Corporate Governance Reform in Saudi Arabia: A Modelling Approach

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Declaration

I declare that the work presented in this thesis is my own.

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Abstract

This thesis argues for building a robust framework of good corporate governance in Saudi Arabia as a key policy option to realize the country's *Vision 2030* goal to transform the national economy from chronic dependence on (decreasing) oil revenues to a diversified resources economy. The thesis adopts a modelling approach to examine experiences and challenges of corporate governance reform nationally and internationally to enlighten and enrich the Saudi reform agenda. After brief introductory background about the country and the research problem and methodology (Chapter 1), the thesis discusses (in Chapter 2) the definition, elements, efficiency and theoretical framework of corporate governance as a foundation for the analysis in subsequent chapters. A generic three-layer taxonomic model of core values, supra-national and national standards of corporate governance is proposed (in Chapter 2) and used as a framework for subsequent discussion and analysis.

Corporate governance reform has generally been slow in Saudi Arabia. The prevailing Saudi institutional and statutory frameworks of corporate governance and their past and recent reforms are discussed in Chapters (3) and (4). The thesis argues strongly for aligning the Saudi regulatory framework of corporate governance with contemporary international principles and international best practices and model of corporate governance.

Accordingly, and considering in particular that the Saudi legal system is fundamentally based on supra-national Islamic Shari'a law, a comparative analysis is conducted in Chapters (5) and (6) to establish compatibility or otherwise between the model of Shari'a principles and modern OECD corporate governance principles. Moreover, Chapter 7 discusses models of national application of corporate governance standards in various jurisdictions to draw lesson for Saudi corporate governance reform. Finally the thesis ends with conclusions and recommendations in Chapter 8 to strengthen both the institutional and statutory components of the Saudi system of corporate governance.

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Abbreviations and acronyms

AGM	Annual General Shareholder Meetings
APR	Authorized Persons Regulation
BLG	Basic Law of Governance
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CL	Companies Law
CMA	Capital Market Authority
CPA	Certified Public Accountant(s)
MAR	Merger and Acquisition Regulations (CMA)
CML	Capital Market Law
CRSD	Committee for the Resolution of Securities Disputes
EGM	Extraordinary General Shareholder Meetings
FRC	Financial Reporting Council
GCC	Gulf Cooperation Council
GSM	General Shareholder Meetings
GCGF	Global Corporate Governance Forum
IAS	International Accounting Standards
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISA	International Standards on Auditing
KSA	Kingdom of Saudi Arabia

LRs	Listing Rules
MENA	Middle East and North Africa
MoU	Memorandum of Understanding
NCB	National Commercial Bank
OECD	Organization for Economic Co-Operation and Development
PIF	Public Investment Fund
RPTs	Related Party Transactions
ROSC	Corporate Governance Report on the Observance of Standards and Codes
SAR	Saudi Riyal
SAGIA	Saudi Arabian General Investment Agency
SAMA	Saudi Arabian Monetary Agency
SDC	The Securities Depositary Center
SOCPA	Saudi Organisation of Chartered Public Accountants
SOE	State Owned Enterprise
Tadawul	Saudi Stock Exchange

1. Chapter One: Introduction

This thesis explores the subject of corporate governance reform in the Kingdom of Saudi Arabia with a view to attaining a greater implementation of *good* corporate governance standards in the country. For a number of reasons, the subject of *good* corporate governance continues to attract widespread attention both on the national and international levels.[1] First, corporate governance is pertinent for regulators on both levels in their efforts to enhance and strengthen trust in financial markets. Secondly, it is also of special importance to investors to preserve their interests and increase their profits in the companies in which they invest. Thirdly, global economic crises and financial scandals such as the collapse of Lehman Brothers, Enron and Worldcom have attracted increasing attention to the regulation and practice of corporate governance particularly because lack of adherence to standards of good corporate governance was arguably a main reason for these collapses.

Fourth, particularly for countries with emerging market or transforming economies such as Saudi Arabia, improving corporate governance can serve a number of important public policy objectives. Arguably, good corporate governance reduces emerging market vulnerability to financial crises, reinforces property rights, reduces transaction costs and the cost of capital and leads to capital market development. Contrarily, weak corporate governance frameworks reduce investor confidence, and can discourage the flow of outside investment. Research over the past several years increasingly demonstrates that good corporate governance practices have led to significant increases in economic value added (EVA) of firms, higher productivity, and lower risk of systemic financial failures for countries.

For all these reasons, the subject of corporate governance occupies a central and vital position in academic research and literature endeavouring to explore and understand the essentials of effectiveness and success of practical regulatory framework of good corporate governance.

[1]See e.g. 'G20/OECD Principles of Corporate Governance: OECD Report to G20 Finance Ministers and Central Bank Governors' (OECD Publication 2015).

This introductory chapter aims to offer brief background information on the country and economy of Saudi Arabia and the significance of corporate governance in the country. The chapter also outlines the research problems addressed in this thesis, its questions and methodology, aims and contributions. Accordingly, Section 1.1 provides a general background on the country and economy of the Kingdom of Saudi Arabia. The remainder of the chapter outlines the research problem and questions, research methodology, research objectives and contributions, and thesis structure and organization in sections 1.2 – 1.5 respectively.

1.1 The Importance of Corporate Governance for Saudi Arabia: a country background

The contemporary modern state of Saudi Arabia was founded by the first King Abdul Aziz Al Saud in 1932 and has since been ruled by descendants of the founding king.[2] The incumbent monarch, King Salman Bin Abdul Aziz Al Saud, is the seventh monarch to rule the country. He ascended to the throne on 23 January 2015 following the death of his brother the late King Abdullah Bin Abdul Aziz Al Saud. Crown princes are, invariably, chosen by the monarch in power and the succession in power is thus streamlined. Presently, the incumbent is Crown Prince Mohammad bin Salman Bin Abdul Aziz Al Saud who was appointed on 21 June 2017.

The *Basic Law of Governance*[3] (BLG) is the principal legislation dealing with state, the authority and structure of the Kingdom. This law was enacted by Royal Decree in 1992 and contains 83 articles of a constitutional nature pertaining, *inter alia,* to the government, social values, rights and duties, economic principles and the state authorities. Article I of the Basic Law establishes the *Qur'an* (The Book of Almighty God) and the *Sunnah*[4] of the Prophet Mohammed as the "formal" constitution, thus

[2] The Basic Law of Governance (see n 3 below) states in Article 5 (b): Governance shall be limited to the sons of the Founder King 'Abd al-'Aziz ibn 'Abd ar-Rahman al-Faysal Al Sa'ud, and the sons of his sons. Allegiance shall be pledged to the most suitable amongst them to reign on the basis of the Book of God Most High and the Sunnah of His Messenger (PBUH).

[3] Basic Law of Governance is enacted by Royal Order No. (A/91) 27 Sha'ban 1412H – 1 March 1992 Published in Umm al-Qura Gazette No. 3397 2 Ramadan 1412H - 5 March 1992.

[4] *Sunnah* or Sunna (plural *sunan*) is defined as the verbally transmitted record of the teachings, deeds and sayings, silent permissions (or disapprovals) of the Islamic prophet Muhammad, as well as various reports about the prophet's companions.

instituting these as the fundamental sources of law in the country which may not be contravened by any subordinate legislation. The relevant Article of the BLG states:

> **Art. 1**. 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).

1.1.1 Population and Geography

According to the General Authority for Statistics[5] the current population of the Kingdom of Saudi Arabia is 31,7402,308. The country's total land area is 2,143,865 Km2 (827,751 sq. miles) thus making it the largest country in the Arabian Peninsula and the second largest country by size in the Middle East and North Africa (MENA) region, after Algeria.

Geographically, the country is strategically located between the two busiest sea routes: the red sea and the Arabian Gulf and it shares boundaries with nine different nations. Riyadh is the capital city, and the country houses Islam's two holiest shrines, Mecca and Medina, which are visited by millions of pilgrims every year.

Table 1 below shows some of the basic information about the country:

Official name	**Kingdom of Saudi Arabia**
Location	**Arabian Peninsula, MENA**
Land Area	**2,143,865 Km2 (827,751 sq. miles)**
Population	**31,7402,308**
Capital	**Riyadh**
Currency	**Saudi Riyal (SAR)**

Table 1 Saudi Arabia Basic information

The landscape of Saudi Arabia is dominated by the Arabian Desert, which includes the world's largest contiguous sand desert known as the *Rub' al Khali* or the Empty Quarter. Agricultural activities are relatively much smaller compared to the total

[5] <https://www.stats.gov.sa/en> last visited on 30 June 2017.

land area amounting to a total of 285,166 agricultural holdings with land and 61,663 holdings[6] without land. Thus, due to its mostly arid land the bulk of the food requirements of the country are imported. The country is split into 13 administrative areas, which are further divided into 118 governorates. The biggest area of all is the Eastern Province, which contains the bulk of the country's oil reserves. Despite the vast area, Saudi Arabia's population is concentrated in the cities. Makkah (Mecca) is the most populated administrative area, where about 26% of Saudi's population resides.

Saudi Arabia is a prominent regional power and takes an active role in the politics of the MENA region. The country is part of many economic and political groups like the GCC, the Organization of the Petroleum Exporting Countries (OPEC) and the Organization of Islamic Cooperation (OIC). Saudi Arabia is also the only Arab state to be part of the Group of Twenty (G-20) nations.

1.1.2 National law and legal system

As already mentioned above, the Basic Law of Governance[7] establishes the *Qur'an* (The Book of Almighty God) and the *Sunnah*[8] of the Prophet Mohammed as the "formal" constitution, thus instituting these as the fundamental sources of law in the country which may not be contravened by any subordinate legislation. A number of other Articles thereof deal with governance, state authorities and the adjudication, including:

Art 7: Governance in the Kingdom of Saudi Arabia derives its authority from the Book of God Most High and the Sunnah of his Messenger, both of which govern this Law and all the laws of the State.

Art 8: Governance in the Kingdom of Saudi Arabia shall be based on justice, shura (consultation), and equality in accordance with the Islamic Shari'a.

Art. 44: Authorities in the State shall consist of:

[6] Ibid.
[7] See (n 3).
[8] See (n 4).

- Judicial Authority.
- Executive Authority.
- Regulatory Authority.

These authorities shall cooperate in the discharge of their functions in accordance with this Law and other laws. The King shall be their final authority.

Art. 45: The source for fatwa (religious legal opinion) in the Kingdom of Saudi Arabia shall be the Book of God and the Sunnah of his Messenger (PBUH). The Law shall set forth the hierarchy and jurisdiction of the Board of Senior Ulema and the Department of Religious Research and Fatwa.

Art 48: The courts shall apply to cases before them the provisions of Islamic Shari‘a, 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.

The constitutional provisions above are underpinned by the Islamic precept of primacy of Sharia as the supreme law. It is the law given by God to man. According to Islam, God is the sole legislator and no man, not the temporal ruler nor parliament or assembly has the authority to legislate. This explains why Article 44 above does not explicitly refer to a 'legislative' authority in the state power structure in Saudi Arabia.[9]

However, the absence of a *stricto sensu* legislative body does not mean that there is no legislation in the Kingdom. It worth noting that Sharia recognizes the right of the ruler to make administrative ordinances intended for policy making to fill gaps left open by Sharia rules. Accordingly, by the exercise of this policy right the sovereign may promulgate regulations for the good administration of his government and prescribe the rules for public law, administrative law or commercial law, as these are areas where Sharia law has left great gaps.

[9] Saudi Arabia is commonly regarded to have only two authorities (executive and judicial) particularly in the prior to the enactment of the BLG. See more on this topic section (3.1), also Joseph L. Brand, *Aspects of Saudi Arabian Law and Practice*, 9 B.C. Int'l & Comp. L. Rev. 1 (1986), p. 20.

Saudi regulations are called *nizam*. These are promulgated pursuant to the Islamic principle of *Shura*, i.e. governance by consultation. The legislative process begins with proposed regulation by a minister of a cabinet office, then drafted and approved by the Council of Ministers and finally ratified by the king. Following publication in the Official Gazette the regulation, now a royal decree, becomes law. Alternatively, the king has delegated to his ministers and to the heads of some government agencies the authority to make regulations by issuing administrative or ministerial circulars. Both regulations promulgated as royal decrees and administrative or ministerial circulars have equal weight as "law".

It is important to note three main features of promulgating policy regulations in Saudi Arabia:

1. The right to promulgate regulations is exceptional and applies only to cases where Sharia, the primary source of legislation, has left some gaps open in administrative matters.
2. Regulations are subordinate to Sharia and each regulation usually contains a clause so stating. Thus, in the view of Saudi Arabian legal professionals, regulations are needed only to supplement and enforce the Sharia.
3. As subordinate legislation, regulations may not contravene or contradict Sharia. Moreover, they may not be issued to regulate any subject that has been clearly and sufficiently regulated by Sharia.

1.1.2.1 Civil law influence: the mixed Saudi legal system

Unlike most Muslim countries, Saudi Arabia did not experience Western colonization and, consequently, western law and legal conceptions have never invaded the core Saudi legal system. However, the discovery of oil in the 1930s heralded a new dawn for the country and extensive national regulations were needed to reconcile the traditional society in unprecedented way with modern life. Given the extensive use of governance by regulation in Saudi Arabia since the mid-1950's, it would seem that ‘policy’ has been at least adequate to the task of modernizing the law to fill gaps between the Sharia and modern needs. Such needs were first and sharply felt when the oil industry but rapidly to other economic areas as he growth brought in foreign investors, foreign managers, foreign laborers and the need to regulate them.[10] Thus, it could be reasonably argued that the Saudi Arabian legal framework for modern commerce and national development through regulations is largely modernised along western legal tradition with the Sharia law providing a general framework.

In the context of the present research, the discussion above raises the following important question: granted that the Saudi legal system has had to yield to economic and development pressures to modernize its national laws along western lines, which western tradition (i.e. civil *v* common law) has in particular had more impact on the contemporary Saudi legal system?

In answering the above question, most analysts agree that the influence of the civil law tradition on Saudi Arabian procedure and its substantive reception in the commercial field have been both significant and continuing. This is explained by two reasons. First, some argue that Roman law, the ancestor of the civil law, has closer affinity than the common law with the Islamic law and tradition. In both systems the 'jurists', as opposed to the judges, play law an important role as progeny of reason and justice. The civil law's importance as an influence in modern Saudi is explained by the need to fill a vacuum which Islamic law did not provide for, such forms of business entities suitable for modern commerce. The second reason is the direct transplantation of the French code into Saudi Arabia law. The first Saudi Companies Law (1965) was directly transplanted from the France rending the system a mixed legal system.[11]

1.1.3 Economy and transformation in Saudi Arabia

Saudi Arabia is a global leader of oil production and, consequently, the country's economy is heavily dependent on oil revenues. Saudi Arabia is also the largest among the wealthier Gulf Co-operation Council (GCC) sub-group of nations in the Middle East and North Africa (MENA) region. Collectively, the GCC countries are net exporters of oil and have immensely benefited from their huge oil wealth and

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[10] See Brand (9) p. 20 ff; Frank E Vogel, *Vogel, Islamic Law and Legal System: Studies of Saudi Arabia*. Studies in Islamic Law and Society Vol 8 (Brill 2000), p. xiv.

[11] Ibid p. 23.

control 29% and 23% of the world's oil and natural gas reserves, respectively. Saudi Arabia is the biggest among them in terms of both GDP and oil reserves.

The Kingdom of Saudi Arabia is not only the world's largest producer of crude oil but it also has the second largest oil reserve in the world. Thus, oil is unsurprisingly the lifeblood of the Saudi Arabian economy contributing about 20% of the country's GDP and 85% of its exports. Additionally, the country also controls 3% of the world's natural gas production and has about 4% of the world's gas reserves under its soil.

Saudi Arabia's economy witnessed a boom at the start of this century. By 2014, the nominal GDP of the country quadrupled to USD754bn from just USD188bn in 2000. The nominal GDP of the economy posted a compound annual growth rate (CAGR) of 10% over the past 14 years. However, the prevailing sharp decline in oil prices is projected to have a strong impact on the country's economy. Observers indicate that the economy has indeed slowed down in recent years. Following a boom in 2011, when oil prices ranged from USD90-130/bbl, the economy is growing at a declining rate. The GDP growth rates for 2015 and 2016 were estimated to be 2.8% and 1.8%, respectively.[12]

1.1.3.1 Economic transformation: *Vision 2030*

The peculiar dependence of the Saudi economy on oil has for a long time been simultaneously a source of concern and a motive for economic innovation and diversification. Consequently, over the years the Saudi economy has become gradually diversified and more so particularly in recent decades. In 2003, about 31% of Saudi Arabia's real GDP was contributed by the oil sector. However, 10 years down the line, the economic activity in the country is more diversified. In 2013 the oil sector was responsible for only about 20% of Saudi's real GDP and the GDP shares of the trade and transport and communications sectors grew about 5% each in this 10-year period.[13]

Moreover, it is worth noting that Article 22 of the BLG provides that:

[12] GT Finance, 'Saudi Arabia: Country Profile. Available at <www.gt-finance.fr/wp-content/uploads/2015/08/Saudi-Arabia.pdf>, last visited 30 June 2017.
[13] Ibid.

Art 22: Economic and social development shall be accomplished according to a sound and just plan.

This provision constitutes the legal basis for continuous efforts to modernise the and diversify the economy. *The Vision 20130 of the Kingdom of Saudi Arabia*[14] is the latest and most comprehensive vision of the country's economic future with tremendous implications for the need to enhance corporate governance in the country. The *Vision* was launched by Crown Prince Mohammad Bin Salman, the chairman of the Council of Economic and Development Affairs, in April 2016. The vision articulates a range of commitments and aspirations, including:

1. The vision represents a plan aimed primarily to reduce Saudi Arabia's dependence on oil, diversify its economy, and develop service sectors such as health, education, infrastructure, recreation, and tourism. Some goals include reinforcing economic and investment activities, increasing non-oil industry trade between countries through goods and consumer products, and increasing government spending on the military, manufacturing equipment and ammunitions.
2. Transforming the Saudi Public Investment Fund to sovereign fund assets valued at $2.5 trillion, thus making it the largest global sovereign fund. According to the Crown Prince the fund will consequently control more than 10% of global investment capacity, and the estimated size of the property is more than 3% of global assets. The cumulative impact is that Saudi Arabia will strengthen investment through the fund, which will be a key global driver, not just within the region.
3. It is envisaged that Saudi Arabia can wean itself off oil by 2020, decreasing oil prices notwithstanding. Thus, the vision aims to increase non-oil revenue six-fold from about $43.5 billion annually to $267 billion, and also aims to increase non-oil exports as a share of GDP from 16% currently, to 50%. The cumulative aim is to improve the global position of Saudi Arabia to become one of the top 15 economies in the world, instead of its current place as the 20th.

[14] Available at <http://vision2030.gov.sa/en> last accessed 16 December 2017.

4. It is also envisaged that Saudi Arabia will offer less than 5% of the giant national oil company Aramco in an initial public offering (IPO) on the stock exchange, and will allocate the proceeds of this IPO to finance the Saudi sovereign wealth fund. Aramco's expected value is more than $2 trillion.
5. The vision also includes a plan to implement a green card system within five years in order to improve its investment climate, and that the system will enable Arabs and Muslims to live in Saudi Arabia. The Kingdom will also open tourism to all nationalities in line with the nation's values and beliefs.
6. There are currently about 8 million annual pilgrims visiting the holy places Saudi Arabia. The vision aims to increase this number to 80 million by 2030. For this purpose it intends to develop and expand the infrastructure and to broaden the investment in areas surrounding certain holy places.
7. The vision also aims to strengthen the fight against corruption and measure the performance of government departments through 551 indexes measuring about 17 major components, with a focus on education, health, housing, and social justice. In addition, infrastructure will be created to confront the corrupt implementation of plans and programs by officials in government agencies. It will also raise the efficiency of the public sector, with a focus on supporting small enterprises and expanding privatization.

1.1.4 The importance of corporate governance reform in Saudi Arabia

The above discussion indicates a number of factors signifying the importance of studying reform of the Saudi framework of corporate governance including the following:

First: Saudi Arabia has one of the largest 20 economies in the world and is a leading political and economic power. By 2014, the nominal GDP of the country quadrupled to USD754bn from just USD188bn in 2000. In the preceding 14 years the nominal GDP of the economy posted a compound annual growth rate (CAGR) of 10%. Having such a large economy presents ample investment opportunities and the Saudi economy can be expected to attract a substantial range of domestic and foreign investors in the coming decades.

Second: The Kingdom of Saudi Arabia is the world's largest producer of crude oil and has the second largest oil reserve in the world. Thus, oil is unsurprisingly the lifeblood of the Saudi Arabian economy contributing about 20% of the country's GDP and 85% of its exports. Additionally, the country also controls 3% of the world's natural gas production and has about 4% of the world's gas reserves under its soil.

Third: Greater emphasis has been placed in Saudi Arabia in recent years on transforming the national economy and developing potentially alternative economic sources in a commitment to free the national economy from its dependence on oil. There are plans in place to increase non-oil revenue six-fold from about $43.5 billion annually to $267 billion. These plans also aims to increase non-oil exports as a share of GDP from 16% currently to 50% and to improve the country's global economic position to become one of the top 15 economies in the world, instead of its current 20th place.

Fourth: in addition to the above characteristics, Saudi Arabia hosts the two holiest places for Muslims, *Mecca* and *Medina* and the Saudi monarch has traditionally the title of being the **"Custodian of the Two Holy Mosques"**. There are currently about 8 million annual pilgrims performing *Hajj* (pilgrimage) and other religious visits to these holy places and the number of these pilgrims is expected to increase to 80 million by 2030. From an economic perspective this offers ample opportunities to enhance '*Religious (or faith) tourism*' which presents substantial and unique investment opportunities.[15]

Fifth: While being based fundamentally on the principles of Islam, the Saudi legal system has also traditionally benefitted from legal principles and experiences from other legal systems.[16] Accordingly, in addition to Islamic principles there is presently a growing body of international principles of good corporate governance including those elaborated by the G20, of which Saudi Arabia is a member, and the OECD. Hence, one of the main arguments advanced in this thesis is that, rather than being assumed antithetical or conflicting, these sources can profitably be

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[15]See e.g. Anna Rita Pinter, 'Religious Tourism to Mecca, Saudi Arabia', (BA thesis, Budapest Business School 2014).

[16]See e.g. F Facchini, 'Economic Freedom in Muslim Countries: An Explanation Using the Theory of Institutional Path Dependency' (2013) 36 *European Journal of Law and Economics* 139.

jointly utilized to maximize the efficiency of the legal framework of corporate governance in Saudi Arabia. Thus, Islamic and international principles of corporate governance should jointly be viewed welcomingly and their respective merits harnessed to further develop and strengthen the corporate governance framework of the country.

Sixth: Increased worldwide competition to attract international investment has made the convergence of national corporate governance and the international standards an imperative policy consideration. This applies not only on policymaking but also on the way in which companies “adopt regulation and governance practices, opting in many instances to implement international standards of best practices".[17]

Finally, corporate governance is therefore at the heart of these endeavours to transform the Saudi economy and develop alternative economic resources. Accordingly, this study aims to contribute to the on-going efforts to bolster the national preparedness and requisite legal and institutional framework to achieve the desired development goals.

