulators to borrow laws that will assist them to reshape local laws and harmonize them with the local situation.[1217] However, opponents argued that legal transplants may not be successful because every law is culturally determined.[1218]

Despite these opposing views, the comparative approach is beneficial in that it enables researchers to appraise existing laws from the regional and global perspectives in order to find a means of addressing the weaknesses in their local legal systems. Corporate governance has been one of the significant subjects in comparative studies across the world. The notion of the corporate governance system is made up of both internal and external structures. Politics, laws, rules, values, cultures and other constituents in any State play a crucial role in developing and improving corporate governance systems.

In fact, the concept of corporate governance is no longer restricted to the advanced economies, it is now been embraced by developing and emerging countries alike. Nowadays, each country is attempting to reform its legal system and economic environment in order to strengthen its financial stability and attract foreign investment. Indeed, reforming local corporate governance practice requires an input from the advanced models of corporate governance. All countries pursue two famous corporate governance models, namely the Anglo-Saxon model (the UK system is an example) and the intercontinental European model (the Germany system is an example). Most studies view the US and the UK models as

[1216] A. Watson, *Legal Transplants: An Approach to Comparative Literature* (2nd edition, University of Georgia Press, 1993).
[1217] L. M. Friedman, *Adapting Legal Cultures: Some Comments on Cotterrell and Legal Transplants* (edited by David Nelken& Johannes Feest, New York, Section 4, 2001) 93-98.
[1218] P. Legrand, *What Legal Transplants? In Adapting Legal Cultures* (edited by J. Feest and D. Nelken. Oxford: Hart, 2001).

'panacea par excellence', when it comes to reforming a corporate governance system and providing good protection for minority shareholders.

This research is based on the critical and comparative analysis to evaluate the effectiveness of the corporate governance system in protecting minority shareholders in the Saudi securities market. The OECD principles of Corporate Governance and the UK corporate governance system have been used as a benchmark in recommending ways of addressing the weaknesses and shortcomings in relation to the issue of protecting minority shareholders' rights in Saudi Arabia.

6.5 Recommendations

In the discussion that follows, an examination of ways to improve the Saudi legal system in relation to capital market operations is provided. As far as protection of minority shareholders' rights is concerned, it is obvious from the literature that the model of ownership structure under the UK system provides much better protection of minority shareholders, unlike the protection provided under the concentrated model.[1219] Thus, it can be said that investment in the UK securities market is more safe and attractive than in other countries that rely on insider-based models of corporate governance.[1220] Therefore, Saudi CGRs would do better for minority shareholders if their laws and regulations are modified to ensure adequate protection of the rights of minority shareholders. To this end, the following recommendations are proposed, which if strictly enforced would ensure adequate protection of the rights of minority shareholders in Saudi Arabia.

- In line with the UK system, the Saudi Capital Market Authority Board (CMAB) should adopt the principle of comply or explain into its Corporate Governance Regulations (CGRs) and also ensure that it is a binding rule for each listed corporation operating in the Saudi securities market.
- There is a need to lessen the concentration of ownership and control in the Saudi securities market. This could be achieved by establishing a solid organisational structure, which would see devolution of powers, jurisdictions, responsibilities and administrative lines among owners, shareholders, employees and management. In addition, it is necessary to limit the number of family members and unqualified

[1219] L.R. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Creation and Agency Costs of Separating Control from Cash Flow Rights* (Working Paper no. 6951, NBER, 1999); R. La Porta et al., 'Legal Determinants of External Finance' (1997), The Journal of Finance, vol 52, no 3, pp 1131-1149; J.C. Coffee, 'The Rise of Dispersed Ownership: the Roles of Law and State in the Separation of Ownership and Control' (2001) T he Yale Law Journal, vol 111, no 1, pp 1-82.

[1220] R. La Porta et al., 'Law and Finance' (1998) Journal of Political Economy, vol 106, pp 1151-1152.

personnel in the company's management board and then use some incentives to attract the highly skilled, well experienced and qualified persons to act in the management of these corporations.