1.2 Research problem and questions

The economy of the Kingdom of Saudi Arabia is presently facing multifaceted challenges and prospective milestone changes. The underlying and corner stone of these challenges and changes is the plans being advanced to steer the economy from dependence on oil revenues to a more diversified economy with developed alternative resources. Developing an efficient and robust governance of the corporate sector is at the heart of the strategic options to move the economy confidently forward to achieve the desired economic transformation and development goals. This, in turn, requires keen assessment of the prevalent corporate governance structures in Saudi Arabia and the potential for their further enhancement. Thus, the research problem addressed in this thesis is twofold.

First: the research attempts an analysis and assessment of the prevalent corporate governance structures in the Kingdom of Saudi Arabia. Consequently,

[17] S Morley, 'The Subject Matter, ‘Form and Process of Convergence and the Ever-Increasing Role of the Foreign Investor' (2016) 37 *Company Lawyer* 71.

the thesis focuses specially on the institutional and statutory (legislative) frameworks as these jointly constitute the legal framework and the most crucial structures of corporate governance in the country. The analysis is aimed at establishing the shortcomings and the required reforms.

Since the 1950s corporate governance in Saudi Arabia witnessed gradual legislative and institutional developments through the introduction of a number of stock exchange regulatory authorities besides the Ministry of Commerce and Industry.[18] These include the Saudi Arabian Monetary Agency (SAMA) which was established in 1952 and the creation of the Capital Market Authority in 2003. Equally, the first Company Law was enacted in 1965 and was followed by a number of crucial capital market regulations. More recently an enhanced new Company Law was promulgated in 2015.

Second: given that the Saudi legal system is fundamentally based on Islamic legal principles, the thesis also explores the question of compatibility or otherwise between modern principles of corporate governance (i.e. OECD) and Islamic principles of corporate governance.

Third: the research also studies the ways in which the compound legal, i.e. legislative and institutional, framework of corporate governance in Saudi Arabia can be further developed and strengthened with particular focus on the country's objectives of prospective economic transformation. This involves the question of defining the appropriate paradigm and means to enhance the efficiency of the Saudi legal framework of corporate governance.

In this respect the thesis adopts a modelling approach and draws on a broad range of resources including international standards of good corporate governance and cross-country models and experiences. In both the developed and developing world, the national supervisory authorities strive to enhance the applications of good corporate governance for its vital role in protecting rights and prevalence of welfare. There are a number of model adopted in this regard which differ according to socio-political and economic environments and systems. However, it could

[18] Renamed *Ministry of Commerce and Investment* by a Royal Decree on 30/7/1437 (07 May 2016). The two names of the Ministry are used interchangeably in this study.

safely be said that the insightful among these is a comprehensive approach encompassing all scene elements; explores legislative and regulatory frameworks, analyses their malfunctions, and determines reform needs, and, at the same time, makes use of the other international best practices.

1.3 Research type and methodology

Corporate governance regulation is regarded in this research as a continuously evolving edifice. It requires development and adjustment to national and international economic conditions and regulatory standards.

The thesis examines experiences of reforming the Saudi legal framework of corporate governance in order to enlighten possible reform in the future. Accordingly, it is worthwhile to note at the outset that the subject of this research, as outlined in the research problem and questions above, is rather complex and multi-layered. Consequently, its investigation and the questions it seeks to answers cannot be properly addressed or captured exclusively through a single research approach or methodology. Instead, it is deemed necessary that a thoroughly research into the subject of reform to build a robust and efficient legal framework of corporate governance in Saudi Arabia can more properly be achieved through a combination of approaches and methodologies. Thus this research employs the following methods:

1.3.1 Descriptive method

In principle, this research may be described as mainly *descriptive* in that the principal constituent variables in the research, including the legislative and institutional elements of the legal framework of cooperate governance, are addressed *ex post facto*. In particular, chapters (3) and (4) are devoted to the discussion of the institutional and legislative aspects of the Saudi framework of corporate governance. These aspects exist ex post facto. However, the research aims to examine them analytically to evaluate their merits and suggest the means and which through they can be developed.

1.3.2 Qualitative method

Moreover, this research can also more appositely be described as fundamentally qualitative in its approach since the investigation and assessment of the national reform experience in this research pertain essentially to the quality (and not the quantity) of the Saudi legal framework of corporate governance. This is particularly the case in the discussion and evaluation discussed in chapters (3) and (4) but also in a number of chapters and section elsewhere in the thesis.

1.3.3 Analytic method

In addition to this, however, the research also employs rather extensively the analytical method. For example, conceptual analysis is extensively used in chapters (2) (3) (4) and (7) which may accordingly be described as partly analytical. These chapters address a conceptual analysis of corporate governance in chapter (2); a generic model of corporate governance standards is developed in chapter (2.4, especially at 2.4.1); analysis of the institutional and legislative frameworks of corporate governance in Saud Arabia, and cross-country models of corporate governance application.

1.3.4 Comparative method

National systems of corporate governance have many varieties to the extent that some assert that 'there are as many corporate governance systems as there are countries'.[19]

Thus, the research also employs the comparative method particularly in chapters (6) and (7). This method is used to comparatively discuss, on the one hand, Islamic an international principles of corporate governance and, on the other hand, to conduct a comparative analysis of cross-country corporate governance models and reform in a number of jurisdictions.

[19] Jill Solomon, *Corporate Governance and Accountability*, 2nd edn, (John Willey & Sons Press, West Sussex, 2007), 181.

1.4 Research objectives and contributions

The main objective of this thesis is to offer an analysis and evaluation of the legal framework of corporate governance in Saudi Arabia with a view of further reform to ultimately to build up an efficient and robust national system. In this regard the thesis attempts as through analysis as possible within the limits that have been available to conduct the research. The investigation in this study will incorporate an analytic investigation of the institutional and legislative frameworks of corporate governance as well as a comparative discussion of these through the prism of Islamic corporate doctrines and international principles and reform experiences. Accordingly, another main objective of this thesis is to recommend the path to enhance the efficiency of the Saudi corporate governance system in convergence with Islamic and international principles of good corporate governance.

The subject of corporate governance in Saudi Arabia is attracting the attention of a growing number of national and international academics. This is illustrated in the growing number of PhD and MA theses being undertaken on the subject at various universities.[20] This thesis is an additional contribution to these academic efforts and is focused mainly on enhancing the efficiency of the legal framework of the Saudi corporate governance system. Thus, the present thesis aims to make the following contributions:

1. The thesis aims to contribute to the existing literature and offer an up to date investigation of the prevalent legislative and institutional framework of corporate governance in Saudi Arabia by including in the analysis more recent legislative development such as the new Company Law 2015, and the new Corporate Governance Regulations 2017.
2. The research also aims to contribute by bringing new insights into means and methodologies which can be employed to further develop and strengthen the efficiency of the Saudi corporate governance system with particular focus on the country's objectives of prospective economic transformation. The investigation in this respect involves defining the appropriate paradigm through comparative and analytic methods.

[20] See the References bibliography for a list of some research theses relating to different aspects of corporate governance in Saudi Arabia.

3. As it has already been mentioned, the Saudi economy is presently facing milestone challenges and changes. The economic aspirations and plans are clearly articulated in the Saudi Vision 2030 which has been discussed in section (1.1.3.1) above. Therefore, this research is intended to contribute to the national strategic economic planning by offering an investigation into the ways in which the corporate sector could be strengthened in the face of the challenges to realize the transformation objectives.

4. As discussed in more detail in chapter (5), it has been observed by researchers that continued ignorance in western academic literature of the applications of Islamic law in practice weakens understanding of Islamic religion, Islamic history, and Muslim societies. It has also contributed to the prevailing assumption that ‘Islamic law early in its career had rigidified into a fixed corpus of doctrines considered divine and unchangeable, and hence had grown progressively out of touch with the societies it professed to rule’.[21] By studying the contemporary framework of corporate governance in the Saudi legal system, which is fundamentally based on Islamic law, the present thesis also aims to contribute, though in a limited way, to the academic literature on contemporary application of Islamic law and the means to foster and maintain synthesis of Islamic and modern legal principles.

1.5 Research Structure

This thesis consists of eight main chapters. The present Chapter 1 (Introduction) is introductory in nature and is aimed to offer background information both on the country and the research problem and academic organization.

The second Chapter (2) is focused on the Definition, Elements and Theories of Corporate Governance. This chapter is aimed to give in-depth background information and analysis of the concept of corporate governance, its core constituent elements and the theoretical frames which shape-up the field of corporate governance in the academic literature. Section (2.4) develops a multi-

[21] F. Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia*. Studies in Islamic Law and Society Vol. 8 (Brill 2000) p. xii.

layered generic model of corporate governance standards including the pillars, international principles, and national applications of good corporate governance.

Chapters (3) and (4) analyse the Institutional and Legislative framework of Corporate Governance in Saudi Arabia, respectively, in order to discern their strengths and any weaknesses. In particular, the Saudi legal framework of corporate governance is divided into these two components in order to facilitate in-depth analysis and to highlight its problems. A corollary aim is that this division is also part of the solution as the thesis concludes that success of enhancing the efficiency of corporate governance in Saudi Arabia requires attention and action on both the legislative and the institutional levels of the system.

Additionally, chapter (5) studies the false assumption, which claims that there is no relationship between the principles of corporate governance applications and the applications of Islamic Law. The chapter explores the Islamic Law literature related to the rights of ownership, the agency theory, and “Gharar” (ambiguity) applications, which are prohibited by the Shariah scholars. There is evidence that corporate governance applications are deeply rooted in the literature of Islamic Law. The discussion included in this chapter is aimed to enhance the functional review tools used for evaluating the Saudi legal framework concerned with corporate governance as the Shariah is considered the main source for law in the Kingdom of Saudi Arabia.

Chapter (6) discusses international corporate This chapter tackles the OECD Principles of corporate governance and embodiment of the main international standards of corporate governance. The chapter also discusses some of the predecessors of the OECD developed in the UK such as the Cadbury and Greenbury committee reports which paved the way for the OECD principles to evolve. The objective of discussing these international standards is to set the required benchmarks both to evaluate the Saudi legal framework of corporate governance and simultaneously to extract the requirements for its development and further enhancement.

Chapter (7) examines a number of cross-country corporate governance models and country-specific experiences which are frequently discussed in the literature. These include the ‘legal origins model’; the ‘institutional v the legislative model, the enabling v the mandatory model. The discussion and analysis in this chapter is intended to inform and enlighten future reform of the Saudi framework of corporate governance.

Thus, these chapters are collectively intended to articulate a wealth pool of doctrines, standards and experiences which can profitably be utilized to enhance the efficiency of the legal framework of corporate governance in Saudi Arabia. First, owing to its fundamental basis in Islamic law the Saudi corporate system can be ameliorated consistently with Islam corporate principles when the latter are clearly elucidated and articulated. In addition owning to its reciprocal relationships internationally, the Saudi system can also utilize international standards to streamline its corporate governance system with those of its partners and also lead the way forward for further regional development particularly within the GCC countries.

Finally, chapter (8) ends with Conclusions and Recommendations of the thesis regarding the subject of efficiency of the legal framework of corporate governance in Saudi Arabia.

2. Chapter Two: Theories, Elements and Models of Corporate Governance

This chapter is devoted to the discussion and conceptual analysis of the concept of corporate governance.[22] The aim of this discussion is to provide in-depth background of the definition, elements and theoretical framework of corporate governance which will be the foundation for the analysis that follows in subsequent chapters of this thesis.

Accordingly, the analysis here will focus on four related aspects of corporate governance. Section 2.1 will address the concept and definition of corporate governance. Section 2.2 will discuss the core constituent elements which shapeup the field of corporate governance including the corporation, the investors, the managers, the directors and stakeholders. Accordingly, the analysis in that Section will define these elements and simultaneously establish the foundations of the universe of corporate governance discourse. Section **Error! Reference source not found.** will address the theoretical models of corporate governance.

2.1 Definition of Corporate Governance

This section tackles the definition and concept of corporate governance. The discussion and analysis here are aimed to elucidate the concept of corporate governance and to investigate the proper definition thereof. Thus, the discussion will focus on the etymology and evolution of corporate governance (in 2.1.1) and its definition and phenomenology (in 2.1.2). An important related concept is that of 'efficiency' of corporate governance which is central in this study in relation to the legal framework of corporate governance in Saudi Arabia. This concept is discussed in section 2.1.3.

2.1.1 Etymology and evolution of corporate governance

From a terminological point of view "Corporate Governance" suggest conceptual linkages and analogy with the more familiar phenomenon of *government* of nations

[22] Udo C. Braendle and Alexander N. Kostyuk, 'Development in Corporate Governance' in Alexander N. Kostyuk, Udo C. Braendle and Rodolfo Apreda (eds), *Corporate Governance (*Virtus Interpress 2007).

or states. As commonly understood, the governance of the modern state refers to the ways in which the state official apparatus is instituted and how the legislative, executive, and judicial powers are exercised. Comparatively, the term 'Corporate Governance' is used to denote how companies should be, and are in fact, directed and controlled.[23] The term involves two components: *corporate* and *governance*. The former refers to corporations which will discussed in more detail in subsection (2.2.1), while the latter, in its Latin root, *gubernare*, means steering a ship.[24]

However, the semantics of the second component *'governance'* might often be the principal source of confusion in clarifying the concept, owing to its allusion to government, which brings a public element into a domain that is considered as essentially private.[25] Thus, while being etymologically related, corporate governance and state governance are distinct terms which can be distinguished primarily by reference to the subject matter of their respective application.

Thus, Magnier[26], for example, has stressed three features which distinguish corporate governance: **First**, corporate governance is characterised by *private* mode of governance in contradistinction to the *public* mode of governance which pertains to government. **Second**, corporate governance is furthermore essentially a *capitalist* mode of governance as opposed to other of private governances such as associations and cooperatives. **Third**, the concept largely involves all those who are involved in the management of the company and thereby contributing to significant decision making.

This thesis is concerned with the application of the term 'governance' to corporations, and not to states, which may thus be metaphorically defined as the stewardship of corporations.[27]

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[23] Robert Tricker, *Corporate Governance: Practices, Procedures and Powers in British Companies and Their Boards of Directors* (Gower Pub. Co. 1984).

[24] See the entry 'govern' at dictionary.com

[25] Karel Lannoo, 'A European Perspective on Corporate Governance' (1999) Journal of Common Market Studies, 271.

[26] See the Introduction in Veronique Magnier, *Comparative Corporate Governance: legal Perspectives*. (Edward Elgar Publishing. 2017).

[27] John Farrar, *Corporate governance in Australia and New Zealand* (Oxford University Press 2001).

Historically, it is commonly believed that the term 'corporate governance' was first used in the academic literature by Richards Eells in the USA in the early 1960s. [28] However, earlier origins of modern corporate governance may be traceable to Adolf A. Berle and Gardiner Means's *The Modern Corporation and Private Property*.[29] Thus, the term 'corporate governance' has an American origin but it has gradually become internationally a feature of corporation and securities regulative discourse. In this process of internationalization of the term the popularity of corporate governance was boosted from the 1970s onwards by endeavours to improve the ethical governance and operation of the business sectors particularly in the USA.[30] Both the use and importance of corporate governance have become globally pervasive which prompted James Wolfensohn, former president of the World Bank, to state that: "the governance of corporations is now as important in the world economy as the government of countries".[31]

This thesis is not particularly aimed at offering a detailed or comprehensive account of the evolution of corporate governance.[32] Nevertheless, the subsequent discussion of the development of the legal framework of corporate governance in Saudi Arabia (in chapters 3 and 4); Islamic and international standards (chapters 5 and 6) may be regarded, at least partially, as an account of the global evolutionary narrative of corporate governance. More particularly, the discussion in chapter 5 may be regarded as a contribution to the growing body of literature on Islam and good corporate governance.

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[28] Richard Eells and Clarence C. Walton, *Conceptual Foundations of Business*, (Richard D. Irwin, Inc., Homewood, II, 1961); Richard Eells, *The Meaning of Modern Business: An introduction to the philosophy of large corporate enterprise*, (Columbia University Press 1960); Richard Eells, *The Government of Corporations* (The Free Press of Glencoe 1962).

[29]Adolf. A Berle. and Gardiner C. Means *The Modern Corporation and Private Property* (The Macmillan Company 1932).

[30] See more on this the discussion in sections 7.3 below.

[31] In Chris Pierce and Kerrie Waring: *The Handbook of International Corporate Governance: A Definitive Guide* (Kogan Page 2005) p. xi.

[32] For detailed historical accounts see e.g Gary Herrigel 'History Without Historians in Geoffrey Jones and Jonathan Zeitlin (eds) *Handbook of Business History* (Oxford University Press 2006); Brian R. Cheffins The History of Corporate Governance, ECGI Working Paper Series in Law. Working Paper N°.184/2012 (January 2012) available at <file:///C:/Users/thoshiba/Downloads/SSRN-id1975404.pdf> last accessed 11 November 2017; Randall Morck (ed.) *A History of Corporate Governance Around the World*: Family Business Groups to Professional Manages (Chicago University Press 2005).

2.1.2 Phenomenology and definition

A conceptual analysis of "corporate governance" shows that the term involves a number of interrelated elements and key players and is, accordingly, susceptible of definition from a number of perspectives.

Broad definition: broadly defined, corporate governance as a collective term refers – in the broadest sense – to all rules (whether imposed by law, ethics, custom, best-practice or contracts), processes, decisions and concerns by which businesses are operated, regulated, and controlled. The term certainly suggests and makes reference to factors and interests defined by reference to all players concerned with the corporate process and business; they are mainly shareholders, management and concerned stakeholders. Thus, on its broad definition corporate governance can encompass the combination of laws, regulations, listing rules and voluntary private sector practices that enable the corporation to attract capital, perform efficiently, generate profit, and meet both legal obligations and general societal expectations.

Narrow definition: Narrowly defined corporate governance concerns the relationships between corporate managers, board of directors and shareholders. But it might as well encompass the relationship of the corporation to stakeholders and society. Thus, the OECD defined the terms as follows

"Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance."[33]

[33] OECD1999.

2.1.2.1 Definition of corporate governance in Saudi law

In practice, different national systems of corporate governance articulate the primary objective of the corporation in different ways and thus implicitly espouse either a broad or narrow definition of corporate governance. Accordingly, predominately in states in continental Europe and Asia the focus is on the need to satisfy societal expectations including, more particularly, the interests of employees and other stakeholders, variously defined to include suppliers, creditors, tax authorities and the communities in which corporations operate. In other states, typical the Anglo-Saxon country, the emphasis is often on the primacy of ownership and property rights with particular focus on returning a profit to shareholders over the long term. Under this view, employees, suppliers and other creditors have contractual claims on the company. As owners with property rights, shareholders have a claim to whatever is left after all contractual claimants have been paid. The corporate focus is on shareholder value.

Remarkably, the Saudi Corporate Governance Regulations (2006)[34] did not include a definition of the term corporate governance. However, the new Corporate Governance Regulations 2017 include the following narrow definition:

"Corporate governance means "rules to lead and guide the Company that includes (*sic*) mechanisms to regulate the various relationships between the Board, Executive Directors, shareholders and Stakeholders, by establishing rules and procedures to facilitate the decision making process and add transparency and credibility to it with the objective of protecting the rights of shareholders and Stakeholders and achieving fairness, competitiveness and transparency on the Exchange and the business environment." [35]

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[34] Issued by the Board of Capital Market Authority Pursuant to Resolution No. 1/212/2006 dated 21/10/1427AH (corresponding to 12/11/2006) based on the Capital Market Law issued by Royal Decree No. M/30 dated 2/6/1424AH, as amended by Resolution of the Board of the Capital Market Authority Number 1-1-2009 Dated 8/1/1430H Corresponding to 5/1/2009G.

[35] Corporate Governance Regulations English Translation of the Official Arabic Text Issued by the Board of the Capital Market Authority Pursuant to Resolution Number (8-16-2017) Dated 16/5/1438H Corresponding to 13/2/2017G Based on the Companies Law Issued by Royal Decree No M/3 dated 28/1/1437H.

It worth noting that both the broad and narrow definitions, relate to the two perspectives of shareholder- and stakeholder orientation. It therefore revolves around the debate on whether management should run the corporation solely in the interests of shareholders (shareholder perspective) or whether it should take account of other constituencies (stakeholder perspective).

Taking purpose as a definition reference, corporate governance is the tool that aims at safeguarding the legitimate benefits and interests of everyone concerned with the operation of the company, mainly shareholders, and more generally, stakeholders. This can be done by ensuring that the company's insiders adhere to the accepted ethical/legal standards and the best practices, as well as to formal laws when dealing with them (i.e., the shareholders and the stakeholders) or when otherwise making decisions and activities affecting them. [36]

Building on the above analysis and by taking the operational side of the definition, corporate governance could be defined as the rules and practices by which the board of directors/management ensure accountability, fairness, and transparency in the company's relationship with its shareholders and stakeholders such as the financiers, customers and the community.[37] It is therefore a comprehensive system of rules, which indicates how the company is directed and controlled in the light of the nexus of relationships that exist between the company and its shareholders and other stakeholders. It is also the marginal code of conduct for the management and the board which will act as an identifier for their responsibilities and an indicator for any possible misuse or breach by them. For better understanding of how the corporate governance mechanism works, it is necessary to analyse the role of managers, directors, shareholders and stakeholders, especially in relation to the company's business strategy and long-term performance. More concretely, it is of critical importance to examine not only the relationships between these groups, but also the relationships within these groups.

[36] Braendle (n 22) 7.
[37] Ibid, 7.

2.1.3 Efficiency of the legal framework of corporate governance

Efficiency is a central economic concept where it enjoys a precise technical definition. The problem of efficiency of the Saudi legal framework of corporate governance is closely related to but distinguishable from economic efficiency.

Economic efficiency is about maximising the aggregate or collective wellbeing of the members of the community. Economists commonly maintain that economic efficiency requires satisfaction of three components:

Productive efficiency: which is economically achieved when output is produced at minimum cost. This occurs where no more output can be produced given the resources available, that is, the economy is on its production possibility frontier (PPF). Productive efficiency incorporates technical efficiency, which refers to the extent to which it is technically feasible to reduce any input without decreasing the output, and without increasing any other input. When more than one input is used, or more than one output is produced, the ratio of outputs to inputs can be formed only if inputs and outputs are summed into two scalars. If prices are used for that purpose, then technical efficiency merges into productive efficiency.

Allocative efficiency: which is about ensuring that a given community gets the greatest return (or utility) from its scarce resources. Invariable, a country's resources can be used in many different ways. The best or 'most efficient' allocation of resources uses them in the way that contributes most to community wellbeing.

Dynamic efficiency: refers to the allocation of resources over time, including allocations designed to improve economic efficiency and to generate more resources. This can mean finding better products and better ways of producing goods and services. This involves innovation (producing more with less) and can also be generated from growth in resources such as capital and labour. Improvements in dynamic efficiency bring growth in living standards over time.

These efficiency concepts are as applicable to the activities of the public sector including taxing, spending, regulating and policy making as they are to everyday, marketed goods and services. The difference is that for marketed goods and services prices play the allocative role (Adam Smith's invisible hand). Under specific conditions markets can be shown to allocate resources to the outputs most preferred by people in way that maximizes economic efficiency. Economic institutions and policy can assist in improving economic efficiency by, for example, helping align market prices of goods and services to their true economic costs. Beyond this, in response to significant market failure, or for other reasons, such as redistribution or risk management to improve the quality of life, governments make decisions that affect production, consumption and investment.