- The Corporate Governance Regulations (CGRs) stated that each listed corporation should comply with the provisions of these regulations and thus endeavour to separate the duties of the chairman and the CEO. However, this rule is still optional instead of binding. Therefore, to ensure the effectiveness of the board of directors, the CGRs should make it compulsory that the duties of the chairman and the CEO remain separated in all Saudi listed corporations. This rule must be binding and not optional.
- In order to provide solid protection of minority shareholders, the Saudi securities market could benefit from the UK experience, especially in the establishment of shareholders' institutions. Thus, this research recommends investing in the securities market via shareholders' institutions instead of through individual shareholders.
- Financial penalties and imprisonment terms imposed by the CRSD are not sufficient to deter violations of the provisions of the CML and its regulations. Similarly, they are not commensurate with the nature of the offence or violations inflicted on the securities market and shareholders. Therefore, the research recommends the need for the Saudi regulators to amend Articles 57c) and 59b) of the CML to increase the financial penalties and criminal sanctions. Also, amending the CML's articles to issue more severe penalties/sanctions would indeed, contribute in protecting the rights of minority shareholders and thus strengthen the stability of the securities market.
- The lack of existence of other judicial committees in other provinces in Saudi Arabia greatly contributes in preventing minority shareholders to bring legal actions before these committees. This is because they have to incur high travel costs due to long distance journeys. Thus, this research strongly recommends that the Saudi regulator could benefit from the UK's experience in this respect. In the UK, High Courts are available in the country to hear all securities market-related disputes. The aggrieved party or parties do not have to travel to London to lodge his or her complaint.
- With the rapid growth in the Saudi securities market and associated market disputes, it appears that the number of members of the ACRSC is no longer enough to deal with the size of the market and volume of cases it presents. Indeed, three members would delay the process of litigation, which may cause damages to the rights of minority

shareholders. Therefore, the need to increase the number of ACRSC to respond to the vicissitudes and exigencies in the market remains sine qua non.

- The findings from this study showed that the CML has not made any provision as to the independence and accountability of the members of the CRSD and the ACRSC. In other words, the issue of judicial independence and accountability of these committee members, when they make mistakes or engage in any form of misconduct, is not covered by the law. For instance, the CRSD's members are appointed by the decision of the CMAB for a renewable three-year term. Therefore, it is reasonable to say that the CRSD's members cannot make any decisions that conflict with the directives of the CMAB. As a result, the performance of the CRSD would perhaps be prone to bias, which will negatively reflect on the justice delivered, as well as the integrity. Therefore, granting the two committees autonomy will reduce all forms of bias, which in turn would ensure fairness in the justice system.
- As a general principle, the integrity and independence of the judiciary members requires that judges should not receive any wages or premiums from government or from any other sector. In Saudi Arabia however, the CML has not prevented the committees' members from working in the public or private sectors, as the members of these committees are still holding other jobs in both government and private parastatals. In addition, the committees' members do not enjoy full judicial immunity, which would guarantee fairness whilst discharging their duties. To address this shortcoming, the research recommends that the Saudi regulatory should prevent the committee members from engaging in any other duty or duties outside their jurisdiction and they also need to be provided with sufficient, statutory protection.
- In accordance with the available information on the website of the Committee for Resolution of Securities Disputes, the members of the ACRSC work as legal advisors in the governmental bodies. The nature of their professional work is subjected to administrative law, and thus they express their legal opinions before the Board of Grievances (administrative court) regarding issues that arise from administrative or contractual relationships. Thus, it is clear that these committees lacked sufficient experience in securities law, commercial law and corporate law. The research recommends the Saudi regulatory to address this issue immediately as it negatively reflects on the confidence of the securities market in protecting its investors.