Thus, economic efficiency and legislative and institutional efficiency of corporate governance in Saudi Arabia go hand in hand. While legal efficiency in this research is focused on achieving the best model of good corporate governance in the country through a thorough examination of the prevalent system and incorporation of international best practice experience and principles, it can ultimately also be measured economically in the sense of instituting a model that is capable of attracting investment and increase exports, standards of living and GDP.

2.2 Elements of Corporate Governance

The basis of the corporate governance edifice is found on a number of intertwined core elements involving natural and legal persons. These elements include the corporation itself, the investors or shareholders, the managers, the directors, and, ultimately, the stakeholders. The designation ‘core’ used here to describe these elements signifies that these are regarded as the basic, and the scope of elements could certainly be enlarged on several levels of generality to include, e.g. all sorts of legal or ethical rules, and those imposed custom, best-practice or agreements, in addition to processes and various public policy decisions and institutions.

The central legal person is the company or corporation which is a complicated business institution involving different contributors in capital, planning and management (performance) units. In fact, the corporation is nothing more than an organized concentration for monies and expertise towards the achievement of a certain business goal (mainly in the form of bigger profit and market share). As a matter of fact, the ramification of roles and responsibilities into different contributors in capital, management and planning, may by itself facilitate abuse opportunities within the corporation and the market. When this very fine crystallized organization is impaired, abuse chances would possibly proliferate. In this sense, the corporate governance is concerned with the conditions under which this institutional organization should operate in harmony and without abuse.

In order to address this question properly, the specification and characteristics of every component in this organizational structure should be identified and studied. The focus in this part of the thesis will be on the players concerned with the corporation as an institute and on the environment in which this institution works and operates.

2.2.1 The Corporation

The roots of the contemporary ubiquitous institution known as the 'corporation' can be traced back historically to Roman law which recognized that ownership (i.e. *dominium*) could be vested contemporaneously on more than one person (or owner). Accordingly, it was possible for joint or co-ownership to arise under Roman law in more than one way. The most notable form was partnership, i.e. *societas*, created by the parties through a consensual contract which determines their respective rights. The contract itself would be enforceable by the *action prosocio*, i.e. by one partner vis a vis the other partner(s) to enforce the terms of the partnership agreement. Another way in which co-ownership arose under Roman law was joint legacy or inheritance. Interestingly, it was not necessary in either form of co-ownership that the owners have equal share as it was recognizable by Roman law that one heir or a partner could have more shares than others.[38]

More elaborate beginnings of the modern corporation can be traced to developments in England as early as the 17th century during which ownership of corporations or companies was typically divided among a few individuals who often also participated in its management[39]. Accordingly, there were no organized markets for the transfer of ownership of corporate rights and claims.[40] As a consequence, shares were only transferred to friends or relatives, and control was therefore characterized by "voice" rather than by "exit".[41] This means that any shareholders dissatisfied with the corporate performance would have to exert

[38]See more on the history of co-ownership in Roman law A M Prichard, *Leage's Roman Private Law Founded on the Institutes of Gaius and Justinian* (Macmillan 3rd edition 1964) pp. 229-230, and 364-7.
[39] Dennis Mueller, *The Corporation - Investment, Mergers, and Growth* (Routledge 2003).
[40]Rober Larner 'Ownership and control in the 200 largest nonfinancial corporations, 1929 and 1963' (1966) The American Economic Review, 56 (4), 777-787.
[41]Albert O. Hirschman 'Exit, Voice, and the State' (1978) World Politics Vol. 31, No.1, 90–107.

personal effort and patience into the company (through “voice”) rather than being institutionally enabled to sell or transfer his shares (i.e. through “exit”).

Another characteristic of the 17th century corporations is that partnership was the dominant form for organising jointly owned business firms. In fact, the partnership was the only form available for most types of business and partners often bore unlimited personal liability for the contractual obligations of the firm. One of the first corporations that came into existence was the British East India Company. It was a joint-stock company, which was granted an English Royal Charter by Queen Elizabeth I at the end 1600, with the intention of favouring trade privileges in India. The company had 125 shareholders, and a capital of £72,000. At the time, the concept of a corporation was quite different than today. Corporations were small, quasi-governmental institutions chartered by the crown for a specific purpose such as banking, and could only exist for a limited time. This was one of the first companies established as well to gather together investors to satisfy the huge capital demand of large projects. Not only Queen Elizabeth I but other European kings and queens closely watched these corporations and did not hesitate to revoke charters if they became unhappy with the way the corporations were being run. But being more the exception than the rule, corporations in general remained small institutions for the next 200 years or so to come.

The advent of industrialisation drastically changed the prevalent operation of corporations as it to was tightly connected with the huge capital demand of new giant firms. This heralded a new era in the history of corporations in which legislators and regulators began to extend their regulative realm to corporations. Equally, corporations began to expand as they were allowed to write broader and less restrictive charters. In particular, the doctrine of limited liability of companies allowed corporate owners and managers to avoid responsibility for harm and losses caused by the corporation and consequently made this business form even more interesting. Thus, corporations were gradually transformed from state-controlled organisations to unlimited private organisations with limited responsibility and limited accountability.

The growth and increasing importance of corporations led to the emergence of exchange markets of corporate shares in New York and some European capital cities. As share trading became easier to capital providers, shareholders increasingly relied on the exit option to express their (pleasure or) displeasure with the managers. Control via voice shifted to the boards of directors, which in turn were dominated by managers. Hence, at the end of the 19th century and beginning of the 20th century, control of corporations shifted more and more into the hands of the managers and therefore ownership and control separated. This phenomenon deepened as corporations continued to grow in the 20th century which gave rise to what is know as 'agency problem' (see subsections 2.2.3.1 and 2.2.3.4) in corporate governance.

Presently laws typically view corporations as fictional persons, i.e. a legal person, or a moral person. That is, a corporation is a person in its own rights, i.e. has legal personality with the attendant duties and rights. The owners of the company are the shareholders (also called members). In return for the money they invest into the company they receive shares. Corporations are managed by directors, who may (or may) not be members of the company. A corporation is typically characterised by the following four key features:

Separate Legal Personality: As already mentioned, a company has its own legal personality. Consequently it can be a party to contracts and the subject of rights and liabilities. Furthermore, the existence of a corporation may continue indefinitely unless and until it is liquidated.

Separation of Management from Ownership: Modern corporate organisation is characterised by a formal separation of the company's management (under the board of directors) from the shareholders. The latter are sometimes termed "the owners" of the company who share the company's profits. As they are collectively entitled to appoint and remove directors from the board, they exercise ultimate control over management. The agency problem indicated above relates to the shareholders' perceived limited liability and their practical inability to control management. Notwithstanding, the separation of the function of management from the function of shareholding arguably enables these functions to be performed more efficiently by specialists. Directors and other managers do not have to possess capital (and risk-bearing expertise) and shareholders do not have to possess managerial expertise. Management can be performed more efficiently by a relatively small and cohesive group of people whereas the risks associated with providing equity capital can be borne more efficiently when shared among a large number of people, who in turn can protect themselves by holding diversified portfolios of investments.

Limited Liability: The essential point for this feature of corporations is the company’s responsibility for its own debts and liabilities. In other words, the shareholders share the company's profits, but they are not responsible for its losses. They are only liable to the company to pay up their share capital and have no further liability. So limited liability actually shifts the risk of business failure from the company's shareholders to its creditors. This appears to give the company's owners and managers too much of an incentive to take risks and can lead to an inefficient use of resources.

Transferability: A share in a company carries rights against the company to receive dividends and (usually) to vote at shareholders meetings. Thus, a share can be transferred to a new holder and this transfers the associated rights and liabilities. Shares in a public company are usually traded on a stock exchange, facilitating transfer and making shareholding a more flexible kind of investment.

In the Saudi context, there is a variety of companies including listed companies and companies limited by liability. In addition, there are state-owned companies, particularly in the industrial sector such as the oil sector, but also family owned corporation. The latter type of corporations, i.e. family-owned, is a very dominant form of corporate ownership in the Saudi economy. Reportedly, the phenomenon of family businesses in Saudi Arabia has a profile percentage of 80% of the business sector. Moreover, some researchers believe that the contribution of family businesses to the GDP- excluding the oil industry- in Saudi Arabia is more than 90% whereas the UK for example has a percentage of 66% of small and medium sized enterprises. Therefore, family business in Saudi Arabia can be described as having a strong presence in the Saudi economy.

2.2.2 The Shareholders (Investors)

The shareholders or investors[42] are the individual persons and entities, i.e. natural or legal persons, directly contributing to the issued capital of a given corporation. They are the joint owners of the company, its assets and any other rights attributable to it. In this capacity, shareholders are the sole body entitled to share in the dividends distributed by the company. Nowadays, particularly in large companies, shareholders are dispersed and individually hold a small percentage of the total issued shares of a company, and they exercise little control over corporate management.[43]

Not every person who is contributing money to the corporation is considered a shareholder. Subscribers in bonds issued[44] thereby, and providers of financial facilities to the company are not technically shareholders, and they, therefore, are not entitled to vote therein or share in its profits.

2.2.2.1 Nature of the Relation

The relation between the shareholders themselves is contractual in nature. All shareholders are signatories on the company's articles and by-laws whether directly such as in the case of the institutional shareholders (i.e., founders), or indirectly through subsequent subscription of non-founder shareholders or share acquisition through the stock market.

The articles of association signed, or otherwise endorsed, by the shareholders necessitate another relation between the shareholders as a whole, on one hand, and the company as a property on the other hand. This relation takes the form of ownership. In this sense, the shareholders, being the contributors to the capital constituting the company, are considered, from legal and factual points of view, the sole and absolute owners of the company and all its tangible and intangible assets.

[42] Investors and shareholders are used in this thesis interchangeably unless the context suggests otherwise.
[43] Daniel Prentice, 'Some Aspects of Corporate Governance Debate' in Daniel Prentice and Peter Holland (eds), *Contemporary Issues in Corporate Governance* (Clarendon Press 1993) 27.
[44] Bonds are technically treated as loans. See articles 116–22 of the Saudi Companies Law (1982).

2.2.2.2 Powers Vested in the Shareholders

Shareholders enjoy essential rights enshrined in the applicable national law of companies and other financial regulations. These rights include attending and voting at general meetings, receiving dividends (profits distributed by the company), subscribing in new shares, appointing and recusing board members, appointing external auditor(s), amending the articles/by-laws, and receiving information about the general work and standing of the company. In addition, shareholders are entitled to sell their shares (exit) whether in part or in full against the prevailing prices in the market.[45]

In spite of their substantial rights and privileges, shareholders' practical exercise of most of these rights is rather restricted in practice. This is due to a number of reasons chief among which is the non-existence of a permanent forum for shareholders, the imposed power-delegation to the board and the managers of the company[46] and shareholders' lack of information and expertise.

2.2.2.3 The Classical Separation of Ownership and Control

The powers granted to the shareholders do not include powers to run the company's ordinary business.[47] National laws commonly allow for a complete separation between the ownership rights vested in shareholders and the management (running) of the company's affairs - the so-called *control rights*.

Vesting the company's control and management in the executives and managers requires good corporate governance practices to ensure placing reasonably skilled and well-qualified persons at positions of control and decision making for the ordinary business of the company.

This separation is truly one of the main dilemmas facing corporate governance, since some past experiences shown that company controllers to be the main source of misuse and the main cause in some major corporate collapse incidents.[48]

[45] See articles 61, 62, 84, 85, 86 and 94 of Saudi Company Law (1982).
[46] Kathleen M. Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) The Academy of Management Review, 57.
[47] George W Dent 'Corporate Governance: Still Broke, No Fix in Sight' (2005) Journal of Corporation Law 55.
[48] Ibid. See also Eisenhardt (n 46).

2.2.2.4 The main goals of shareholders

Invariably, shareholders' engagement in the company is basically an act of investment Thus, the main goal of shareholders is to maximize their equity rights and magnify their profits. As for any investor, the basic desire of good financial returns and stability in the market remain the core value of shareholder pursuit.

Another shareholders' goal is the market value of the share of the company. To some extent, the price value of shares is indicative of the size and market share of the company, its level of management efficiency and the profits achieved. The price value is also important to shareholders desiring to 'exit' from the company.

Similar to the question of price value is the number of deals and purchase claims of the company's issued shares. Again, it is in the interest of the shareholders that purchase claims for the company shares in the market increase. This will result in an increase in the share value, the wealth of the shareholders and more reputation to the company in the market.

2.2.3 Corporate Managers and Executives

Corporate managers and executives are the senior personnel entrusted with the running of the company's daily work. Aspired by the general and strategic plan of the company drawn by the board of directors, the managers and executives are the ones entrusted with handling the operational side of business in the company.

The term 'manager' is a wide term usually used to refer to the senior personnel or executives working for the company. In this research, however, the terms managers, senior personnel and executives are regarded and used as synonyms unless otherwise indicated.

2.2.3.1 Managers relation to the company and shareholders

The manager's relation with the company is a contractual relation. It is usually an employee-employer relation. The managers and executives, similar to any personnel, are, staff members working for the company. Thus, managers/executives owe obligations stemming from the labour law of the company. On the top of these obligations comes the obligation to dedicate time and efforts to achieve the goals and the best interests of the company.

The manager's relation with shareholders is quite complicated. The fact that managers are employees of the company does not lead to the conclusion that the managers are working for the shareholders themselves because the company, as a distinctive institution, enjoys separate legal entity and capacity from the shareholders. Moreover, the managers are not *per se* signatories on the company articles/by-laws. Legally speaking, there is no direct contractual relation between managers and shareholders according to the traditional law classification.

Given the above, there is a growing demand that, notwithstanding to the settled law traditions, the relation between shareholders and managers is to be regarded as a principal – agent relation.[49] This is because of the strong assumption that managers, while practicing their jobs as runners of the property of shareholders (the company), are doing so as agents on behalf of the owners. Management scientists seem to be quite settled on the classification of the relation prevailing between managers and shareholders as agency relation. In their view, apart from the legal jargon, managers are the owners' de facto appointed agents for running the property they own.[50] Today, there are also growing concerns amongst law specialists to consider the relation between managers and shareholders as proposed (potential) agency relation. This legal recognition is argued on the basis that as long as the law obliges separation between 'ownership' and 'control' rights, it certainly imposes some sort of relation between these two and this could be nothing but in the form of agency or legal representation.

2.2.3.2 Powers and duties

Managers' powers are determined in accordance with many factors including their hierarchy position within the company, their mandate and their job description.

Managers are generally granted comprehensive discretion in running the company's ordinary and daily activities. This includes, especially for senior managers and executives, the right to appoint (or recommend the appointment of) ordinary staff and decide on their salaries and job descriptions. They also have the right to represent the company before clients and competitors, the right to decide how the business of the company is done, the right to operate and control all

[49] George (n 47).
[50] Eisenhardt (n 46) 58.

managerial and financial systems such as the human resource systems, the accounting and book-keeping systems and the other systems related to invoicing, pricing and collection.[51]

The wide powers enjoyed by managers and the thin involvement of shareholders in the company's works leaves ample opportunity for the abuse by managers.[52] This is one of the critical issues which business is facing in practice, and which the corporate governance as an idea, and the science of management as an academic subject, are trying to solve or at least minimize to an accepted level.

2.2.3.3 Managers' standard of responsibility

Managers standardly owe a duty of care to the company they work for. The same duty of care is proposed to be vested in the managers vis-à-vis the shareholders. This is a direct application for the proposed agency theory. The duty of care in this sense imposes on the managers the obligation to dedicate their time and resources, including the intellectual resources, to achieve the goals and the interests of the company.

As detailed above, this duty of care is a question of degree, and it differs from one person to another and from one circumstance to another. Moreover, finding an agreed-upon priority scale for the imminent objectives of the company is also an area of dispute.

As a result of the foregoing, finding whether a certain manager has breached its duty is vested in the courts to decide; however, the matter is always surrounded with a great deal of uncertainty as long as there is no universal scale identifying the objectives of the company and the roles and priorities of the management while achieving the same.

2.2.3.4 Possible problems of agency

As indicated above, the pattern of ownership - control separation, though a pivotal principle of good corporate governance is equally a source of fragility in the corporate organization mainly because it proved to be a source for abuses by

[51] George (n 47).
[52] Jean Tirole, 'Corporate Governance' (2001) Econometrics, 1.

managers. This could be seen as one of the problems of agency, for instance when managers' varied acts and actions are factually driven and dictated by their self-interests rather than the interests of the company.[53]

The recent years witnessed many well-known scandals caused by managers' misconducts. This does not usually take the form of directly enriching at the cost of the company, but rather by entering into agreements and taking decisions not to the favour of the company, a matter which results in burdening the company with unnecessary costs and depriving the company from actual profit had the decision taken been within the company's interest. Such misconducts are numerous and include, for example, the acceptance of bribe, the release of confidential information to a competitor, concluding agreements with companies, hiring relatives or friends, etc.

Even membership in businessmen clubs by managers and executives may be considered as misuse specially when such membership amounts to engaging the company in unnecessary political affairs and debates. This is, of course, driven by the subjective personal popularity of the managers/executives, and it usually results in endangering the side of the company without any objective benefit to the company in return.

The second agency problem, which may operate against the interests of shareholders, is the management variable responses to business risks. Apart from the *mala fide* conduct of managers and executives, *bona fide* behaviour of managers and executives may result in a detriment to the company just because they have different levels of, or responses to, business risks.[54]

The clash happens when the risk-aversion policy or attitude of the management conflicts with the general policy and goals of the shareholders who, in response to their own goals and needs, prefer adopting a different policy based on a different level of risk.

[53] Eisenhardt (n 46) 60.
[54] ibid.

2.2.3.5 Accountability before the Board

Managers and the executives of corporations and are, in principle, monitored by the company's board of directors. Monitoring is comprehensive in scope and it is suggested to include all acts and actions of the management which may affect the commercial and the financial standings of the company.

For the sake of categorization, monitoring usually takes two sides; a passive side which pertains to how management implements the general plan of the company, and an active monitoring side which aims at detecting management's faults and misuses in general.

Sometimes monitoring requires that managers and executives disclose to the board in full transparency any clash or conflict of interest they may have with the company's business, or with any specific deal the company is to engage in.

Boards are given wide spectrum of remedies to use in order to relieve any conversion the management may have from the planned course of the company. Again, reliefs are twofold: a passive one which depends on just directing the management to act for certain goal or end, and, on the other end of the spectrum, an active (direct) one which includes notification to management, direct involvement to rectify an action of misuse and, or taking an exemplary/punitive action such as the dismissal of the defaulted manager/executive.

Despite the existence of monitoring and accountability as a principle, the same may sometimes be insufficient to safeguard the interests of the company. This happens especially when the board lacks the necessary means to perform these duties particularly when the information and reporting system does not inform the board of the actual position in a timely manner.

2.2.4 Board/Directors: Definition and Relation with the Company and Shareholders

The board is a group of individuals who are appointed by the shareholders to act as their representatives to plan and manage the corporate business and make decisions on major corporate issues. In this capacity, the board is the highest reference in the company.

As an institution, the board is regulated by the articles of the company and by the national corporate law. The board, taken as an institution, is a superior unit of the company, and its main role is to liaise between the shareholders and the management.[55] In this sense, the board owes a fiduciary duty to the shareholders in safeguarding their interests in the company.

2.2.4.1 Duties

The main duty assigned to the board is to represent shareholders' interest in the company and before the management. In doing so, it liaises between the owners and the controllers of the company and thereby greatly reduces the consequences of the agency problem between managers and shareholders.

Importantly, a board also has a number of other corporate law duties including the duty to draw the general business plan of the company. In this respect, the board of directors draw the broad lines of the company business, activities and marketing strategy. This duty is not limited merely to drawing the general map; it is extendable to monitoring how management performs the assigned tasks and implements the general plans drawn. The board is required to intervene whenever necessary to rectify any abuse or mis-performance by the management.

Another duty of the board is to build reliable information system in the company based on file and financial record keeping and reporting at different levels.[56] The information system is very important for reliable monitoring and decision-making. In doing so, boards should receive from the management detailed reporting and information, on regular basis, on all operational and financial aspects of the company.

2.2.4.2 The Nature of the Board's Responsibility: the Fiduciary Duty

The board is largely qualified as owing a fiduciary duty to the shareholders because the trust relation binding it to the shareholders. As a fiduciary, the board undertakes an enhanced duty of care to the benefit of all shareholders taken

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[55] Oliver Hart, 'Corporate Governance: Some Theory and Implications' (1995) The Economic Journal, 678.
[56] Eisenhardt (n 46) 60.

collectively; this indicates that the directors' fiduciary duties are owed to the company and not to every particular shareholder.[57]

However, a fiduciary duty is a general term encompassing many latent duties such as the duty to make self-interest disclosures, obligation to act in good faith and the obligation of loyalty. Accordingly, directors are required to be neutral and should devote their efforts to result in the good of the company. Acts and transactions passed or otherwise approved by the board should not be induced by their self-interest. Equally, there is a general duty of disclosure on the board members to disclose to the board, and in some times to the shareholders, any self-interest they may have with respect to any action or transaction. National laws and the articles usually determine the matters that need to be disclosed by the board members.

In addition to the disclosure duty, the board and the directors are under a general duty of loyalty. This is a duty to act in good faith, often directly imposed by national law requiring the directors to act with due diligence and care to achieve the best interest of the company.[58]

The standard of this issue is unclear; it is generally agreed that obligations, like acting in good faith and in due diligence, are always tested objectively. This obligation looks to be of subjective nature in the modern corporate law in the sense that members should act in accordance of what they personally think fit and in the best interest of the company. Under such subjectivity test, it will be extremely challenging to have conclusive proof of breach of this duty by the board which adds extra immunity to the board.

However, to minimize or eliminate the subjective nature of this duty, courts require that not only the subjective good faith act of the director be the issue, but they also require that such an act be in the best interest of the company. The latter requirement is more sensible and objective. This objective technique implies the requirement that the directors have the necessary skills and exert reasonable care while doing their works. This does not imply the obligation to have distinguished academic degrees, but rather good judgment and full dedication to their duties.

[57] This should not be confused with shareholders right to directly claim damages from board members based on their (i.e., the board members) faults. See articles 76 and 78 of the Saudi Companies Law (1982).
[58] ibid.

2.2.4.3 The Board accountability before shareholders: the Disqualification System

Members in the board hold their office for a definite term (often for one year). They are either re-elected or dismissed by the shareholders' annual general assembly. The board is annually examined in the light of the company's annual results and performance, and the shareholders are able to modify its membership in a free election.

Moreover, in any particular case of serious faults or omissions by a board member, the member may be disqualified.[59] This may be decided by an extra ordinary decision, by a court decision or even by virtue of law in some instances. In addition to dismissal or disqualification a member may still be held legally liable vis-a-vis the company for compensation of damages sustained as a result his breaches or faults.[60]

2.2.5 Stakeholders

Stakeholders are a wide variety of persons and entities having a certain interest in the company or in its business. These interests are not of the same type, level or value, but rather they share the distinctive element of being attached with the company or its business.

2.2.5.1 The Main Characteristics and Sources of Relation with the Company

Stakeholders are not shareholders, managers or board members in the company. They just enjoy recognizable interests attached to the company or its business. They are not signatories on the articles, nor do they form part of the management.

As a term, 'stakeholders' is open-ended and refers to many persons and entities on the top of which comes the community; other possible stakeholders could be banks, lenders, unions (including labour unions), religious systems, the government, consumers, insurance companies and so many others.

[59] See Article 109 of the Saudi Companies Law (1982).
[60] ibid.

Stakeholders may sometimes have a kind of legal relation with the company such as when they are bound with employment contract, loan, or contract of supply with the company.[61] However, in many other situations, they do not have any contract bond with the company at all. This is why, especially for the second group, stakeholders' rights may be of lesser protection, compared to the shareholders. Due to this shortage in the legal bonds, it was argued that stakeholders' theory in the corporate governance is a theory of ethical conducts that should be recognized and enforced; but it should be in a creative and unique way in order to avoid falling fouls of the classical law requirements for institution of valid legal actions.

In addition to the enjoyment of lesser protection stakeholders also enjoy a lesser information. This is basically true due to the fact that companies do not usually allow their information to be disseminated without a cause. This deficiency undoubtedly deprives stakeholders from a very important tool, which is necessary for participation in the corporate governance processes.

The final characteristic of the stakeholders group is their essential contribution to the intangible assets of the company. Questions of competitiveness, loyalty, reputation, quality and goodwill of companies are all stakeholder related issues.[62] These intangible resources act as the customers' attractive forces towards said company's goods and services. Companies are today fully aware of the importance of building and maintaining these nexus with the stakeholders, and they are also aware of the fact that such forces are so vital in maintaining their profit margins and the shares they occupy in the market.

2.3 Corporate objectives: a theoretical view

Corporate governance is basically about the idea that the management, shareholders and stakeholders are acting, or otherwise be treated, fairly, efficiently and in sufficient transparency. The main goal remains to reduce disputes and arrive into an accepted scale for the management and board performance.

These goals will not be firmly fixed and regulated unless the main objectives of companies are first identified. This identification will also provide the management

[61] ibid.
[62] Lionel Bently and Brad Sherman, *Intellectual Property Law* (2nd ed., OUP 2004).

and the board with a kind of a road map for their work, and it will also act as an identifying reference for their efficiency, honesty and corrective performance in the sense that deviation from such objectives will be considered an act of misuse triggering liability of management/board.

When scholars attempt to identify these objectives, they ramify in three main theories developed on different priority scales for shareholders and stakeholders' interests.

2.3.1 The Shareholder Value Approach

According to this approach, the main objective of the company is to work for an increase in the value of the shareholders' interests. This increase of value should be the primary objective of the management when acting and making its decisions.[63]

This way of thinking is basically grounded on the fact that shareholders are the legal owners of the company, and they, in such capacity, acquire the legitimate interest to monitor the activities of the management, the board and the general conducts of the company and direct the same to their absolute interest. Under the same stream of thinking, all planning, transactions and decisions to be made by the management should be reasoned on grounds of, and only be triggered to seek or achieve, shareholders' interest. That is to say, the shareholder's value maximization should be the single guiding principle of the management and the board.

The shareholders interest in this meaning is financial in nature. It is the vindication and increase of shareholders' investments in the company in commercial means. Unquestionably, supporters of this approach believe that stakeholders and corporate social responsibility affairs enjoy a secondary importance when compared with the shareholders' interests.

Shareholder value theory has had wide acceptance in the academic references and the actual business practice in the West, especially in the era of the 1990's. The theory has also a legal support based on the assumption that while

[63] Tirole (n 52) 5.

shareholders provide their monies in the company as investors, the company shall operate to provide them with a sufficient and secured return. The theory also applies as a parameter for the management and the board performance because they are hired in the first place to achieve this goal.

2.3.1.1 The Parameters

This theory has mainly three parameters; namely, the profit maximization of the company and dividends value, the increase of the company share price in the market and the risk aversion.[64]

As for the first parameter, the management will devote its activities to realize more financial returns to the shareholders. It shall work hard on making the equation of 'return' and 'cost' balances positively in favour of more profits. By doing so, companies are also required to operate efficiently and to cut unnecessary operational costs. Since the realization of profits becomes the supreme goal of business, companies will turn to operate on large scale, and economies of large scale (for efficiency reasons and for the sake of cutting operational costs) will be more witnessed. The increase of profit will also increase the value of dividends to be distributed annually to the shareholders.

The second parameter comes as a direct result for the first one; the good financial results of the company (profit), and the large scale efficient operations of business the company has, will both result in more confidence in the company's financial status by the financial market. Investors will start to invest more money in the company and will try also to acquire its listed shares. This logical attitude, coupled with the fact that a large amount of money is annually distributed to shareholders as dividends, will result in the rise of the company share price which, i.e. the rise, will also act by itself as an indicator to the prosperity of the company and its current business.

Finally, the management of a company having the sole purpose of profit maximization will be risk sensitive. It will prefer safe investments instead of high-risk investments even if the latter may derive more profits. For example, a company will not usually concentrate on intensive investments in research and development

[64] Steve Letza and William Sun, 'Corporate Governance: paradigms, dilemmas and beyond' (2002) 2(1) Poznan University Economic Review, 45.

and will depend instead on purchasing licenses and new technologies from external resources. The management will expand into new markets indirectly through appointment of dealers or commercial representatives instead of directly existing in these new markets as operational utilities.

2.3.1.2 The Main Trends

Companies working for the maximization of shareholders' values as a main objective usually share some contractual and operational trends. These trends are the actual tools that are necessary to achieve the shareholders' value and to allow the parameters, indicated above, to operate successfully.

The main trends are usually four; aversion of long-term investments and depending instead on short-term ones, building of efficient and reliable information system, contracting with managers and executives on out-come basis, and paying secondary attention to the stakeholders' interests.

As indicated above, companies that are totally devoted for shareholders' interests are risk aversion. This is a general policy, which usually results in making companies avoid engagement in long-term investments. This is reasoned on grounds that long-term investments are risky and unpredictable and do not generate profits quickly.

It must be noted that companies need to realize income and profit on regular short intervals within the financial year. Profit realization in every fiscal year is necessary in order to enable the company from meeting the desire of the shareholders in receiving returns in the form of dividends.

Investments on the long run, to the contrary, are not producing profits within a short period. Although returns from the long run investments could be sometimes guaranteed, the fact that most shareholders are not economically educated to catch this result will cause the managers to avoid this form of investment. Managers, as per this traditional perspective, are aware that the evaluation of their performance will be tested with reference to profits achieved and dividends distributed annually, and this is why they will not approach investments on long term conditions. Besides, people making investments in shares are usually investors of short-term goals and their main concentration is on the annual result instead of the strategic future of the company.

The second trend is monitoring related; it is built on the creation and operation of very reliable and accurate information system about the operation of the company and the results thereof. The system should reach and report all aspects of the company in sufficient manner to enable the board and the shareholders to monitor the performance of the management and reduce any possible abuse thereby.[65] On the top of these systems, naturally, comes the financial reporting and auditing.

The third trend is the outcome-oriented nature of executives/managers employment contracts. For reasons related to reducing agency problems and possible misuse of power by managers. Companies will seek new contractual strategy with managers and executives. According to this strategy, managers and executives will be rewarded in accordance with the results achieved by them; behaviour-oriented contracts stating fixed monthly salary as reward will seldom be used. This technique is also risk-related and aims at shifting risk burdens to be on the part of management, a matter which will reduce management misuse and will devote its full attention to achieve the good of the company and the shareholders.[66] Surprisingly, the outcome oriented contracts technique will also make managers so keen to maximize the profits of the company and will make them adopt short-term investment strategy for the company!

The last trend for companies adopting shareholders value strategy is the lesser weight the stakeholders have in the planning and decision phases of the company. Managers will not give priority to building long-term nexus with the stakeholders, and companies will not make intensive commitments to the community.

2.3.2 The Stakeholder Value Approach

Some have recently argued that emphasizing the interests of shareholders over those of other stakeholders is not always a good strategy. They argue that companies should observe all interests affected by its activities, not only the

[65] Eisenhardt (n 46) 60.
[66] ibid 61-63.

interests of the shareholders. This approach enjoys less legal recognition, and it mainly depends on rules of ethics.[67] Today, the stakeholder model is widely and successfully prevailing in the Japanese governance schools; it has interesting manifestations in the German system that will be further detailed in the sixth chapter of this research.

2.3.2.1 The Parameters

Companies implementing this approach will usually have three main parameters; namely, seeking the satisfaction of the stakeholders, the maximization of the company's intangible assets and risk acceptance in investment and in the conducting of business. Planning and decision phases by managements in such companies should be enlightened and reasoned by these three parameters.

The first indicator is the satisfaction of the stakeholders as a primary goal.[68] Satisfaction in this sense is not measured in money, and stakeholders will remain un-entitled to receive dividends or financial benefit, but, to the contrary, the company will take into its consideration while performing in the market, the legitimate interests of the stakeholders depending on principles of ethics and social commitment. Such prospective emphasizes responsibility over profitability, and it depends on acting in fairness, without causing indispensable harm to others and even on engagement in charity acts for the good of the society.

The second parameter is the maximization of the company's intangible asset. Intangible assets could be the result of multi-source contributors on the top of which are the stakeholders. Goodwill, reputation and competitiveness are all stakeholders related, and they usually come as a result of the stakeholders' satisfaction with the company's acts and decisions in the market and the community.

The third parameter is risk acceptance. Managements will not be chained by the annual financial demands of the shareholders. This will allow managements to

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[67] Knowledge Centre, 'Emphasizing responsibility over profitability: Explaining Stakeholder Value Perspective' <http://www.12manage.com/methods_stakeholder_value_perspective.html> accessed 20 January 2015.

[68] Kent Greenfield, 'New Principles for Corporate Law' (2005) Hastings Business Law Journal, 87.

apply more resources in research and development and in internal training and capacity building of the company's personnel.

2.3.2.2 The Main Trends

Companies working for the maximization of stakeholder value as a main objective usually share some common trends. The main trend is the adherence to ethical and social responsibility rules by the management when making its decisions and actions in the market[69]. To this end, companies will give more adherences to the internationally recognized codes of conduct which give more weight to the interests of stakeholders and push toward more fairness in dealing with them. Companies will engage in more social and environmental activities, and they will recognize and give its employees more facilities, including an option to contribute in its capital (equity).

The other possible trend under this stream of thinking is the acceptance of long-term investments. This is due to the fact that managements are no more restricted with the sole obligation to gain large amounts of profit annually. Finally, the company will act in transparency with the stakeholders and will give more advisory role to them. As a possible attitude, companies will seek building nexus of trust with major stakeholders and, they will give them some advisory role and communication channels with the board. The transparency attitude will depend on releasing more data to the stakeholders and giving bigger role to media and independent classification agencies.

Despite the fair dress the stakeholder value approach has, the theory is not free from criticism. On one part, it might be argued that this theory was only successfully applied in very developed economies, such as Japan and Germany, where companies are so wealthy and rich, and the shareholders thereof are fairly satisfied with the financial results achieved annually. On the other part, the theory does not classify shareholders' interest amongst the company objectives and somehow ignores it. In all cases, shareholders' interest should remain the prime goal of any company. In addition, the theory does not give any advice to management on how to behave in situations of potential conflict between the

[69] Archie Carroll, *Business and society: Ethics and stakeholder management* (2nd ed, South-Western Publishing 1993).

interest of shareholders and those of the stakeholders. Likewise, the theory deals with the stakeholders as having one type of interest while, in fact, this is necessarily untrue. The theory does not give clear indicators to managements on how to deal when the interests of different categories of stakeholders conflict together. Finally, the theory was criticized on the basis of being a kind of metaphoric thinking. Without law recognition, dependence on ethical rules to enforce the interests of stakeholders will be useless since stakeholders will not be able to institute lawsuits to vindicate their rights legally. The stakeholder theory simply claims while companies pursue their primary objectives they have to voluntarily take into account the legitimate interests of stakeholders. Ethical rules remain, in the legal context, optional, and they will not gain mandatory status unless transplanted within the law by means of corporate law reform.

2.3.3 A Compromise: The Enlightened Shareholder Value Approach

To overcome the rigidity of both shareholder value and stakeholder value approaches, some business practices and academic writers suggest a compromise between these two models. What is suggested is a compromising practice that lies in the middle of the spectrum of governance, not on any of its two different ends. This will happen by combining elements of both models in order to ensure justice for all players. According to this middle stream of thinking, the management and the board's basic duty shall remain the maximization of the shareholders' value and interests in the company. Nevertheless, building good nexus with stakeholders and recognizing their needs and concerns while making decisions will also be the duty of the management and the board.

The idea is simple and it is built on the fact that it is almost impossible to find a successful company with disappointed customers and angry community! Building on this, the shareholders' interests indispensably include achieving the satisfaction of the stakeholders, not only achieving return in form of good profit (money). Had this new definition for the shareholders' value been admitted, managers will be released free to think and work for more recognition to the stakeholders' concerns, which, by themselves, are the shareholders' value on the long run.

There is no need to make major reform in the Corporate Laws in order to adopt this compromising approach since the shareholders' value (profit) maximisation remains the main objective of the company. All that needed to change is how such value is defined and within what time limits. Law implantation is not an issue since the reform required will be so trivial.

The enlightened shareholders value approach requires that the shareholders' value be defined on long-term basis. It also requires that the stakeholders' interests be recognized and considered by managers, provided that the same conform to the long-term interest of the shareholders.

Managers and directors should run the company in a manner that observes all interests on the long run. In case of conflict between the shareholders' interest and a stakeholders' interest, or in case of conflict of interests between two categories of stakeholders, the criterion to be followed is the long-term interest of the shareholders.

2.4 Taxonomy of Corporate Governance Models

The discussion and analysis in the previous sections was focused on the *definition* and *conceptual analysis* of corporate governance. The present section takes the discussion further by focusing more particularly on the *taxonomy* of corporate governance standards. Accordingly, this section will be devoted to the analysis of the *normative* aspects of corporate governance and the constitutive standards that characterize the various models of *good* corporate governance.

In attempting to classify models of corporate governance standards this thesis proposes in section 2.4.1. a global model of corporate governance standards which offers the basis for classification of sub-models embodied therein. The proposed model consists of three normative layers as follows:

a) the fundamental pillars of good corporate governance (section 2.4.2);

b) the supranational standards of good corporate governance (section 2.4.3); and

c) the national applications of good corporate governance (section 2.4.4).

2.4.1 A generic model of global corporate governance standards

The discussions of the normative standards of corporate governance in the academic literature span three broad and distinguishable areas. The first of these areas is focused on the fundamental pillars of corporate governance whereas the second and third areas are focused on the international principles and the various national rules of corporate governance, respectively. While these areas are often discussed separately, an attempt is made in this section to bring them together in a broadly global model of good corporate governance. Thus the proposed model is characterized by a cascade of three normative layers, which can be visualized in three co-centric circles as follows:

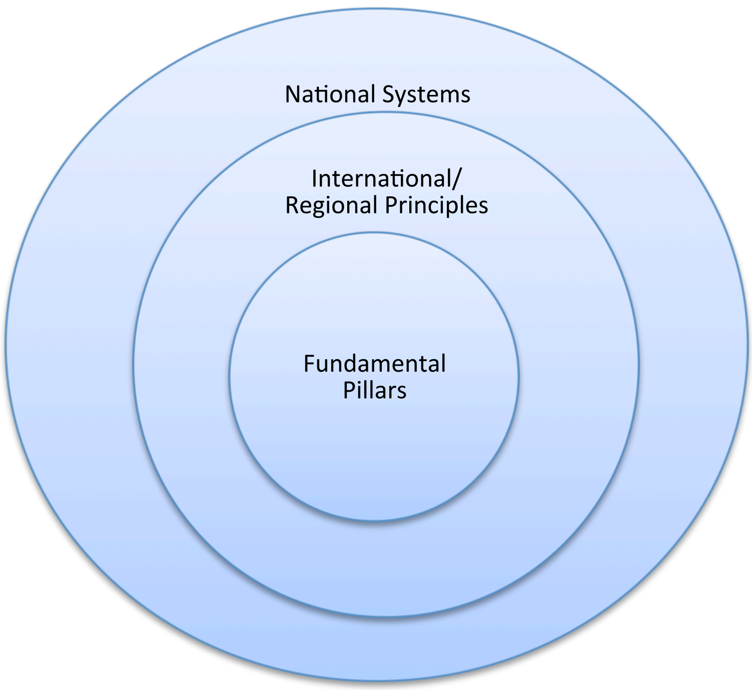

Figure 1 Generic model of good corporate governance standards

These layers of this generic model are constituted of the following:

1. **The core or nucleus layer:** consisting of the fundamental pillars or values of corporate governance;
2. **The central layer:** consisting of international principles of corporate governance;

3. **The outer or peripheral layer:** consisting of rules constituting the national framework of corporate governance in various states' jurisdiction.

2.4.2 The fundamental pillars of good corporate governance

It is commonly believed by specialists in the field that globalization has had a significant impact on contemporary corporate governance. Chief among the areas clearly demonstrating this is the impact globalization brought onto "the ethical basis of regulation and integrating ethical concerns into governance practices'.[70] There is number of ethical concepts have been emphasized by various authors as constituting the 'pillars' of good corporate governance. For example, Abdul Munid[71] discusses *accountability*, *transparency*, *fairness* and *responsibility*, while Masons[72] discusses *accountability, transparency, integrity,* and *risk management.* Furthermore, while these authors approach the subject of corporate governance pillars from a theoretical perspective, others[73] adopt a practical or operational perspective focusing more on the actual implementation of the pillars and the practical challenges they raise. The analysis of the pillars of corporate governance in this thesis will be undertaken from a theoretical point of view focusing on the four concepts of accountability, transparency, fairness and responsibility.[74]

2.4.2.1 Accountability

In the context of corporate governance accountability simply means that those responsible individuals or groups in a company who make decisions and take actions on specific issues are accountable for their decisions and actions. Mechanisms must be in place to ensure accountability. This provides investors

[70] Veronique Magnier *Comparative Corporate Governance: legal Perspectives* (Edward Elgar Publishing 2017) p. 53.

[71] Shahral Lali Haji Abdul Munid, *Corporate Governance in Islamic Perspectives,* 5th International Conference on Islamic Finance: Thirty Five Years ON – The Future of Islamic Finance, Kuala Lampur, 2007. available at <https://lariba.com/knowledge-center/articles/Corp_Gov_in_Islam_InternationalIslamicFinanceConference3SeptMonash-IBBM.pdf> last accessed on 20 August 2017.

[72] Pinsent Masons, *Corporate Governance: the benefits of good practice for private companies in the GCC*. 2013. available at <https://www.pinsentmasons.com/PDF/gulfregion/Article-CorporateGovernanceFeb2013.pdf> last accessed on 20 August 2017.

[73] See e.g. Price Waterhouse Coopers *Corporate Governance in the Boardroom: a practical perspective* PwC Point-of-View-Paper 2015,available at<https://www.pwc.com/ee/et/publications/pub/corporate-governance-in-the-boardroom.pdf>last accessed 22 August 2017.

[74] These four concepts enjoy relative international acceptance as the pillars of corporate governance. For example, they have been adopted in code of best corporate governance in Kenya <http://www.ecgi.org/codes/documents/principles_2.pdf>last accessed 22 August 2017 and in Brazil <http://www.ecgi.org/codes/documents/ibcg_sep2009_en.pdf> last accessed 22 August 2017.

with the means to question and evaluate the actions of the Board and its committees. Thus, accountability embraces ownership of strategy and task required to attain organisational goals of corporation. This also means owing reward and risk in clear context of predetermined value proposition. When the idea of accountability is approached with this positive outlook, people will be more open to it as a means to improve their performance. This applies from the staff all the way up to top leadership embracing Risk management within defined formal appetite for risk. This also include fostering culture of compliance to create real and perceived believe that the entity is operation within internal and external boundaries.

2.4.2.2 Fairness

As already discussed above, stakeholders are the central focus of corporate governance. Accordingly, good corporate governance denotes the collective standards that regulate the various relationships between various participants and stakeholder. “Fairness” is regarded as the underlying principle upon which these relationships are organised and regulated. It means treating all stakeholders s including minorities, reasonably, equitably and provide effective redress for violations. Establishing effective communication mechanism is important to ensure just and timely protection of resource sand people asset as well correcting of wrongs.

Moreover, fairness must be recognized and implemented in practice to ensure balance in the organisation. The rights of various groups have to be recognised and valued. For example, minority shareholder interests must receive equal consideration to those of the dominant shareholders.

2.4.2.3 Transparency

Transparency is often simply defined as “having nothing to hide” which encompasses both intentional and practical elements. For corporations, this means that each company deliberately allows its processes and transactions to be observable to outsiders. It also makes necessary disclosures, informs everyone affected about its decisions, and complies with legal requirements. Thus, transparency is regarded as the ease with which an outsider is able to make significant assessment of a company’s actions, its economic fundamentals and the non-financial aspects relevant to that business. This is a measure of how good management is at making necessary information available in an open, precise and timely manner – not only the audit data but also general reports and press releases.

Following the financial scandals in the early 2000s, transparency has played a bigger role in preventing fraud from happening again, especially at such a large scale. But aside from stopping the next illegal moneymaking scheme, transparency also practically builds and enhances a good reputation of companies.[75] Arguably, when shareholders are content and accordingly feel they can trust a company, they consequently become more willing to invest more, and this greatly helps in lowering cost of capital and positively rewards the company, the investors and stakeholders.

Additionally, transparency is a critical component of corporate governance because it ensures that all of a company's actions can be checked at any given time by an outside observer. This makes its processes and transactions verifiable, so if a question does come up about a step, the company can provide a clear answer. And after the Enron scandal in 2001, transparency is no longer been regarded merely as an option, but a legal requirement that a company has to comply with.

But although transparency is a necessity for the whole company, its presence is even more important at the top where strategies are planned and decisions are made. Shareholders expect that the corporate board is open about their actions; otherwise, distrust will form. And when trust breaks, shareholders tend to stay away and invest somewhere else.

2.4.2.4 Responsibility

Responsibility relates to the behaviour that allows corrective action to be taken and penalising mismanagement and misconduct. Responsible management would, when required, put in place what it would take to set the organisation on the right path. While the Board is answerable to the company, it must act responsively to and with responsibility towards all shareholders of the company. The difference between accountability and responsibility is that, one is liable to provide an account

[75] See e.g. Pinsent n 72.

when one is accountable and one is liable to be called to account when one is responsible. In corporate governance terms, one is accountable by law to the organisation if one is a director and one is responsible to the shareholders identified as relevant to the organisation. Therefore, the pillars of accountability and responsibility are utilised to ensure that the Board of Directors is both accountable and responsible for their actions.

Accountability denotes the obligation to answer for the conduct and execution of responsibilities. It differs from responsibility in that where responsibility can be delegated accountability cannot. Thus, responsibility can be delegated without, however, abdicating accountability.

2.4.3 Supra-national standards

As used in this thesis, the supranational standards of corporate governance refer to international principles with global appeal, such as UN[76] and OECD principles, and principles endorsed regionally for designate groups of countries such as the Islamic principles of corporate governance discussed in chapter (5) below and EU principles of corporate governance enunciated through a number of instruments.[77] Presumably, supranational principles espouse the values embodied in the core or fundamental pillars of corporate governance and they, in turn, constitute a normative source to inform and guide formulation of national standards of corporate governance as indicated in the generic model above.

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[76] See e.g. United Nations Conference on Trade and Development (2006), Guidance on good practices in corporate governance disclosure, United Nations: New York and Geneva; United Nations Conference on Trade and Development (2009), 2008 Review of the implementation status of corporate governance disclosures: An examination of reporting practices among large enterprises in 10 emerging markets, United Nations: Geneva; United Nations Conference on Trade and Development (2010), 2009 Review of the Implementation Status of Corporate Governance Disclosures: An Inventory of Disclosure Requirements in 24 emerging markets, United Nations: Geneva; United Nations Conference on Trade and Development (2011), Corporate Governance disclosures in emerging markets, United Nations: New York and Geneva.