- To prevent duplication between the CMAB and the CRSD regarding the imposition of sanctions and penalties, the research recommends the amendment of Article 59b) of the CML, so that CRSD is seen as the sole court empowered to impose sanctions and penalties against those who violate the provisions of the CML and its regulations.
- Articles 77 and 78 of the Company Law 1965 have reinforced the dominance and control of the majority shareholders, as it stated that filing the claim against the board of directors must be made at the regular general meeting. Accordingly, the controlling shareholders have the right to accept or reject the claim of the minority shareholders, as well as the power to relieve the members of the board from a liability suit. These Articles represent a significant shortcoming, which may harm the rights of minority shareholders. Therefore, the research recommends the amendment of these Articles to ensure that minority shareholders have the right to sue boards of directors without any restrictions. Derivative action is a common mechanism under the UK system used to strengthen and reinforce the protection of minority shareholders against the abuse and expropriation of board members and controlling shareholders. Therefore, the research strongly recommends the Saudi regulator to benefit from the UK experience in this context and adopt this method in the securities laws and regulations.
- The findings of this study also revealed that minority shareholders face some ambiguities when it comes to identifying the appropriate or competent court to refer their cases to when they have conflicts with the board of directors. Sadly, there is no clear provision in the law as to which court they need to channel their grievances to. Therefore, it is recommended that the security regulators should clarify which court of law has the jurisdiction to deal with disputes arising between minority shareholders and boards of directors.
- Proxy voting represents an important issue in protecting the rights of minority shareholders. The advantage of this idea is that it enables shareholders to vote without attending the general meeting. It saves time, effort and money of shareholders.[1221] As discussed earlier, exercise of this right by minority shareholders in Saudi Arabia does not guarantee adequate protection. Therefore, preventing minority shareholders to cast their votes by using proxy or technological means may weaken the protection of their rights in the Saudi securities market. In the UK Company Act, shareholders have an absolute right to appoint another person as a proxy to attend, speak and vote at a

[1221] U. C. Braendle, 'Shareholder Protection in the USA and Germany - "Law and Finance" Revisited"' (2006) German Law Journal, vol7, no 3, pp 267.

general meeting on their behalf.[1222] Furthermore, they are also allowed to send all documents relating to the general meeting (such as the appointment of a proxy in meeting without the need to attend) by using all forms of electronic media.[1223] Therefore, it is recommended that using proxy voting and technology tools, including electronic voting, would widen shareholders' participation and strengthen their position in the market. It will also help mitigate any conflict of interest between minority shareholders and controlling shareholders. Similarly, a strong regulatory framework is needed to mitigate any undue pressure from the directors, who may capitalise on any weakness on the part of minority shareholders to expropriate their rights.

- The findings from this research showed that Saudi Arabian regulations have indeed, affirmed the transparency and disclosure requirements as fundamental principles in its stock market. Specifically, the SCL of 1965 gives shareholders the right to obtain copies of the reports of the board and of the auditor and to receive an invitation to a GM together with its agenda. However, no mechanism was provided under the law to ensure that the information the shareholder receives is a genuine and accurate reflection of the company's status. Indeed, without a clear picture of the company's situation, shareholders cannot effectively play their part in the company's affairs. Therefore, the need to revise the provisions of the SCL so that shareholders would have easy access to all company's reports and other relevant information, as long as such information is not detrimental to the company, should be provided at no extra cost.
- The Corporate Governance Regulations (CGRs) have not explained or shown the form of proxy, particularly in the case of the absence of shareholders. In addition, these regulations have not mentioned to use any distance communications or new technology tools in the voting process. Consequently, the recommendation here is that using proxy voting and technology tools, including electronic voting, will definitely lead to widened participation of minority shareholders and strengthen their position in listed corporations.
- The use of cumulative voting is still an optional, instead of mandatory, mechanism of shareholder protection in Saudi Arabia. As a result, participation of minority shareholders in the election and dismissal of board members is still not enforceable.

[1222]Sec 324 (1) UK Company Act 2006.
[1223]ibid Sec (333).

This is because most boards of family-listed companies are controlled and dominated by the same family members. Hence, the right to appoint and dismiss the board members are subjected to their own whims and caprices. Therefore, it is necessary to make cumulative voting a compulsory tool in all listed corporations in the Saudi securities market.