[77] See e.g. Communication from the Commission to the Council and the European Parliament Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward, COM (2003) 284 final; Communication from the Commission Europe 2020. A strategy for smart, sustainable and inclusive growth, COM (2010) 2020 final; DIRECTIVE 2006/46/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL, Official Journal of the European Union L224/1.

2.4.3.1 Motivation and rationale

A legitimate question may be raised as to why supranational principles of corporate governance are considered pertinent to the discussion and analysis in this thesis. In fact the discussion involves a number of aims and consequently the answer to that question is manifold and may be summarised in the following points:

Analytical aim: the discussion in section (1.1.2) demonstrated that the Saudi legal system is fundamentally based on Islamic Sharia legal principles. At the same time, this system includes substantial degree of western-style legislation particularly in the area of corporate governance. Thus, considering the mixed characteristic of the Saudi legal system, appeal to supranational standards such as OECD and Islamic principles of corporate governance may be a source of conflict. Consequently, it is important to discuss and analyse supranational standards in order to establish answers to the following questions: Are OECD and Islamic principles compatible (or not)? And, which set of these standards should the Saudi system adhere to?

Informative aim: another aim of the discussion is to inform policy options designed to enhance the efficiency of the legal framework of corporate governance in Saudi Arabia not only of the existence but also of the relevance of a pool of instruments which can profitably be utilised in this regard. In particular, the OECD Principles are particularly relevant to Saudi Arabia on account of the country being a member of the G20 which is a partner to the latest version of OECD Principles published in 2015. More generally, however, there is a need to shed light on the international standards and efforts by inter-governmental organisations in relation to standardised corporate governance rules in the context of corporate governance and the GCC. These standards include many aspects, such as by providing benchmarks and recommendations to enhance the national legislative, institutional and regulatory framework of corporate governance.

Evaluative aim: as stated in chapter 1, one of the objectives of this thesis is to assess the efficiency of the Saudi legal framework of corporate governance. Hence, the various international principles and standards provide appropriate criteria for this evaluative assessment.

Teleological aim: another objective of this thesis is to recommend the means to strengthen the efficiency of the Saudi legal framework of corporate governance. International principles and standards can been seen in this regards as benchmark to build an environment of trust, transparency and accountability necessary for fostering long-term investment, financial stability and business integrity in the country.

2.4.4 Models of national standards

National application models of corporate governance refer to the adoption or implementation of corporate governance standards on the level of national jurisdiction of individual countries. The discussion and analysis of the institutional and statutory framework of corporate governance in Saudi Arabia in chapter (3) and (4) respectively, is an example that. Equally, the discussion and comparative analysis of the national models of corporate governance, such as the institutional v the legislative approach or the civil v the common law system of corporate governance, discussed in chapter (7) of this thesis.

2.4.4.1 Distinction between supranational and national standards

Supranational and national standards of corporate governance may *prima facie* be distinguished hierarchically. That is to say, supranational standards pertain to a higher level of application comparable to the distinction between international and national law. Another distinction is that supranational standards apply to a group of countries and, in contradiction, are consequently not confined to a single national jurisdiction.

Another important distinction proposed in this thesis pertains to the normative character of supranational and national standards. It is argued here that supranational standards consist of legal principles whereas national standards consist, largely though may be not exclusively,[78] of legal rules.[79] It is important to elaborate this distinction between rules and principle a bit further before returning to the nature of national standards.

[78] Corporate governance standards and regulations in individual national jurisdictions often involve both rules and principles of corporate governance.
[79] The argument is based on distinction made by Ronald Dworkin in 'The model of Rule 1', in *Taking Rights Seriously*, (1994), 7th impression Duckworth, p. 14ff.

Dworkin argued that the distinction between legal principles and legal rules is a logical one. Thus, while both ‘standards point to particular decisions about legal obligation in particular circumstances, but they differ in the character of the direction they give’.[80] Accordingly, he characterized rules as applicable in all-or-nothing fashion for a particular decision, whereas a principle, contrarily, ‘states a reason that argues in one direction, but does not necessitate a particular decision’.[81]

The difference stated above between principles and rules entails another; that is, valid legal principles may conflict with one another but rules do not. According to him, if two rules conflict they can not both be valid, i.e. one of them must be invalid. This difference in turn entail that principles have a dimension lacked by rules; that is, the dimension of strength or importance. One two principles conflict the one which is more important or has more weight will prevail over the other.

These characteristic differences between rules and principles must not be regarded as shortcoming. Instead, they must be recognized as essential attributes adding flexibility to the adoption of supranational principles of corporate governance in national jurisdictions.[82] This is particularly important because supranational standards of corporate governance are invariably intended to apply to more countries with varying needs and circumstances.

[80] ibid p. 24.
[81] Ibid p.26.
[82] It could be argued that the same arguments and characteristics of principles apply equally to the core values of corporate governance discussed above.

3. Chapter Three: The Saudi Institutional Framework of Corporate Governance

One of the main arguments advanced in this thesis is that good corporate governance requires on the national level a well-established structure of government institutions based most fundamentally on the principles of separation of powers and the rule of law. These principles divide and balance state power in order to advance the values of good governance generally and serve certainty and predictability by delimiting discretionary power on government officials. Equally, they enhance investor confidence by enabling legal remedy through independent courts based on the important principle of equality before the law. Moreover, some authors point out a growing parallelism between corporate legitimacy and government legitimacy.[83] Therefore, this thesis argues that the substantive standards of good corporate governance, whether national or international, not only require but also actually presuppose the existence of a well-established institutional structure domestically.[84]

Thus, the analysis in this chapter will examine the impacts of the Saudi institutional framework on corporate governance regulation at two levels: the level of law-making (legislation) and the level of law application. On the first level section (3.1) discusses the Saudi State authorities and institutions from the vantage point of the doctrine of separation of powers while section (3.2) focuses more specifically on the legislative power and process. Law application is discussed in sections (3.3) and (3.4) focusing the administration of justice and judicial power and institutions, and the supervisory authorities entrusted with implementing corporate governance in Saudi Arabia, respectively.

[83] Cary Coglianese, 'Legitimacy and Corporate Governance', *Delaware Journal of Corporate Governance* (2007) Vol 32, pp 159-67, by the same author "Legitimacy and Corporate Governance" (2007). Faculty Scholarship. Paper 145. h p://scholarship.law.upenn.edu/faculty_scholarship/145

[84] Arguably, this argument is supported by the requirements of the first OECD Principle: *Ensuring the basis for an effective corporate governance framework* which principle requires that the framework of corporate governance should promote transparent and fair markets, and should be consistent with the rule of law and support effective supervision and enforcement.

3.1 Saudi State authorities and institutions

Pursuant to Article 44 of the BLG the Saudi State authorities consist of the following three:

- The Judicial Authority
- The Executive Authority
- The Regulatory Authority’

These authorities *prima facie* map well into the traditional and well-known distinction of state authorities into legislative, executive and judicial authority with the difference between ‘legislative’ and the Saudi ‘regulatory’ authority being, *prima facie*, terminological rather than conceptual. However, whereas the three doctrinal powers are traditionally entrusted to three different institutions, i.e. parliament, judiciary, and the executive (government), the institutionalization, i.e. distribution between national institutions, of these powers is not clear-cut in Saudi Arabia as discussed below.

3.1.1 Institutionalizing State powers

The Basic Law of Governance entrusted the regulatory authority with the responsibility of issuing legislations that achieve the general interest. Article (67) of the BLG stipulates that:

"The regulatory authority issues the laws and motions needed to fulfil the interests of the State; and revises the same; all in accordance with the *Sharia*. This authority exercises its functions in accordance with the BLG and the laws pertaining to the Council of Ministers and the Consultative Council."

However, the BLG does not clearly provide which institution is entrusted with the powers of the regulatory authority and, as such, is meant in the above provision. There are at least two fundamental in institutionalizing the regulatory power pursuant to these Articles mentioned above:

1. Article 67 refers, indirectly to some sort of legislative partnership that is needed between the Saudi Council of Ministers and the Consultative Council for the exercise of such the regulative power. It should be noted here that the Council of Minsters is part of the executive power whereas the

Consultative Council is a quasi legislative organ. Moreover, it is unclear which role each of these institutions plays in the exercise of regulatory powers.

2. Moreover, the above-mentioned Article 44 adds even more ambiguity in stating in its final part: 'These authorities cooperate with each other in the performance of their duties, in accordance with this statute and other laws. The King shall be the Head of all these authorities.' This means that all powers are ultimately not separated but rather concentrated into one body.

Thus, the *prima facie* considerable weight given by the BLG to the application of the principle of separation of authorities is negated by revealing the role of both the Council of Ministers, the Consultative Council as well as the King in taking over the regulatory authority. In this regard, it was said that "the Kingdom followed the idea of cooperation between authorities by regulating the relationship between them; performance of the duties is meant to be a cooperative matter between the authorities, to prevent the autocracy of any of them in making decisions."[85]

Additionally, Article (19) of Council of Ministers Statute 1993[86], stipulates the following: "the Council of Ministers shall plan the internal, external, financial, economic, educational and defence policies and all the public affairs of the State, and shall oversee the implementation thereof. The same shall take into consideration the decrees of the Consultative Council, shall have executive powers and will be the competent authority with regard to financial and administrative affairs in all the ministries and other governmental bodies."

Article (20) thereof further stipulates the following: "Subject to the stipulations of the Law of the Consultative Council; other laws, international treaties, agreements and concessions shall be issued and amended by virtue of Royal Decrees after the same having been studied by the Council of Ministers."

Article (21) of the mentioned Statute reads as follows: "The Council of Ministers shall study draft laws and regulations submitted thereto, vote on each article of the

[85] Muhammad bin Abdullah Al Marzouqi, *The Regulatory Authority in the Kingdom of Saudi Arabia* (Obeikan Publishing House 2004) 184,85.

[86] Law on the Council of Ministers, 1993 (Royal Order No. A/13). Adopted on 21/8/1993.Published in Umm al-Qura Gazette, No. 3468.

same, and then vote on the whole articles in accordance with the procedures stipulated in the internal statute of the council."

It is clear from the above articles that the Council of Ministers is granted vast powers in this regard, making it the key element in the regulatory duty in the country. On the other hand, Article (15) of the Consultative Council Law (1991)[87] laid down the role of the Council by stating explicitly that it is no more than an advisory role, as the mentioned Statue stipulated as follows:

"The Consultative Council shall give opinion on State general policies referred thereto by the Council of Ministers. In particular, the same is entitled to the following: a- discussing the general plan of social and economic development to give its opinion thereon. b- Studying the statutes, regulations, treaties, international agreements, and concessions to give its opinion thereon. c- Interpreting the Laws."

The articles discussed above demonstrate that the role of the Consultative Council is no more than advisory as regard to the laws and policies referred to it. The particular drawback in this regard is that the Council of Ministers is under no commitment to submit all legislations and policies to the Consultative Council for approval. In other words, the Council of Ministers takes the lead in the legislative process, while the role of the Consultative Council is only consultative and even evitable, i.e. it is a powerless parliament!

As for the King and his role in legislation, the statute stipulates that the King is the Head of all judicial, executive and regulatory authorities. While the Consultative Council is given an advisory role, i.e. making studies and giving opinions, the Council of Ministers was given the responsibility of issuing legislations and policies. However, most of the decisions of the Council of Ministers cannot be final unless they receive royal ascent by the King and a Royal Decree is issued to validate them. Thus, the combination of all powers ultimately into a single institution is clearly incompatible with the doctrine of separation of powers.

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[87] Royal Decree No. A/91 of 27 Sha'ban 1412 Corresponding to 1 March 1992. Available at http://www.wipo.int/wipolex/en/details.jsp?id=14901 last visited 20 December 2017.

3.2 Legislative Power and Process

The issue of separation of powers has direct impact on the actual legislative process. The legislative process in the Kingdom consists of a range of references, including legal divisions in ministries, specialized committees in the Consultative Council, panels of experts in the Council of Ministers, the Council of Ministers itself, and at the top, the King. The components of such a system are explained herein below:

1. Panel of experts in the Council of Ministers

This Panel in particular can be technically considered as the legislative body in the Kingdom of Saudi Arabia. It consists of around (20) consultants, and supported by (10) researchers.[88]

Article (30) of Council of Ministers Statute stipulates the following: "The following bodies are included in the administrative formations of the Council:
(1) The office of the Chairman of the Council.
(2) The General Secretariat of the Council.
(3) The Panel of Experts.

The internal statute of the Council of Ministers explains the formation and the specializations of these bodies and the manner in which they carry out their duties. According to Article (11) of Council of Ministers subdivisions statute: "the Council of Ministers Office shall form a Panel of Experts. The number of the members thereof shall be determined by the Council of Ministers as deemed necessary."

As for the competences of this Panel of Experts, the same is provided under Articles (14) and (15), whereas article (14) stipulates that, "the Presidency of Council of Ministers may assign the expert to give opinion". Article (15) stipulates that: "the expert may give opinion on the following matters: a- Matters referred

[88] Ibrahim An-Nassiry, 'The Legislative and Judicial Structure in the Kingdom of Saudi Arabia, Executive Summary' (December 25, 2003). The study was prepared in light of Saudi Arabia's negotiations to join the World Trade Organization, which it joined in December 2005.

thereto by the Prime Minister or by the Council of Ministers. b- Matters referred thereto by competent ministries".

The competencies of the Panel of Experts in the Council of Ministers can be viewed in more details as provided under the Regulation on the Panel Work issued pursuant to the Royal Decree number (431) of the year 1972. The mentioned Regulation stipulates that the role of the panel is limited to receiving draft laws from governmental entities and reviewing the drafting and other technical aspects of referred draft laws!

This demonstrates how limited the role of the Panel of Experts is as a legislative body. It is very clear that the competences of the Panel are partial, limited and do not reflect an integral legislative process.[89]

2. Management and Laws Committee of the Consultative Council:

This Committee consists of nineteen members. The mandate of the Committee is limited to studying the draft laws referred from other agencies to the Consultative Council. In turn, the Committee reports its opinions on the draft laws to the Consultative Council. It must be stressed once again that the role of the Committee is no more than consultative.

3. Legal Divisions in the Ministries:

These Ministerial divisions carry out two tasks:

1) Suggesting and preparing draft laws, then referring statute drafts to the Council of Ministers.
2) Setting the executive regulations of the applicable laws.

There are no reference available to specify the rules applicable on nominating the staff members of such divisions, or what kind of specialized training needs to be given to such staff members.

[89] Ibid 41.

However, these divisions are given the authority to issue executive regulations. Such subordinate degree of legislation becomes a binding role by virtue of a decision issued by the concerned Minister, and hence it does not need the approval of legislation central institution, which is the Council of Ministers. It is, therefore, legitimate to express the worry as to the wide discretion granted thereto in this regard.

3.2.1 Legislative Process Scrutinized

In addition to the shortcomings pointed out above, many specialized studies pointed to the existence of many deficiencies in the legislative process in the Kingdom of Saudi Arabia, which can be summarized as follows:[90]

1. The lack of technical personnel in the legislative system of the Kingdom, compared to legislative systems of other countries and the many tasks commissioned to such a system.
2. The legislative system in the Kingdom lacks institutional view to build the capacities of its personnel.
3. The legislative system is currently no more than a range of executive cycles with limited competences, lacking an institutional methodology to form a coherent legislative view.

Moreover, the weakness of the legislative system and process has negatively impacted the quality of legislation and the legal performance of governmental bodies in general. For example, and as stressed above, the discretion granted to legal divisions in ministries in the absence of central supervision over legislation represented a serious expansion of the competences of the executive authority. Moreover, it results in inherent contradictions in laws as well as threats to many individual rights.

The absence of institutional view in Saudi legislative process engendered a number of characteristic shortcoming and defects in the exercise of the regulatory power. These include, slow pace of legislative reform, uncontrolled legislative

[90] Ibid 39.

delegation, lack of legitimacy, weak methodology, heavy legal transplantation and duplication of legislation.

3.2.1.1 The Slow Wheels of Reform

One of the major requirements of enhancing commercial investment is the continuous review for the legislations that support investment and provide stability for financial markets. On the contrary, it can be clearly remarked that the reform of Saudi laws is in a very slow process. This has led to a situation where many commercial transactions were left with no legal provisions to regulate them under the Commercial Law. The Commercial Law, which was issued in 1931, was never subjected to any review, and remained valid as originally issued with a lot of old terminology that is completely abandoned nowadays. What yet complicates the scene more is the fact that the Saudi Companies Law was issued more than fifty years ago and have never been reviewed since then, although the Capital Market Authority was established. The Kingdom joined WTO and the two Basel Accords, and the market itself developed beyond what a conventional companies law like that of KSA can accommodate.

The following list shows a number of some Saudi laws that was never reformed. This highlights the fact that the slow reform is the persistent character of the Saudi legislative process. As such, a straightforward answer to the efficiency question related to the Saudi Legal framework can easily be inferred.

1. The Commercial Law of 1931(Known also as *the Law of the Commercial Court*)
2. The Companies Law of 1965.
3. The Buildings and Roads Law of 1941.
4. The Bus Owners Syndicate Law of 1953.
5. The Basic Radio Service Law of 1955.
6. The Law of Protecting and Promoting National Industry of 1961.
7. The Commercial Agencies Law of 1962.
8. The Law on the Protection of Railways of 1962.
9. The Commercial Papers Law of 1963.
10. The Banks Regulation Law of 1966.
11. The Population Census Law of 1971.

12. The Law on the Disposal of Municipal Real Estate Properties of 1972.
13. The State General Statistics Law of 1960.

3.2.1.2 Weak Methodology

The making of Saudi legislation is carried out without any procedural guide, which determines the necessary procedural steps to be taken towards making of the legislation. This sheds doubts on the accuracy of the title of this section, which assumes the presence of a specific methodology, but it is characterized by weakness. However, the making of Saudi legislation, whether characterized by absence of methodology or its weakness, is clear from the above explanation of the legislative process. It jumps directly to the drafting stage without passing through the preparatory stages. The first of these preparatory stages is the group of reports for the drafting instructions, upon which the legislation drafter depends. This stage includes analysis of the local legal framework connected with the new legislation and the sources of legal applications, which are expected to be utilized in designing the proposed legislation. Here, in this preparatory stage, we can assume the existence of a report specialized in analysing the position of the new legislation in light of the Islamic jurisdiction. This is in accordance with the constitutional article of the Law of Governance, referred to above and which stipulates that the Sharia is the source of legislations.

The second preparatory stage is the design of legislative proposal in light of the reports of the first preparatory stage. This document includes the raw legal content of the new bill of law in addition to the regulatory impact analysis, which explains the necessary regulatory requirements of the new legislation prior to commencing its drafting. These are preparatory stages which should precede the drafting process and which are necessary for obtaining high quality product, i. e an effective legislation.

The absence of this methodology, which has been enhanced by the academic contribution, represented in the legisprudence, in addition to the advanced international applications, led to jumping directly to the drafting stage. This, in turn, makes the role of the legislation drafter more difficult, the thing that explains the excessive importation of foreign legislations and the attempt to implant locally in order to overcome the impossible mission of drafting a legislation without any procedural framework, which organizes the drafting process.

In light of this hurry review of the methodology for making legislations, it is clear that the absence of methodology represents the main disadvantage of the Saudi legislation framework. This also leads to many problems regarding the Corporate Legislations, which we have briefly reviewed and evaluated their contents. This analysis indicated the poorness of the legislation contents in addition to the presence of contradiction between these Corporate Legislations, resulting from the absurdity of foreign legislations implanting.

3.2.1.3 Uncontrolled Legislative Delegation

Again, this title lacks accuracy, as it implies the existence of true separation between legislative and executive powers, the thing that is difficult to prove. The Council of Ministers, in absence of any real legislative power with Ashura Council (the Saudi Parliament), practice both powers.

However, we shall discuss the legislative delegation assuming that there are two powers; the first is the legislative power, resembled to the Council of Ministers, and the other is the executive power represented by the different ministries. The provisions stipulated in the main laws, which determine the scope of secondary legislation and refer to certain provisions included in the implementation regulations represent the instrument for legislative delegation. In light of the provisions of the Basic Law, which states that the Council of Ministers is the source of legislations and in accordance with the provisions of the laws, which include the legislative delegation instruments, referred to herein, the legality of any secondary legislation, produced by the executive power will be determined.

The validity of the above assumption, about the existence of two separate powers: a legislative power (Council of Ministers) and an executive power (Ministries and other supervisory organs) is doubtful. Based on our previous discussion of the stages of the legislative process, it is apparent that the bills of laws started from the Ministries themselves. This means that the bill of law, which contains the legislative delegation instrument, referred to herein above, has been drafted by the employees of the legal department in the concerned ministry itself. Thereafter, the proposed draft will be referred to the Bureau of Experts at the Council of Ministers, which is the organ responsible for legislations. The role of the Bureau of Experts does not exceed the formal review of the text, without doing any fundamental amendments. This means that the executive authority, represented in the concerned ministry, is the original initiator of the legislative delegation instrument and its scope. I will not discuss the lack of true legislative delegation in this improper legislation process, but I will criticize the outputs of this legislative delegation, which is witnessing embarrassing disorder. It will give an easy answer to the question of efficiency, which encounters the regulatory and legislative framework of the corporate governance applications in the Kingdom of Saudi Arabia.

The main demerits of the legislative delegation in the Saudi legislation process are represented in three issues, which I will tackle here with their examples trying to give examples from the commercial legislations.

3.2.1.4 Lack of Legitimacy Due to the Absence of Legislative Delegation Instrument

The most prominent examples of this are:

1. The Principles of Corporate Governance for Banks Operating in Saudi Arabia: This regulation has been issued by SAMA in July 2012 and updated in March 2014. SAMA did not explain the legislative delegation instrument, which gives SAMA the authority to issue this law. SAMA, for sure, is a supervisory executive authority and not a legislative organ. Definitely, there is no legal provision, which gives SAMA this legislative delegation. Thus, this law, which regulated the principles of corporate governance for the banking sector, is simply without any legitimacy.
2. The Corporate Governance Regulation in the Kingdom of Saudi Arabia issued by the Board of the Capital Market Authority: CMA has issued this regulation on 2006. This regulation states in its preamble: "issued by the Board of the Capital Market Authority pursuant to the Resolution No 1- 212 2006, dated 21/10/1427 H (corresponding to 12/11/2006) based on the Capital Market Law, promulgated by the Royal Decree No M/30 dated 2/6/1424 H." This refers to Article

Six of the Capital Market Authority Law, which gives the Board of CMA the "power to issue and amend the Implementation Regulations, as may be necessary to enforce the provisions of this Law." This article shows clearly that the scope of delegation given to the Board of Directors of CMA is very wide. This uncontrolled legislative delegation gives the Board of CMA the power to issue principles for corporate governance, while the function of CMA is limited in the capital market issues and the related rules for listing, registration and trading. The power for issuance of corporate governance rules is within the jurisdictions of the Ministry of Commerce and Industry. This fact explains why some of the provisions of this regulation are contradicting the Saudi Companies Law. The uncontrolled legislative delegation given to CMA, which gives CMA the tool for overriding its authorities, led also to the issuance and provision of a bill for Credit Rating Agencies Regulation, which actually falls within the authority of SAMA. Despite the wide range of legislative delegation provided for by Article Six, CMA cannot justify the issuance of this regulation as the business of the credit rating agencies has nothing to do with the Capital Market Authority Law.