6.6 Limitations of the Study and Suggestions for Future Research

The findings from this research need to be considered within the context of some methodological limitations. Therefore, they have to be interpreted with caution. First, the research methodology was designed to achieve a complete understanding of similarities and differences in corporate governance and minority shareholder protection in Saudi Arabia and the UK. Although the choice of the UK as a benchmark for comparison was highlighted, particularly her recognition as one of few countries with sound and efficient corporate governance practices in the world. It could have been necessary to include another MENA country in the comparison. This would allow for a meaningful conclusion to be drawn concerning whether the corporate governance practice in Saudi Arabia generalises to other countries in the region, or whether it is specific to Saudi Arabia alone. A further examination of the influence of corporate governance on minority shareholders' protection could therefore be to investigate whether the Saudi findings can be generalising to other MENA countries. Secondly, the study examined the legal framework for protecting minority shareholders in Saudi listed corporations in general. This is a weakness in that corporations differ in terms of capitalisation size, industry sectors and ownership structure. Indeed, the findings from this thesis may have led to a different conclusion, had these variables been taken into consideration. A series of studies could address this issue by controlling these variables in their analysis. Thirdly, the present research relied mainly on secondary sources of information in its analysis. Even though these techniques save time and are easily-accessible, it may not capture the true realities of the situation in the jurisdiction of study. Besides, the information may be obsolete or unreliable. Future empirical research that adopts an interview or questionnaire approach is needed to gain in-depth understanding of the phenomenon.

6.7 Conclusion

This thesis has explored the influence of corporate governance mechanisms on the protection of minority shareholders' rights in Saudi Arabia and compared these with the UK corporate governance system. Specifically, the findings from this thesis have revealed some differences and similarities between the two jurisdictions, on the influence of the internal and external structures of corporate governance, on the protection of minority shareholders' rights. Importantly, both jurisdictions have enacted some laws to regulate the activities of the stock market and in particular, safeguard the rights of the minority shareholders, which indeed suggest evidence of a global standard of good corporate governance. Despite the existence of these regulations, the enforcement of these rights remains a bigger challenge in Saudi Arabia than in the UK. This is due to a weak legal system, characterised by an inadequate or weak enforcement of corporate governance regulations. Besides, the fines and sanctions imposed on those who violate the provisions of corporate governance are not commensurable with the offence committed. In fact, the impact of this weak legislation on the rights of minority shareholders cannot be underestimated. Indeed, minority shareholders in Saudi Arabia still suffer various forms of abuse and expropriation of their rights, from the hands of controlling shareholders. This is still a big concern considering the ownership structure in the Kingdom, which is characterised by a powerful influence of the State and wealthy families.

Another noticeable difference between the two jurisdictions is on the use of proxy voting and technology tools. In fact, this technique is rarely used in Saudi Arabia compared to the UK. The implication is that the absence of proxy voting limits participation of minority shareholders in the affairs of corporations. There is also a problem with the use of cumulative voting, which is still an optional rather than mandatory mechanism of minority shareholder protection in Saudi Arabia. Furthermore, CEO duality is still a norm in most Saudi listed firms as opposed to the UK, where every corporation is expected to comply with the Corporate Governance Code, which recommends that the duties of the CEO and chairperson should be separated.

Although the debates concerning the success or failure of legal transplantation is outside the focus of this thesis, the findings from this thesis suggest that the Saudi security market would likely benefit from the adoption of UK capital market laws and regulations. Indeed, some of the issues that need to be considered when adopting foreign legal rule is for a legislator to consider proven efficiency of the rule in their country of origin and whether it will produce

the desired effects in the destination country. As previously mentioned, the UK has an international reputation when it comes to good corporate governance, hence the need for transplanting some of the UK corporate governance practices to the Saudi context. Specifically, encouraging the use of electronic voting, granting minority shareholders easy access to company's information, the use of derivative action against the abuse and expropriation of board members and controlling shareholders, would improve the way that corporations are governed and help increase investors' confidence in the Saudi Arabia security market.

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