3.2.1.5 Exceeding the Scope of Legislative Delegation and Contradiction of the Implementation Regulation to the Main Law

This can be shown by the following examples:

1. The Implementation Regulation for the Cooperative Insurance Companies Control Law. It is not difficult to prove how this implementation regulation is exceeding its legislative delegation. The Cooperative Insurance Companies Control Law, as shown from its title, deals with the business of mutual insurance, while the Implementation Regulation is wholly specified for the provisions of the traditional insurance. This is a true exemplar for an uncontrolled legislative delegation.
2. Another example for the uncontrolled legislative delegation, which shows clear contradiction between the implementation regulation and the main law, is the Implementation Regulation of the Enforcement Law. This implementation regulation stipulates in Article 98 that the Board of Grievances has jurisdiction to decide on the requests for enforcement of foreign judgments issued prior to the date of enactment of the main law, while article 96 of the main law annulled the jurisdiction of the Board of Grievances to decide on the requests for enforcement of

foreign judgments. This is of course a clear example for disruption of the legislative delegation.

3. Uncontrolled legislative delegation can also be evidenced in the provision of the last article of the Implementation Regulation of the Enforcement Law, which stipulates that the provision of the (Enforcement Law) should be applied to the enforcement writs issued after the issuance of the Law. The main law stipulates that the provisions of the Law should apply on all enforcement writs whether issued prior or after the date of issuance of the Law.

3.2.1.6 Limitation of the Scope of Legislative Delegation

The main law determines the scope of legislative delegation granted to the executive authority to enact implementation regulations required for completing the implementation of the main law. If an executive authority or a regulating body issues an implementation regulation that does not cover the implementation provisions, included in the delegation given in the main law, this is considered one of the main features of uncontrollability of the legislative delegation. Moreover, this will result in disabling the provisions of the main law itself, as some of its provisions will become non-operational clauses. The main legislation, if not complemented by the necessary implementation regulations, which explain how these law provisions will be implemented and fill the gabs, will turn to be non-operational clause, which is one of the limitations of Efficiency Question, upon which this research, about the legislative framework for Corporate Governance is based. Below, I will give some examples, which illustrate the uncontrollability of legislative delegation in the Saudi Arabia legislations:

1. In the Finance Lease Law, there are implementation provisions, which were referred by the Law to its Implementation Regulation, but the Implementation Regulation does not include any reference to these provisions, which are:

- Provisions of recording, amendment and cancellation in the Contracts Register (Clause 3, Article 18 of Finance Lease Law);
- The right of third parties to access the register (Clause 3, Article 18 of Finance Lease Law);
- Term of keeping (Clause 3, Article 18 of Finance Lease Law);

- Provisions for the registration information unit and exchange and access (Clause 3, Article 18 of Finance Lease Law);
- The provisions for measures concerning marking on the Finance Lease Contracts register in case of securitization.
- Provisions for revoking the contract in case of default of due payments (Article 21 of the Finance Lease Law).

2. In the Real Estate Finance Law, there are implementation provisions, which were referred by the Law to its Implementation Regulation, but the Implementation Regulation does not include any reference to these provisions, which are:

- Provisions allowing banks to practice real estate finance for ownership of properties for the sake of financing (Article 1/2 of the Real Estate Finance Law);
- Provisions for publication of data concerning the real estate market activities (Article 4 of the Law);
- Provisions for allowing real estate financiers to access the real estate records (Article 5 of the Law).

3. In addition to that, Finance Companies Control Law referred a number of implementation provisions to its Implementation Regulation, but the later includes none of these provisions. These provisions are:

- Provisions for carrying out finance business by legal and natural persons (Clause 3 of Article 4 of the Law).
- Provisions for rehabilitation of persons nominated to perform supervision and executive work in a finance company (Clause 3/D of Article 5 of the Law);
- Provisions for permitting finance companies to stop activities for more than three (3) successive months (Article 6 of the Law);
- Provisions for cancelling the license if it appears that the company provided false information to the Agency, or failed to disclose material information (Article 7 of the Law);
- Provisions for dismissing a board member of a finance company or any external comptroller who receives finance in breach of this Law (Clause 2 of Article 12 of the Law);
- The proportion to be deposited in the Authority of the value of deposits received from the clients (Clause 7 of Article 11 of the Law);

- Provisions for obtaining short term foreign finance (Clause 8 of Article 11 of the Law);
- The legal form of the entities willing to practice activities supporting finance activities and the conditions, which should be satisfied (Clause 2 of Article 10 of the Law).

3.2.1.7 Heavy Transplantation

At the beginning of this chapter, we have examined the Saudi legislative process and witnessed the absolute absence of any technical methodology or procedural manual that should be exercised or utilized in a sound legislative process. In these circumstances, legal transplants would be quick and easy way in responding to legislative needs.

Academic debate on legal transplants has been revived in recent years, with varied opinions being voiced in favour of, and against, the effectiveness of transplants. Alan Watson, a well-known scholar in this field, states that, “Legal rules may be very successfully borrowed where the relevant social, economic, geographical and political circumstances of the recipient are very different from those of the donor system.”

Professor Legrand[91] and the Professors Seidman represent the other side where it is believed that law is a culturally determined artefact, which cannot be transplanted. The Seidmans have stressed this view and they even have formulated a “Law of non-transferability of law.”[92]

Others believe that this topic is too complex to be expressed as a choice between these two positions. Professor Teubner and Professor Kahn-Freund have developed a more specific view on this regard. Kahn-Freund’s opinion was that some areas of law are more closely linked to society than others, and that the success of transplants of more organic areas of law depends primarily on the political system.[93] Teubner argued that some areas of law are more or less strongly “coupled” to “social processes”, and that the degree of success of a transplant

[91] See Pierre Legrand, ‘Against a European Civil Code’ (1997) MLR, 44; Pierre Legrand, ‘European Legal Systems are not Converging’ (1996) ICLQ, 52; Pierre Legrand, ‘The Impossibility of ‘Legal Transplants’ (1997) Maastricht Journal of European and Comparative Law, 111.
[92] See Ann Seidmanand Robert B. Seidman, *State and Law in the Development Process: Problem Solving and Institutional Change in the Third World* (Palgrave Macmillan1994) 44—46.
[93] O Kahn-Freund, ‘On Uses and Misuses of Comparative Law’ (1974) MLR, 1, 5-6.

depends on the degree of coupling.[94] Teubnersays that "While in the loosely coupled areas of law a transfer is comparably easy to accomplish, the resistance to change is high when law is tightly coupled in binding arrangements to other social processes."[95]

So what is the significance of this debate for our attempt to answer the efficiency question of Saudi legal framework of corporate governance? Can it be simply said that if the Watson is right, transplanting laws is suitable in efficient legislative process? And if the Seidmans and others are right, then the answer will depend on whether these laws are culture-neutral or culture-specific. If it is culture-neutral, no problem, but if it is culture-specific, it is not suitable. However, and only at this point, I find it useful to refer to my review of corporate governance applications in Islamic Law in Chapter Two. Nevertheless, the cultural dimension of legal transplants is not the only crucial consideration. In Russia experience, we have seen that adaptation of the U.S. corporate model has failed because the lack of harmonization between the Russian institutions and the borrowed U.S. model, which brings us back to the argument of Troy A. Parades on whether the transplantation of a corporate law is the right response to reform requirements.

Whatever the answer that academics provide on whether legal transplants is feasible or not, heavy transplantation that has characterized the Saudi legislative process is an answer for distortions in Saudi legal framework that lacks a reasonably efficient court system, and sophisticated specialized institutions. The following sections of this research will shed more light on the efficiency of judicial and supervisory institutions.

3.2.1.8 Duplication

As per Article Seven of *Nizam Alhokm*, The Kingdom of Saudi Arabia adopts *Sharia* as a source of its legislation. To assess the application of this constitutional Article, I would refer to my evaluation to the content of Saudi corporate legislations conducted in chapter (5) where we witnessed the poor presence of *Sharia* principles related to fiduciary duties and transparency. In this part, I will try to explain why this weak operation of *Sharia* principles has occurred and how it led to

[94] Gunther Teubner, 'Legal Irritants: Good Faith in British Law or How Unifying Law Ends Up in New Divergences' (1998) MLR, 11.
[95] ibid 19.

the undesired duplication. I would also mention here that this duplication was totally unjustified, especially in the light of the proven *Sharia* deep roots of corporate governance applications. Such proven roots were a clear result of the analysis conducted in Chapter (5) of this research. In that chapter we saw how *Sharia* philosophy dealt with some particular affairs in detailed manner, and left a wide space for human endeavours to decide on what is in the best interest and welfare of human society.

The human aspect in *Sharia* is an important part of its integral system dealing with lives of individuals and societies. While *Sharia* revealed detailed contexts for worships and rituals, it laid down general principles in which human efforts can be exerted in accordance with civil society requirements. Agreements for instance were not revealed from heavens, but the holy *Quran* instructed to fulfil them in general, and forbade some certain agreements like usury, gambling, and enriching on the account of others without right to do so. The Prophet, peace be upon him, conceded most of commercial transactions between people, and he ordered to fix what can be fixed, i.e. he ordered to stipulate the life period of contracts, quantity and price of the subjects of contracts, ordered to show the sold products and their characteristics, and forbade concealing their defects. This is collectively called *fiqh Al-Mouamalat*, or the Islamic law of transactions. However, the Islamic rules of law-making are also clear and equipped with cautions parameters to make the rules that stem from the obligatory sources of the Islamic law by way of inference.

Undoubtedly, this contradicts with the understanding of many researchers who simply think that legislation in Islam is a mere theological process. Thus, they find it difficult to absorb the possibility of adaptation between Islam and contemporary legal concepts, such as, say, democracy. Ironically, the position of these researchers is similar to that of a few of traditional religious institution symbols in the Kingdom of Saudi Arabia who took a passive position towards legislation and codification as a civil process, exposing the legislative process to certain shakes, with which the legislative institution preferred to retreat and avoid confrontation with traditional religious institutions.

In an attempt to overcome this problem, the legislative institution used two main methodologies[96] for two purposes: first, it is to decrease the range of its activities remarkably, avoid substantive legislations and focus on procedural legislations. Second, it is to avoid traditional jurisprudence, leaving it solely to public *Sharia* tribunals.

This retreat reinforced the duplication in both the judicial and legislative structures. Passive effects of such duplication doubled with the overlooking of modern legislations by legislative tribunals and kept away from teaching modern Saudi laws in *Sharia* schools. This resulted in a doubled legislative system, which could not view its way through a coherent perspective that considers the *Sharia* and convince scholars on one hand, and meets the needs of growth and its regulatory requirements, on the other.[97]

Saudi Arabia could develop a leading legislative thought that is legally and jurisprudentially advanced, giving a live example created from the womb of Saudi experiment, which embraced *Sharia,* on one hand, and continued the modernization journey, on the other. This can be done in a way that decisively proves the validity of *Sharia* in every place and time.

3.3 Judicial Authority

The discussion and analysis in the previous two sections (i.e. 3.1 and 3.2) was focused on the level of law creation, i.e. legislation. This section will complete the picture by focusing the analysis on the level of law application, i.e. the judicial power in Saud Arabia.

3.3.1 The Saudi judicial system

The competence of the Saudi Judicial Courts System as such was set up by the Law of the Judiciary, adopted in 1975 and reinforced in 1992 by the Basic Law of Governance. Currently, Saudi Arabia has a dual judicial system comprised of the Sharia Courts System (al-Mahakim al-Shariy'ah) and an independent administrative judiciary known as the Board of Grievances (Diwan Al-Mazalem). In

[96] ibid 53–54.
[97] ibid 54.

addition to these judicial bodies there are several Administrative Committees with jurisdiction over certain specified cases.
Moreover, the Law of the Judiciary[98] permits the establishment of specialized courts by "Royal Order on the recommendation of the Supreme Judicial Council." There are two specialized courts within the Sharia Courts System: the Courts of Guarantee and Marriages, which exercise jurisdiction over civil suits regarding marriage, divorce, as well as child custody, and the Juvenile Court, which hears Juvenile delinquency cases.

According to the Law of the Judiciary and the Basic Law of Governance, Sharia Courts have jurisdiction over all disputes and crimes except those exempted from their jurisdiction by law. Sharia Courts hear cases related to personal status, family affairs, civil disputes and most criminal cases. However, different laws and regulations have granted jurisdiction over different claims and crimes to either the Board of Grievances or to Administrative Committees.[99]

The 1975 Law of the Judiciary organizes the Courts System in the following hierarchical structure, provided below in descending order:

- Supreme Judicial Council;
- Courts of Appeals; and,
- First-Instance Courts (General Courts and Summary Courts).

Each of these courts has jurisdiction over cases brought before it in accordance with the Law.

3.3.1.1 Supreme Judicial Council

Article 5 of the Law of the Judiciary identifies the Supreme Judicial Council as the highest authority in the Saudi judicial system. The Supreme Judicial Council is composed of eleven members. Five full-time members hold the rank of Chief of the

[98] The Law of the Judiciary, Royal Decree No. M/64, art. 26 (14/7/1395H,/Jul. 23, 1975), O.G. Umm al-Qura No. 2592 (29/8/1395H, Sep. 5, 1975).
[99] Many of these Committees were created as a result of the Ulama and Sharia Courts refusal to enforce "Nizams". Until recently Ulama refused most of the content of these laws and most of the adjudication enforcing due to the fact that they strongly oppose the idea of codifying the Rules of Sharia. Instead, they apply Sharia Rules found in books of "Fiqh" written by medieval ulama. *See* Frank E. Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (BRILL 2000).

Appellate Court and constitute the Permanent Panel of the Council.[100] Five part-time members include the Chief of the Appellate Court or his deputy, the Deputy Minister of Justice, and the three members with the longest time in service as Chief Judges of the General Courts in the following cities: Makkah, Medina, Riyadh, Jeddah, Dammam and Jazan. All members constitute the General Panel of the Council, which is overseen by its Chairman. The Supreme Judicial Council, ".convene[s] as a Permanent Panel composed of its full-time members, presided over by its Chief or by a designee from amongst the senior most member in the judiciary."[101]

3.3.1.2 Courts of Appeals (Courts of Cassation)

The Saudi Courts of Appeals are the second tier in the current Saudi Arabian judicial system. A Court of Appeal is composed of a chief judge and a sufficient number of senior judges from the legal community. The Court consists of several panels with jurisdiction over criminal cases, cases of personal status and other cases that do not fall into the first two categories. The Court of Appeal can establish as many panels as it needs, and the Chief Judge or one of his deputies must head each of these panels.

3.3.1.3 First-Instance Courts

There are two types of First-Instance Courts under the current Saudi Arabia Courts System:

- Summary Courts; and,
- General Courts.

Summary Courts are composed of one or more judges. The composition, jurisdiction, and designation of the Summary Courts are constituted by decisions of the Minister of Justice on the recommendation of the Supreme Judicial Council.[102] A single judge hands down the judgments issued by these courts.

General Courts are composed of one or more judges. Composition, jurisdiction, and designation of the Saudi Sharia General Courts are determined by decisions of

[100] *See* The Law of the Judiciary (1975) art.6.
[101] ibid. art. 9
[102] *See* The Law of the Judiciary (1975) art. 24.

the Minister of Justice on the recommendations of the Supreme Judicial Council.[103] In particular, General Courts have Jurisdiction over cases wherein the sentence claimed is either the death penalty, or qisas (retaliatory punishments) in cases other than death. They also have jurisdiction over civil claims for sums totalling more than 20,000 Saudi Riyals ($6,000 USD).

3.3.1.4 The Board of Grievances

An increasing number of disputes between government agencies and private contractors led to the creation of the Board of Grievances that stands in parallel to the Sharia Courts, while being directly affiliated with the King and falling outside of the Ministry of Justice.[104] The Board of Grievances is composed of a President, one or more Vice-President(s), and a number of Assistant Vice-Presidents and members specialized in the Sharia and the law.

Although Article 1 of the Board's law states that the Board is an independent administrative judicial board, it has been authorized to decide cases and disputes to which the administration is not a party. It is authorized to temporarily adjudicate criminal and commercial disputes, and to have sole authority over the enforcement of foreign judgments and foreign arbitration decisions. It covers four main categories of disputes:

- Disputes in which the government is a party;
- Disputes involving unethical business practice subject to statutory provisions;
- Disciplinary actions against civil servants; and,
- The execution of foreign judgments.

According to Article 8 of the Law of the Board of Grievance adopted in 1982, the Board adjudicates the following administrative disputes:

(A) Cases related to the rights provided for in the Civil Service and Pension Laws;

(B) Cases of objection filed by parties concerned against administrative decisions where the reason of such objection is lack of jurisdiction,

[103] *See* The Law of the Judiciary (1975) art. 22.
[104] The Law of the Board of Grievances, Royal Decree No. M/51, art. 1, (17/7/1402H, May 11, 1982).

a deficiency in the form, a violation or erroneous application or interpretation of laws and regulations, or abuse of authority;

(C) Cases of compensation filed by parties concerned against the government and independent public corporate entities resulting from their actions;

(D) Cases filed by parties regarding contract-related disputes where the government or an independent public corporate entity is a party;

(E) Disciplinary cases filed by the Bureau of Control and Investigation;

(F) Penal cases filed against suspects who have committed crimes of forgery as provided for by law, crimes provided for by the Law of Combating Bribery, crimes provided for by Royal Decree no. 43 dated 29/11/1377H [June 16, 1958], and crimes provided for by the Law of Handling Public Funds issued by Royal Decree No. 77 dated 23/10/1395H [Oct. 29, 1975], and penal cases filed against persons accused of committing crimes and offenses provided for by law, where an order to hear such cases has been issued by the President of the Council of Ministers to the Board;

(G) Requests for implementation of foreign judgments;

(H) Cases within the jurisdiction of the Board in accordance with special legal provisions; and

(I) Requests by foreign courts to carry out precautionary seizure on properties or funds inside the Kingdom.

3.3.1.5 Administrative Committees

Most of the laws passed in the Kingdom stipulate the formation of administrative committees with judicial powers to settle disputes related to the competence of each committee. These "Administrative Committees" have jurisdiction over civil, commercial, administrative and criminal cases and disputes arising out of the implementation of several laws and provisions. The jurisdiction of each committee is determined by the decree that created it. Examples of current Saudi administrative committees are as follows:

- The Tax Committees;
- The Committees for Penalizing Traffic Violations;

- The Mining Disputes Committee;
- The Fraud, Cheating and Speculation Committee;
- The Banking Disputes Settlement Committee; and
- The Copyright Committee.

3.3.2 Judicial system reform

On October 1, 2007, King Abdullah bin Abdul-Aziz issued a Royal Decree approving a new body of laws regulating the judiciary and the Board of Grievances.[105] Some observers believe these new laws represent a major step toward meeting the requirements of a modern and thriving economy, while also improving the business environment. The new law affirms the Saudi justice system's independence and impartiality; it also ensures the highest possible fair trial standards.

3.3.2.1 The New Role of the Supreme Judicial Council

Under the new Judiciary Law of 2007, the Supreme Judiciary Council no longer serves as the Kingdom's highest court. However, it will continue to oversee administrative aspects of the judiciary. The Supreme Judicial Council is composed of a president and ten members: the Chief of the High Court, four full-time members of the rank of Chief of the Appellate Court appointed by the King, the Deputy Minister of Justice, the Chief of the Bureau of Investigation and Prosecution, and three members, who possesses the qualifications required by the Appellate Judge, appointed by the King. All Supreme Judicial Council members serve for a period of four years, which is renewable for other periods [106].

Under the new law, the Supreme Judicial Council performs several administrative roles. In its administrative capacity, the Council, as stated in Article 6 of the new law, has a supervisory role over sharia Courts and Judges in accordance with the Law of the Judiciary, adopted in 2007. The Council primarily supervisees the courts, administering the employment-related affairs of all members of the judiciary

[105] Royal Decree No. M/78 of 18 Ramadan 1428H (October 1st, 2007), available at http://www.wipo.int/wipolex/en/details.jsp?id=14607 , last visited on 21 December 2017.
[106] *See* The Law of the Judiciary, Royal Decree No. M/78, art. 5, (19/9/1428H, Oct. 1, 2007), O.G. Umm al-Qura No. 4170 (30/9/1428H, Oct. 12, 2007).

within those limits laid down by the law. Such affairs include promotions, transfers, assignments, and training.

3.3.2.2 The New Courts System

The new Law of the Judiciary organizes the Courts System in the following hierarchical structure in descending order:

- High Court;
- Courts of Appeals; and,
- First-Degree Courts, which are composed of:
  - General Courts;
  - Criminal Courts;
  - Personal Status Courts;
  - Commercial Courts; and,
  - Labor Court .[107]

3.3.2.3 High Court

The High Court assumes the previous Supreme Judicial Council's main function as the highest authority in the judicial system. The High Court is seated in Riyadh and is composed of a president-who possesses the qualifications required of the Chief Appellate Judge. He is appointed by a Royal Order, along with a sufficient number of judges who hold the rank of Chief of the Appellate Court- appointed by a Royal Order on the recommendation of the Supreme Judiciary Council. The High Court exercises its jurisdictions through specialized circuits (as needed), which is comprised of three-judge panels-except for the Criminal Circuit. It reviews judgments involving certain major punishments such as the death sentence. These are composed of a five-judge panel. Chief Judges of the High Court Circuits are appointed by decisions of the Supreme Judicial Council on the recommendation of the Chief of the High Court.[108]

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[107] Ibid art. 9.
[108] Ibid art. 10,11,12

3.3.2.4 Courts of Appeals

The new reforms are aimed at introducing safeguards such as Courts of Appeal, which can overturn decisions by lower courts. The new law establishes one or more Courts of Appeals in each of the Kingdom's provinces. Each court functions through specialized circuits comprised of three three-judge panels, except for the Criminal Circuit, which reviews judgments involving certain major crimes, including those that bear the death sentence. It will be composed of five judge panels. Courts of Appeals consist of the following circuits: Labour Circuits, Commercial Circuits, Criminal Circuits, Personal Status Circuits, and Civil Circuits[109].

3.3.2.5 First-Degree Courts

The First-Degree Courts are established in the Kingdom's provinces, counties and districts in accordance to the needs of the system. First-Degree Courts consist of General Courts, Criminal Courts, Commercial Courts, Labour Courts, and Personal Status Courts. General Courts are established in provinces and consist of specialized circuits, including Implementation and Approval Circuits and Traffic Cases Circuits. General Courts are composed of one or three-judge panels as specified by the Supreme Judicial Council. The Criminal Court consists of the following specialized circuits: Qisas (Retaliatory Punishment) Cases Circuits, Hudud Cases Circuits (Prescribed Punishment), Ta'zir (Discretionary Punishment) Cases Circuits, and Juvenile Cases Circuits. The Criminal Court is composed of a three-judge panel. Other cases (offences) specified by the Supreme Judicial Council are heard by one judge. It is worth noting that all existing Summary Courts are transmitted to Criminal Courts.[110]

3.3.2.6 Board of Grievances Reforms

The pyramidal structure of the new Board Administrative Courts stands parallel to the structure of the Judicial Courts. The new law affirms that the Board of Grievances, which is based in the city of Riyadh, is an independent administrative judicial commission responsible directly to the King.[111]

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[109] Ibid art. 15, 16
[110] The Law of the Judiciary, art 18,19,20
[111] The Law of the Board of Grievances, Royal Decree No. M/78, art. 23 (19/9/1428H, Oct. 1, 2007), O.G. Umm al-Qura No. 4170 (30/9/1428H, Oct. 12, 2007).

The Board of Grievances consists of a President of the rank of minister, at least one Vice-President, a number of Assistant Vice-Presidents, and several judges. Vice Presidents is appointed by Royal Order from among those who possess the qualifications required to become a Chief of the Appellate Court.

Alongside the Supreme Judicial Council, the new Board of Grievances Law establishes an Administrative Judicial Council composed of the President of the Board, the Chief of the High Administrative Court, the senior Vice President of the Board, and four judges of the rank of Chief of the Appellate Court, all appointed by Royal Orders. The Council performs several administrative tasks similar to those of the Supreme Judicial Council. The Administrative Judicial Council meets every two months; its meetings are valid if attended by at least five of the members, and decisions of the Council are made by majority vote. Finally, the Administrative Judicial Council encompasses several committees, including the Jurisdictional Conflict Committee, the Judicial Disciplinary Committee, and the Department for Judicial Inspection.

The Board of Grievances Law organizes the Board according to the following hierarchical structure:

- High Administrative Court;
- Administrative Courts of Appeals; and,
- Administrative Courts.[112]

3.3.2.7 High Administrative Court

The new law also establishes a Higher Administrative Court, which is comprised of a President holding the rank of minister-appointed by Royal Order, and a sufficient number of judges bearing the rank of Chief of the Appellate Court-appointed by Royal Order on the recommendation of the Administrative Judicial Council. The High Court exercises its jurisdictions through specialized circuits (as needed), which are composed of three-judge panels. The Higher Administrative Court has a General Council, which is presided over by the Chief of the High Administrative Court and the membership of all of its judges. Its meetings are valid if attended by

[112] Ibid art 2-15.

at least two thirds of its members. The Council's decisions are issued by majority vote. If, while reviewing a complaint, one of the High Administrative Court Circuits deems it necessary to depart from an interpretation adopted by either the same or a different circuit of the same court, the case will be referred to the Chief of the High Administrative Court, who refers it to the High Administrative Court General Council for a decision. [113]

3.3.2.8 Administrative Courts of Appeals

The new law establishes at least one Administrative Court of Appeals. Each court functions through Specialized Circuits composed of three-judge panels. The Administrative Courts of Appeals hear appealable decisions from the lower Administrative Courts. The render their judgment after hearing the litigants' arguments in accordance with the Law of Procedure before Sharia Courts and the Law of Criminal Procedure.[114]

3.3.2.9 Administrative Courts

The new law establishes one or more Administrative Courts. Each court functions through specialized circuits such as Administrative Circuits, Employment, and Disciplinary Circuits, and Subsidiary Circuits, and it is composed of either a one or a three-judge panel.[115]

After this quick review of new Law of Judiciary and new Law of the Board of Grievances, we clearly note that the Board of Grievances continues to handle administrative disputes involving government departments. The previous Law of Board of Grievances, adopted in 1982, empowered the Board to hear and punish offences involving bribery, forgery, exploitation of official influence or abuse of authority in criminal prosecution proceedings, or violations of human rights. However, the new law relinquished to the new Judicial Court System the jurisdiction over criminal offenses that had been granted by the Law of 1982.

[113] The Law of the Board of Grievances, art 10,11.
[114] Ibid art 8&12.
[115] Ibid art 8.

3.3.3 Saudi Judiciary Scrutinized

3.3.3.1 Unregulated Judicial Review

Saudi Judges are not always keeping stable relations with the provisions of the laws under which they adjudicate the cases, which they consider. Sometimes judges issue decisions that are expressly contradicting the provisions of the laws. To take an example or two for this contradiction, we refer to the judgment No 642/10/3/132H issued by Dammam Administrative Court, concerning the request of the Claimant, who is a partner in a limited liability company, to enable him to have access without timeframe limitation, to all Company's financial books and records. The text of this judgment reads as follows:

> Therefore, the Circuit comes to enabling the Claimant to see the works of the Company and review its papers and documents. This will not be affected by the defence of the Defendant that Article (171) has a time limit for this review and it should be within 15 days prior to the date of presenting the final annual accounts to the partners. This time limit is asserting the right and intended to oblige the Company to enable the partners to review the documents before presenting the annual reports and does not mean to prohibit the partners from seeing the works of the company and to review its books and documents throughout the year. This right is granted by the law and assured by the obligation to disclose to the partners whichever affects its legal position of rights and obligations. For these reasons, and after deliberation, the Circuit judges that the Defendant/ The United Gulf Steel Company Limited shall give access to the Claimant/ Al-Marzui Holding Company to see the works of the Defendant company and to review its books and documents for the reasons stated herein.

Article 171 of the Companies law 1965 stipulates that, "The partner who is not a manager in the company where no control council exists, shall advise the managers and shall also request, at the company head office, to be informed of its operations, examine its ledgers and documents, and such within the fifteen days preceding the appointed date of presenting the annual final accounts to the partners, and each condition contradictory to such shall be considered null."

Here it is clearly shown that the justification given by the Judge for not abiding to the provision of this article is ambiguous and not understandable. The text of the article is clear and direct, and it gives no chance to interpret otherwise. In my discussion, as the attorney of the Defendant, with the head of the legal circuit, which issued the judgment, I reached that he thought that the article was contradicting one of the Islamic Sharia rules related to ownership and the rights resulting there from, although he had not stated that expressly in his reasoning of the judgment. It seemed that the judge was not able to state frankly the existence of this assumed contradiction because of the lack of any frame that regulates reconsideration and review of the legislation texts. To avoid stating directly the unconstitutionality of this article, the judge tended to use this ambiguous reasoning, which he thought appropriate to use in that context.

Another example is Judgment No 106/D/Com/7 / 1430 H issued by the Seventh Commercial Circuit at Board of Grievances in Riyadh. The Circuit judged that partnership has not been proved. The Circuit stated in the reasons for reaching this judgment that (One of the fundamentals for sustaining partnership is the payment of the share agreed upon). This statement contradicts the Companies Law as payment of share is not considered a condition for the validity of partnership nor un-payment of share will cause invalidity of partnership, as stated in Article (5) of the Companies Law, which reads "Each partner owes the company the pledged share and in case of delay in payment of such share beyond the specified date, the partner shall be liable for any damage that may be incurred by the company and shall indemnify the company for the damage resulting from such delay)." The said Article does not stipulate the invalidity of the partnership in case of delay of payment of the share but only indemnity for the damage resulting from such delay.

How can we explain the tendency of some Saudi judges not to be governed by the provisions of the legislations? Can we say that the violation of the Companies Law by the judge is just a technical error that the Supreme Court may revoke and correct? Or to consider that as a justifiable judicial review guaranteed by the Basic Law, which stipulates in Article Seven that, " Government in the Kingdom of Saudi Arabia derives its authority from the Book of God and the Sunna of the Prophet (PBUH), which are the ultimate sources of reference for this Law and the other laws of the State."

Prior to giving an answer to this question, we want to refer here to the differences of the scope of judicial review in Common Law, Civil Law and the Saudi legal system, with its Islamic identity that gives wide space for scholars' judgment and supremacy for Holy Quran and Sunnah over other legislations. The Saudi legal system is similar to the customary law, which uses the judicial review as a tool for the legibility and interpretation of the legislations.

The judges in Saudi Arabia are not controlled by the law provisions they are not practicing judicial review, on the contrary they are violating the interpretation of the law, which is considered a default in the legal system, attributed to the general regulatory structure and not the judges. Neither the Basic Law for Governance nor the other laws have any detailed procedures for regulating the judicial review process and determining the level of court that has competent to practice this review.

Establishing detailed regulatory structure for the judicial review rules resembles the most fundamental element of the desired legal reform. The best approach for establishing effective corporate governance is not confined only to issuance of legislations, but also it includes creation of institutional structure consistent with and supporting to the legislative structure. As far as this inconsistency between the judicial system and the legislations provisions exists, it is difficult to have convincing and effective regulatory legal frame for corporate governance in KSA.

3.3.3.2 Disparity in Judicial Decisions

I am not going to discuss or analyse here the disparity of judicial decisions, but instead I will focus on the lack of clear vision for the remedy of this disparity. It is clear that the disparity of the Saudi judicial judgments is a result of the insufficiency of legislations in the Saudi legislation system. This system lacks criminal law, family law and important parts of the civil law. The legal system fill this gap by giving judges the freedom to use their own judgment to rule on the matters they are considering.

The disparity of judicial decisions takes different forms, the most prominent of which is the inconsistency of discretionary sentencing and the difference of judicial judgments on personal matters such as divorce, custody and many issues concerning land grants. Because of disparity of judicial decisions, it is difficult to predict the judiciary position in any case, which, in addition to the irritating state, creates to both litigants it gives sense of injustice.

It is clear for any observer that the judicial institution is trying to overcome this disparity by publication of judicial precedents and classifying the judicial principles through specialized committees established in the Ministry of Justice and the Board of Grievances. These committees are attempting to publish the judicial precedents and principles in order to organize and rationalize the decisions of the judges. However, there are several questions concerning the process of publication of the judicial precedents, which should be within its functional and historical context. It is widely acknowledged that the judicial precedent takes its practical importance as a tool for discovering the law, when it is difficult to have access to that law. The judicial precedents are highly valued in the customary law because that law is non-codified and, therefore, it is difficult to identify the applicable norm. Practitioners of common law introduced judicial precedents as tools for discovering the law rules through entrusted and liable legal body so as to be applied. The Islamic law, although it is non-codified, is not similar to the Common Law in this regard. The implications that accompany discovering the norms in the Common Law, are not necessarily present in the Islamic legal system. This difference is the reason behind the practical need for stating the judicial precedents and classification of principles in the Saudi legal environment. What I want to stress here is that the provisions of Shariah have been codified by Islamic scholars in a clear language and classification, which made access to these provisions very easy. The ease of access to these provisions by legislators and judges raises the question about the need for stating the judicial precedents, which function is only discovering and accessing these provisions. This assumption leads us to the ideal remedy of the disparity of decisions, which is the codification of these provisions and not the classification of judicial principles. Legalization represents, without doubt, a big professional challenge for the specialists as it requires stable mechanisms within the legal reform process and having clear features according to the legisprudence tools.

Absence of clear vision for remedy of disparity of judicial decisions sheds doubts on the credibility of the Saudi judicial institution and requires hard work to complete the desired legal reform that enhances the efficiency of the Saudi legal structure that regulated the business environment.

3.3.3.3 No uniform Structure

Despite the supposed reform that the new Law of Judiciary introduces in 2007, we still see the existence of administrative committees (Quasi-judicial), which result in dividing the judiciary utility and disperse of its competences amongst such committees that are more than thirty committees established far away from an umbrella for a one unified authority. The other worrying side of these dispersed judicial committees is that each committee follows the ministry competent of the law for which the committee is held to look at the disputes arising from its application. The subordination of such judicial committees to the executive authority is considered to be a major breach to the principle of separation between authorities, disperse of judicial competence, disturbance of dispute parties and state bodies with repetitive claims. Thus, the judiciary utility is deprived from precedents settlement, along with the weakness of executive power of the judgments of these judicial committees because of the absence of complete judicial characteristic of such judgments.

We can as well notice that there are no certain judgments of pleadings for all these committees, with the exception of trade bills, resulting in the weakness of the judge's authority and ambiguity of dispute parties. Consequently, lengthening litigation procedures and raising their cost eventually leads to the disorder of the dispute parities right to plead in front of judicial authority of independence guarantee to protect their right, making it urgently necessary to unify these judicial committees under the umbrella of independent judicial authority.

3.4 Supervisory authorities

3.4.1 Ministry of Commerce and Investment (MCI/MoCI)

The Ministry of Commerce and Investment[116] is the major official body that is in charge of controlling companies in Saudi Arabia. The MCI is responsible for

[116] Formerly named the Ministry of Commerce and Industry; see (n 18)

regulating, supervising, and monitoring all types of companies, and as per the mandate thereof by the provisions of the law. It is entrusted with the duties of ensuring companies' compliance with the Corporate Law and other related regulations. Within the structure of the MCI, such mandates are exercised by Companies General Department, which is specifically in charge of studying and authorizing the applications of establishing new joint stock companies and reviewing the articles of incorporation. In addition, the Department is responsible for registering and monitoring companies businesses, reviewing companies' balance sheets, and supervising the proper implementation of the Corporate Law.

3.4.2 Capital Market Authority (CMA)

The Capital Market Authority was recently established in Saudi Arabia. It is answerable directly to the Prime Minister, and it enjoys a juridical legal personality and financial and administrative independence. It was also entrusted with all the authorities as may be necessary to fulfil its responsibilities and functions under the relevant regulations. The Authority enjoys the exemptions and facilities enjoyed by public agencies in Saudi Arabia, and its personnel are subject to the Labour and Workmen Regulations.

To ensure the Authority's impartiality in the execution of its authorities and responsibilities in the regulation of financial markets towards the betterment thereof, and by explicit legal provision in the Capital Market Law (2004), the Authority was prevented from engaging in any commercial activities. It was also prevented from having any special interest in any project intended for profit and seeking any financing facilities, or acquiring, owning or issuing any securities.

To go more specific in the description of the Capital Market Authority; being the Governmental institution responsible for issuing rules, directives and instructions, for the regulation of the capital market, and for implementing the provisions of these references; and in general in order to achieve its objectives, the Authority was entrusted with the following duties:

To regulate and develop the Stock Market Exchange, including the endeavours to develop and improve the methods, systems, and entities trading in Securities, and to develop the procedures that minimize the risks vesting in securities transactions.

- To regulate the issuance of securities and monitor securities and trading therein.
- To regulate and monitor the works and activities of the various entities falling under the control and supervision of the Authority.
- To protect citizens and investors in securities against unfair and unsound practices or practices involving fraud, deceit, cheating or manipulation.
- To endeavour for the realization of fairness, efficiency and transparency in Securities transactions.
- To regulate and monitor the full disclosure of information regarding securities and the issuers, the dealings of informed parties; i.e. internal persons and major shareholders and investors, and to define and make available information which participants in the market shall provide and disclose to shareholders and other stakeholders.
- To regulate proxy, purchase requests, and public offerings of shares.

In addition, the Authority was given, pursuant to the Capital Market Law (2004), the right to publish draft rules and directives before formally issuing or amending them. The rules, directives and instructions issued as such become effective in the manner prescribed thereon. The Authority also has the power to conduct inspections on records or any other materials, notwithstanding whoever the holder thereof may be, in order to determine whether any person has violated, or is about to violate, any provision of these Regulations or the Implementing Rules or the directives issued by the Authority.

In its works towards the regulation of the capital market, the Authority is given, under the applicable regulations, rules, instructions and directives, the authorities needed to support such endeavours, including without limitation the following:

1. To set policies and plans, and conduct studies and issue the necessary rules to achieve the Authority's objectives.

2. To issue and amend the Implementing Rules as may be necessary to enforce the provisions of the regulations.
3. To approve the floatation of Securities.
4. To give advice and make recommendations to Governmental authorities in respect of matters which enhance the development of the exchange and protection of investors in securities.
5. To suspend the Stock Market Exchange activities for a period of not more than one day; and, in cases where the Authority or the Minister of Finance deems necessary, to extend such suspension; however subject to the approval of the Minister of Finance.
6. To approve the listing, cancellation or suspension of the listing of any Saudi Security traded on the Exchange; or those of any Saudi Issuer, traded in any stock exchange outside Saudi Arabia.
7. To prohibit any Security or suspend the issuance or trading of any Securities on the Exchange, as the Authority may deem necessary.
8. To determine the maximum or the minimum commissions to be charged by brokers from their customers as the Board of the Authority may deem appropriate, and to approve the fees and other commissions to be charged by the Exchange and the Centre.
9. To set the standards and conditions required for auditors who audit the books and records of the Exchange, the Centre, the brokerage companies, investment funds and joint stock companies listed on the Saudi Market Exchange.
10. To determine the information that should be provided in the annual and periodical financial statements, reports and documents that should be submitted by issuers of floating Securities for public subscription or issuers whose securities are listed on the Exchange.
11. To define and explain the terms and provisions set out in the relevant regulations.
12. To issue decisions, instructions and set the procedure as deemed necessary for the implementation of the provisions of the relevant regulations and the Implementing rules, and pose inquiries and conduct investigations regarding violations of the provisions of the relevant regulations and the Implementing Rules.

13. To set the internal rules, issue instructions, and set the procedures as necessary for the management of the Authority.
14. To approve the rules, directives and policies of the Stock Exchange and the Centre.
15. To prepare the rules and directives for the control and supervision of entities subject to the provisions of the regulation.
16. To approve the establishment, merger and liquidation of investment funds and set the related operating rules applicable thereon such as the organizational structure, accounting system and operating rules, investment fund governance and decision-making, liquidity requirements and risk limits.
17. To appoint a licensed auditor to audit the Authority's financial statement, balance sheet and final accounts.
18. To grant the necessary licenses to be issued in accordance with the provisions of the regulations and their Implementing Rules, including the licenses for rating companies and agencies and the conditions applicable thereon.
19. To prepare the Capital Market Authority's annual budget.

The Capital Market Law (2004) states that, upon exercising its power in accordance with the above regulations and their Implementing Rules, the Authority should coordinate with the Saudi Arabian Monitory Agency (SAMA) in connection with measures that it intends to undertake and which may have an impact on the monetary situation.
The Authority is supervised by a board, which should comprise five Saudi full time members, who should be professionally qualified. Board members are appointed by a Royal Decree, which shall also determine their salaries and financial benefits. The Chairman and the Deputy Chairman of the board are appointed as such by the Royal Decree, and the Deputy Chairman replaces the Chairman in his absence. The office of the Board is five year, and it may only be renewed once. The Board should set the internal rules of the Authority and the manner in which personnel, advisors, auditors and any other experts should be appointed, as may be necessary, for carrying out the responsibilities and functions entrusted with the Authority. The board should determine the salaries and remunerations of the aforementioned.

Any person who becomes an employee or a member of the Board of the Authority must immediately upon accepting its functions, declare to the Authority the securities he/she owns or has at his/her disposal or the disposal of one of his/her relatives. He should also declare any change thereon, within three days of becoming aware of such change; and whomever acts or works for the Authority must also make this declaration in connection with the work entrusted thereto, in the manner specified in the rules of the Authority.
Finally, members of the Board and employees of the Authority should not engage in any other profession or job, including occupying a position or a post in any company, government, public or private institutions. Furthermore, they should not provide advice to companies and private institutions.

3.4.3 Saudi Organization for Chartered Public Accountants (SOCPA)

The professions of accounting and auditing faced two serious challenges; on one hand, they lack an appropriate system for educating and training professionals and qualified national human resources, and on the other hand, there is absence of a specialized organization to represent the interests of, organize and develop, the profession. This led to absence of professional standards, rules and regulations to govern the practices of accounting and auditing. In 1991, Royal Decree No. M/12 passed a new regulation to apply on chartered public accountants in Saudi Arabia, which provided for the establishment of "SOCPA" as an institution that operates under the supervision of the Ministry of Commerce and Industry, with the view of promoting the accounting and auditing profession and develop and improve the practices relevant thereto in the Kingdom. The main objectives for SOCPA are to:

1. Review, develop and approve accounting standards.
2. Review, develop and approve auditing standards.
3. Set the necessary rules for fellowship certificate examination (Certified Public Accountants exam), including the relevant professional, practical and scientific aspects of audit profession and applicable regulations.
4. Organize continuous education programs.
5. Establish an appropriate quality review program in order to ensure that Certified Public Accountants implement professional standards and comply

with the provisions of Certified Public Accountants Regulations and relevant by-laws.

6. Conduct special research work and studies covering accounting, auditing and other related subjects.
7. Publish periodicals, books and bulletins covering accountancy and audit related subjects.
8. Participate in local and international committees and symposiums relating to the profession of accounting and auditing.

3.4.4 Saudi Arabian Monetary Agency (SAMA)

Saudi Arabian Monetary Agency (SAMA), the central bank of the Kingdom of Saudi Arabia, was established in (1952). It has been entrusted with performing many functions pursuant to several laws and regulations. The most important functions are the following:

1. To deal with the banking affairs of the Government;
2. Minting and printing the national currency (the Saudi Riyal), strengthening the Saudi currency and stabilizing its external and internal value, in addition to strengthening the currency's cover;
3. Managing the Kingdom's foreign exchange reserves;
4. Managing the monetary policy for maintaining the stability of prices and exchange rate;
5. Promoting the growth of the financial system and ensuring its soundness;
6. Supervising commercial banks and exchange dealers;
7. Supervising cooperative insurance companies and the self-employment professions relating to the insurance activity;
8. Supervising finance companies;
9. Supervising credit information companies.

3.4.5 Supervisory Role Scrutinized

The economic and legal development in the Kingdom of Saudi Arabia led to the establishment of different forms of companies such as finance companies, insurance companies, banking companies (banks), workforce companies, companies licensed to practice securities works, food & drug companies, foreign investment companies and media companies. Each type of these companies has its special provisions that regulate its legal structure, incorporation requirements and the rules that regulate practicing activities, control and supervision of business. As there are different institutions responsible for supervising the business of these companies, namely SAMA, the Ministry of Labour, the Ministry of Commerce and Industry, the Capital Market Authority, the Ministry of Information, the Ministry of Foreign Investment. The role of each of these institutions should be clearly stated. The legislations, subject of this study, which I have tackled in Chapter Six, do not include any clear regulatory structure that determines, in precise manner, the supervisory jurisdiction of each institution. This will ultimately lead either to overlapping of jurisdictions or to the existence of jurisdictional gap that leads to lack of control in certain aspects of the businesses of these companies, or even to the application of different remedies for similar issues. The lack of clarity in the roles of these supervisory public organs makes many of the regulations' provisions pertaining to business environment mere papers without any practical effect on the market works, the thing that reflects passively on the level of the desired integration between the institutional and legislative structures.

There is nothing to say about the efficiency of these supervisory institutions and the capabilities of their workforce. Nevertheless, we can say that the level of efficiency of the supervisory institution is a reflection of the quality of regulatory and legislative frame that regulates its work. Clarity of legislations and the distinct supervisory roles of the institutions, responsible for the business environment, will lead without doubt, to raising the qualification level of the employees of these governmental institutions. They will also enable them to regulate and control the market works and sustain ideal compliance with standards and legal requirements imposed by these legislations, and thus maintaining the best requirements of good governance rules.

4. Chapter Four: The Statutory Framework of Saudi Corporate Governance

As indicated in section (1.2) analysis of the reform of the Saudi legal framework of corporate governance will be tackled through detailed analysis of: a) the institutional and b) the statutory components of this framework. The former component, i.e. the institutional framework, has already been discussed in the previous chapter (3). Accordingly, this chapter will analyse the statutory framework of corporate governance in Saudi Arabia focusing principally on the legal instruments which constitute the building blocks of this framework. While providing an historical account of the development of the Saudi legislative corpus, the main aim of the chapter is to provide an analysis and evaluation of the pertinent legal development and reforms of this framework from the vantage point of the standards of good corporate governance.

Moreover, as already discussed in sub-section (1.1.2), Islamic Sharia Law is the fundamental source of law in Saudi Arabia. Besides Sharia, the legal system also includes several sources of law such as Royal decrees or orders and *nizam* which elaborate on the Sharia and govern, *inter alia*, commercial relations including the banking sector, business, labour, taxation, arbitration and the settlement of commercial and securities disputes. Thus, within the Saudi legal framework, Sharia provides the broader legal framework whereas more specific statutory requirements in the commercial and economic areas are implemented through regulations often issued by government agencies.

The relevant principles of Sharia in relation to corporate governance will be discussed in the following chapter (0). This chapter will therefore focus more particularly on the statutory framework of corporate governance in Saudi Arabia.

4.1 Overview of the Saudi corporate legislation

The enactment of the Saudi Companies Law in 1965[117] is commonly regarded as the cornerstone of modern corporate governance regulation in the country. It was followed by enactment of a number of pertinent laws and regulations in subsequent decades the latest of which in 2015 and 2017. For convenience of exposition and analysis, the development of the Saudi statutory or legislative[118] corpus of corporate governance can be divided chronologically into two phases:

1. First phase1965 - 2012

This phase starts with the enactment of the Companies Law 1965 which is considered the oldest legislation relating to corporate governance in the country and includes a number of laws and regulations enacted subsequently including, *inter alia*, the following:

1. The Companies Law 1965 (the 'old Companies Law').
2. The Capital Market Law 2003 (CM Law/Code).
3. The Listing Rules regulation 2004 (LRs).
4. The Corporate Governance Regulation 2006 (the old CGR).
5. The Principles of Corporate Governance for Banks Operating in Saudi Arabia 2012 [BO-Code].
6. The Law on Supervision of Finance Companies 2012.[119]

2. Second phase since 2015 - 2017

More recently, the Saudi legislative framework of corporate governance witnessed a substantive reform with the introduction of new legislative instruments including, most significantly, the following:

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[117]Royal Decree No. (M/6) Dated 22/3/1385H (corresponding to 22/7/1965AD) endorsing the Council of Ministers Resolution No. (185) dated 17/3/1385H (corresponding to 17/7/1965AD). It was amended by Royal Decrees No. M/5 on 12/2/1387 corresponding to 21/5/1967; No. M/23 on 28/6/1402 corresponding to 22/4/1982; No. M/46 on 4/7/1405 corresponding to 25/5/1985, and No. M/22 on 30/7/1412 corresponding to 3/2/1992.

[118] Unless otherwise indicated, the words 'statutory' and 'legislative' are used interchangeably in this chapter to refer the legal instruments regulating corporate governance in Saudi Arabia.

[119]This was followed by the Implementing Regulation of the Law on Supervision of Finance Companies prepared by the Saudi Arabian Monetary Agency (FC-Code 2013).

1. The Companies Law 2015 (the new Companies Law, to replace the Companies Law 1965).
2. The new Corporate Governance Regulations 2017.

Accordingly, the discussion in subsequent sections of this chapter will be structured as follows: Section (4.2) will analyse and discuss the early phase of the Saudi legislative framework of corporate governance, while section (4.3) will discuss the recent developments and introduction of new legislative instruments in 2015 and 2017 as mentioned above.

4.2 Formation and early reforms: first phase 1965 - 2012

The Companies Law 1965 represents the formative and most fundamental instrument of corporate legislation during the first phase. Its provisions can be regarded as the basis of corporate governance legislative theory in the Kingdom of Saudi Arabia. In order to cope with the rapid developments in the financial and business sector, the law has subsequently undergone many modifications, and has ultimately been comprehensively updated in the Saudi Companies Law 2015 (subsection 4.3.1). The following are the most important issues that appear in the Companies Law 1965 in relation to corporate governance.

4.2.1 Characteristics of the Companies Law 1965

4.2.1.1 Board of Directors of Joint Stock Companies

Under the Companies Law 1965, the management of the joint stock companies in Saudi Arabia is composed of a board of directors. This board, appointed by the shareholders, must have a minimum of three members. Directors must own at least 200 shares of the company.

Articles 66 to 82 of the law are provide detailed regulation regarding the Board of Directors. Article 66 of the Law stated that a joint stock company must be managed by a board of directors. Board members of a joint stock company must be three and more. Ordinary general meetings have rights of appointing, reappointing and dismissing board members.

According to Article 68 a director must hold shares in the company of not less than SR 10,000 in value. The shares must be deposited in one of the banks designated by the Minister of Commerce within 30 days of the director's appointment. The shares are non-transferable until the lapse of the time prescribed for the hearing of any liability suit against the director, or until a judgment is entered in a liability suit.

Moreover, Article 69 requires that a director must not have any direct or indirect personal interest in any business or contract carried out on the company's account, unless he holds a permit from the ordinary general meeting to do so. This permit must be renewed every year although transactions by a director which were subject to a public bid, where the director makes the best bid, are excluded.

Article 72 is concerned with directors duty not divulge to the shareholders or others, other than at the ordinary general meeting, any of the company's secrets which came to their knowledge through their role as a director. Directors' compensations is dealt with in Article 74 which requires companies to clarify the which could be monetary, physical, percentage of dividend (not more than 1 0 % of net dividends).

Article 74 states that the directors' report to the ordinary general meeting must give a comprehensive statement of ail fees, dividends, expenses and/or other advantages obtained by the directors during the fiscal year.

According to Article 76 of the law, directors shall be jointly liable to pay damages sustained by the company if the company's Articles of association or any amendments to them are not published correctly. Moreover, Articles 229 and 230 provide for the penalties which a director may be liable for in respect of non-compliance with the Companies Law. These penalties are without prejudice to the requirements of Islamic law and its relevant penalties. The penalties pursuant to the Law included imprisonment for a term between three months and one year, and a fine between SR I,000 and SR 20,000, depending on the nature of the non-compliance or contravention.

Thus, it can be said that the duties and powers of directors of the Saudi joint stock companies are both statutory and contractual in nature. They are conferred by the Saudi Arabian Companies Law and by the company's constitutional documents. Additional directors' duties are also set down in specific legislation such as the Banking Control Law, the Commercial Registration Law, the Commercial Information Law and the Commercial Fraud Law.

4.2.1.2 Shareholders' Rights

The rights of shareholders are granted in a number of Articles of Companies Law 1965. For example, Article 84 stipulated that at least one ordinary general meeting should be held during the six months following the end of the financial year. The stated purpose of the meeting is to examine and discuss the agenda items as indicated by the law including items such as the board of director and auditor reports besides any other items, in order to advise the shareholders of the company's position and allow them to discuss and comment on all matters related to the company's activities (Article 94).

In addition, Article 88 stipulates that the date of the general meeting must be published in a local newspaper at least 25 days prior to the meeting, and the proposed agenda and all related documents should be sent to all shareholders and to the Companies Department at the Ministry of Commerce allowing sufficient time prior to the meeting.

Moreover, Article 83 of the Saudi Companies Law (1965) stipulates that any shareholder owning 20 or more shares shall have right to attend the general meetings with the possibility of attending these meetings by proxy. Besides, Article 91 states that general meetings would not be regarded as valid unless attended by shareholders owning at least half of the company's capital otherwise, another meeting must be called for and conducted during the following thirty days of the date of meeting.

Article 93 of the Law emphasizes that the company's regulations must clarify the voting methods used by their system in general meetings. However, while shareholders are explicitly granted the right to vote and participate in the general assembly of the company, some practical restrictions are placed on exercising the vote. Although shareholders are entitled to attend the general assembly personally or by proxy, electronic means such as voting via email was not allowed or not practiced. This was deemed unduly restrictive and the law should take into account technological and organizational developments.

There are also the right to participate in the conversations of the general assembly meetings of the company and voting on the relevant decisions, and the rights to dispose of shares and to examine the company's books and accounts. Moreover, Article (109) of the Law states that shareholders, who hold at least 5% of the company's capital, should have the right to ask the Companies Settlement Authority at the Ministry of Commerce to inspect the company if they have doubt regarding the behaviour of the board of directors or the external auditors.

4.2.1.3 Separation between ownership and control

It should be noted that the separation of ownership and control in Saudi Arabia, however, has not yet at this stage been fully realized. This separation constitutes a special requirement of good corporate governance particularly after the international corporate crises and the call from experts in the developed countries recommending the separation between the Chief Executive Officer (CEO) and the duties of the Chairman of the board. While this recommendation may in theory be acceptable, it proved difficult to practically implement in Saudi Arabia particularly because the majority of companies are family-owned. And although the Saudi Companies Law specified in Article 66 the minimum required number of non-executive directors, it does not provide for the separation of the roles of the chairman of the board from those of the general manager (Ministry of Commerce, 1965). The existence of three non-executive board members was considered sufficient to exercise independent judgment and avoid conflict of interest. Experience, however, showed that despite the existence of non-executive members, their role in this regard is not practised. In many cases, the controlling shareholders are in a position to choose all board members. Consequently, the assigned persons are either inexperienced in the field of activity of the company or in financial matters, or are in close relationship with executive board members or the Chairman, and may feel obligated to act in the interest of the controlling shareholders.

4.2.1.4 Audit Committee and Internal Audit

Regulation of audit is regarded as an important tool in the context of good corporate governance in order to serve transparency and accountability and to enhance economic performance and market integrity. As discussed in this section, the evolution of audit regulation in Saudi Arabia has been piecemeal but gradual process.

One of the earliest reforms of corporate regulation in Saudi Arabia is the issuance of Resolution No. 422[120] to supplement the Saudi Companies Law by specifying certain requirements that should be complied with in order to practise auditing in Saudi Arabia. The resolution remained in force until the Certified Public Accountants (CPA) Regulations, regarded as the first foundation stone laid to organize the accounting profession in the Kingdom, was issued in 1395H (1974). A higher committee for certified public accounting was established, in accordance with the Regulation, to supervise and monitor the profession (SOCPA).[121]

Recognising the importance of audit committees as a major tool to increase confidence in financial statements the Minister of Commerce issued a resolution in January 1994, mandating all public companies to establish audit committees. In 2003, the Saudi Organisation of Certified Public Accountants (SOCPA, 2003) regulated the establishment of audit committees in Saudi Arabia stating the requirements from the audit committees' members. These regulations and guidelines are summarized as follows.

- Audit committee must be composed of at least four members. A maximum number of two members could be elected from the non-executive board members.
- Audit committee member:

[120] Issued by the Minister of Commerce in 1388H (1968).
[121] See SOCPA in section (3.4.3).

- must be a shareholder holding at least 100 shares and not more than 5 per cent of the company's shares.
- must be qualified and have knowledge of accounting and financial matters as well as the company's business. One of the members must:
  - hold a P h D in accounting with at least two-year experience in the accounting and auditing field; could be reduced to one year if he has the Saudi C P A ; or
  - hold a master in accounting with at least four-year experience in the accounting and auditing field; could be reduced to three years if he has the Saudi CPA; or
  - hold a bachelor in accounting with at least seven-year experience in the accounting and auditing field; could be reduced to six years if he has the Saudi CPA.
- must not be an executive board member of the company or its branches.
- must not be a member of any other committee in the company which is assigned by the board of directors.
- must be independent. A member is independent if:
  - he has no direct or indirect interest in the company's transactions and/or contracts;
  - he has no direct financial benefits with the executive board members or their wives;
  - he has no personal relationship with the executive board members; and
  - he is not a member of more than one committee in the same industry at the same time.

Each audit committee member must provide the board of directors with a nomination of the eligible board members with the CV for each person nominated. The board of directors, then, choose from those nominated by the audit committee members.

Section 7 of the Regulation stated that the committee must meet every three months at least (four meetings a year). It also stated that the audit committee must meet with the external auditor, the chief executive officer, the board of directors and the internal auditor at least once a year (SOCPA, 2003).

The audit committee should also nominate five audit firms (external auditors) from those licensed by the Saudi Ministry of Commerce. The nominated audit firms are then asked to submit proposals to the company. The audit committee, then, recommends one or more firm/s as appropriate. The recommendation will then be taken, by the directors, to the general meeting, which has the ultimate responsibility for appointing the external auditor, determining the audit fee and the tenure of office

Subject to the requirements in the resolution, if only one audit firm is appointed, then the audit committee does not recommence the nomination process until three years after the audit firm commenced the audit. W h e n more than one audit firm is appointed, the nomination process does not recommence until five years after the audit firms commenced their audit (Ministry of Commerce, 1994).

With regard to internal audit in Saudi Arabia, Al-Twaijry et al (2003)[122] held some interviews in 1998 with academies and external and internal auditors to examine the effectiveness of the internal audit in the Saudi Arabian corporate sector. The result showed that the internal audit in the Saudi corporations "was not well developed"[123]. The authors state that:

“The results show that internal audit is not well developed. Where it does exist it operates in departments that are inadequately resourced, lack qualified staff, have restrictions on their degree of independence, concentrate on compliance audit rather than performance audit and where internal auditors are not accepted by management and auditees.”[124]

[122]A. Al-Twaijry, J. Arierley and D. Gwilliam ‘The Development of Internal Audit in Saudi Arabia: An Institutional Theory Perspective’. (2003) *Critical Perspectives on Accounting,* 14: pp. 507-531.
[123] Ibid 507.
[124] Ibid.

4.2.1.5 Disclosure and Transparency

Article 89 of the Saudi Companies Law 1965 emphasizes that the board of directors must prepare mandatory information including: balance sheets, income and cash flow statements, directors' reports, changes in stockholder equity and board composition, as well as the external auditors report. These statements must be prepared no less than sixty days before the annual general meetings. The board's chair must sign all statements and keep copies in the main branch of the company so that they could be available to shareholders at least twenty-five days before the general meeting.

Compliance with these requirements is monitored and enforced by the capital market regulating agencies as well as the Saudi Stock Exchanges. Non-compliance with these legal requirements is subject to sanctions. Article 89 also states that the board of directors must publish the abovementioned statements in a Saudi newspaper.

Annual Reports are regarded as a principal means of information about joint stock companies in Saudi Arabia. Abu Baker and Naser (2000)[125] argued that the annual report is viewed as the main source of corporate information in developing countries and it is used by companies as a medium to disseminate information to external interested parties. Given that the report contains information on a firm's profitability and liquidity, it is expected to help investors, creditors and other users make informed decisions about the company. Unlike companies operating in the developed world, the annual report published by a Saudi company represents the only source of financial information available to users from the company.

Finally, regarding remuneration of Board members Article 74 of the Saudi Companies Law requires the companies to clarify the board of directors' remuneration method in the company's general meeting. This remuneration could be a salary, bonus or percentage of revenues (must not exceed 10 per cent of net revenues) or it could be a combination of these.

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[125] N. Abu Baker and K. Naser, 'Empirical Evidence on Corporate Social Disclosure (CSD) Practices in Jordan' (2000) *International Journal of Commerce and Management,* 10 (3/4): pp. 18-34.

4.2.2 The Capital Market Law (2003) and its implementing regulations

The introduction of the Capital Market Law[126] and a bundle of regulations in 2003 was considered by some authors a paradigm reform shift in the framework of corporate regulation in Saudi Arabia.[127] The law was intended to create a transparent, fair and regulated Saudi financial market consistent with international developments in the field. It regulates a range of issues including the capital market organisation, issuance of securities, supervision of transactions by authorized persons licensed by the Saudi Capital Market Authority (CMA), and the protection of investors and citizens from illegal practices.

In fact one of the main innovations of the Capital Market Law is the creation of the governmental organization CMA. It has full financial, legal, and administrative independence, and is directly linked with the Prime Minister. The major task of CMA is to create a regulated, fair and transparent financial market that protects all investors from illegal practices or those that include fraud, manipulation and deceit. These tasks and responsibilities are set in Articles 5 and 6 of the Capital Market Law and include the following:

4.2.2.1 Application of Implementing Regulations

It is important to note that the Capital Market Law does not provide detailed regulatory provisions for each of the implementing tasks the CMA has to carry out as set out in Articles 5 and 6. Accordingly, the issuance of the implementing regulations is intended to provide the necessary details to carry out these tasks and responsibilities. For example, according to Article 5 one of CMA responsibilities is to regulate the issuance of securities and control trading in it. Accordingly, the CMA has issued two separate implementing regulation lists to regulate the issuance of securities. These are the “Offers of Securities Regulations” and “Listing Rules” setting out conditions for public, private and excluded offering. They also set the terms for the financial advisor and his responsibilities, listing rules, registering terms and conditions, prospectus rules and other details that were

[126] Royal Decree No. (M/30) dated 4/6/1424H, corresponding to 31/7/2003.

[127] Abdullah Wahtan Alkahtani, ‘Corporate Governance Standards in Saudi Financial Sector: Achievements and Challenges’, (2016) *International Journal of Business and Social Science,* Vol. 7, No. 12; 124-138.

not included in the Capital Market Law. Similarly, CMA issued some implementing regulations to regulate securities business, authorised persons, market conduct and investment funds.

4.2.2.2 Achieve the Transparency and Disclosure

The Capital Market Law and CMA's implementing regulations require transparency and full disclosure on all the important financial information concerning listed companies. Such information should be fully and accurately disclosed at a specific time without discrimination. Investors are entitled to know the full and true picture of any company performance and to know all the information that might affect the price of its shares. This applies to all companies in different sectors and industries.

Accordingly, the principle of transparency and disclosure is the axis that regulating bodies of the financial markets is based on. It ensures the effectiveness of these market's performance. By improving the levels of transparency and disclosure, risk levels decrease and securities are valued according to their fair prices.

The Capital Market Authority imposes the transparency and disclosure principle in its implementing regulation through two main instruments: the prospectus and Continuous disclosure for companies.

First: Each company planning to list its shares and make them available for trading is required by CMA to publish a prospectus that includes all the necessary information to help investors assess the company's activities, its assets and liabilities, its opposing parties, its financial position as well as its expected chances of success and its profits and losses. It should also include adequate information on the rights, responsibilities and privileges associated with these securities.

Second: Through the Continuous Disclosure for Companies CMA imposed on listing companies, in addition to the prospectus, a continuous disclosure for its securities as long as it is traded. If there is any violation, there will be some penalties that range from temporary suspension of trading or paying a fine to cancellation of full listing.

The companies' continuous disclosure is based on three pillars:

a) Disclosure of Important Developments: The important developments according to CMA's implementing regulations are any developments that might have an effect on the company's assets or liabilities, its financial position or its general line of work which may lead to a drastic change in the listed security price. If these developments occur, then the issuer should disclose it to CMA and the public without any delay. The important developments are considered matters such as increase or decrease in the net assets of the company in question, changes in the members of the board, lawsuits (against the company) and increase or decrease in the total sales.
b) Disclosure of Financial Information: CMA's implementing regulations require the issuer to publish, through the "Tadawul" website, its quarterly and annually financial statements and the board of directors' report as soon as it is accepted by the board and before distributing it on any of the shareholders.
c) The Board of Directors Report: The Listing Rules require the issuer to attach a report from the board of directors to the financial statements that includes the company's operations throughout the past financial year, the factors that affect the company and help the investor in evaluating the company's assets and liabilities as well as its financial position. Article 27 of the Listing Rules specifies the important major points to be included in the report.

4.2.2.3 Achieve the Justice Principle in the Capital Market

Justice is achieved if all parties involved in the market think that they have the same chances and when they believe that they are all subjected to the rules and regulations without discrimination.

4.2.2.4 Provide Protection for the Capital Market Investors

Article 5 of the Capital Market Law, stipulates that one of the CMA objectives is to protect citizens and investors in securities. The Law gave CMA the authority to issue whatever it finds necessary of the implementing regulations to achieve this protection.

4.2.2.5 Develop the Procedures to Reduce Risks Related to Securities

As in other countries, transactions in the Saudi financial markets are classified as high-risk investments. The sources for of risks to be reduced or avoided in in Saudi Arabian financial markets can be divided into three kinds:

First, Risks arising from outside the financial markets such as the risks of inflation, recession, or volatility in exchange rates and so on.
Second, Risks arising from inside the financial markets such as the low levels of disclosure and transparency, lack of justice, or imbalance in the investment behaviour by the parties and so on.
Third, Risks related to the investor's awareness and culture. The role of capital market authorities is primarily in dealing with the second kind of risks as well as doing what they can to reduce the risks arising from the third kind. CMA works on reducing those risks by enhancing the levels of disclosure and transparency when companies disclose their financial statements, any core incidents that would affect its operations and work to deliver the information to everyone without any discrimination. CMA also works to reduce dealing practices based on insider information and control spreading rumours and wrongful information as well as controlling the practices involving fraud or manipulation in dealing with securities.

4.2.3 Implementing Regulations of the Capital Market Authority (CMA)

CMA has issued a number of implementing regulations to implement the rules of the capital market law. These include Market Conduct Regulations, which is considered the one set of rules that pays attention to organizing the investor's activities and conduct.

The Authorized Persons Regulations regulate and organizes the relationship between the investor and the authorised person.

FIRST: Market Conduct Regulations aims to protect those who trade in the capital market from illegal practices. The most important types of illegal practices, according to it, are:

1. Market manipulation.
2. Insider trading based on insider information.
3. Untrue Statements (Rumours).

Second: Authorised Persons Regulations

Those who work in the business of securities such as, financial advisors, brokers and portfolio managers are usually held responsible for most of the financial activity done in the capital market. For this reason, a set of rules has been set up to determine the necessary procedures and conditions to get the license and its validity. The regulations also include the rules and conduct guidelines, applied systems and precautions as well as the conditions relating to the clients' assets and money. In addition to the general principles mentioned in Article five that includes licensing and licensed conduct standards such as integrity, professionalism, internal audit, financial sufficiency and disclosure; there are some other principles related to the relationship between the authorized person and the client. The most important one is that the authorized person must comply to:

- Protecting Clients' assets, by arranging for adequate protection.
- Communicating with clients, by communicating information to them in a way which is clear, fair and not misleading.
- No conflicts of interest, by managing conflicts of interest fairly, both between itself and its customers and between a customer and another client.
- Adopting adequate risk management policies and systems.
- Customers' suitability, by taking reasonable care to ensure the suitability of its advice and discretionary managing decisions for any customer to whom it provides those services.

4.2.3.1 Penalties for Violations

The Capital Market Law stipulates some penalties for those who violate its Articles or any of the implementing regulations set by CMA. The penalties can be classified into:

a) general penalties for any violation to the rules of the Capital Market Law or the implementing regulations, and

b) special penalties on specific violations in the Capital Market Law.

General Penalties If it appears to the Authority that any person has engaged, is engaging, or is about to engage in acts or practices constituting a violation of any provisions of the Capital Market Law or its implementing regulations, then The Committee for the Resolution of Securities Disputes would sentence him in one or more of the following penalties:

- Warn the person concerned.
- Oblige the person concerned to cease or refrain from carrying out the act which is the subject of the suit.
- Oblige the person concerned to take the necessary steps to avert the violation, or to take such necessary corrective steps to address the results of the violation.
- Compensate the persons who have suffered damages as a consequence of a violation that has occurred, or oblige the violator to pay to the Authority's account the gains realized as a consequence of such violation.
- Suspend the trading in the security.
- Barring the violating person from acting as a broker, portfolio manager or investment adviser for such period of time as is necessary for the safety of the market and the protection of investors.
- Seize and execution on property.
- Travel ban.
- Barring from working with companies whose Securities are traded on the Exchange.
- Impose a fine

Specific Penalties: In addition to the general penalties mentioned above, CMA has more severe penalties for those who fall in one of the two Capital Market Law violations which are: market manipulation and insider trading.

Based on Article 57, in addition to the general penalties, whoever commits one of the previous two violations may be sentenced to jail for a period not exceeding five years. In Article 60, imprisonment is applied for a term not to exceed nine months in addition to a fine for whoever worked as a broker or claimed to be one without a license. Settling Disputes The Committee for Resolution of Securities Disputes looks into the complaints and cases filed against the authorized persons or statements of claim regarding some CMA or “Tadawul” decisions or those cases where loses are caused as a result of violations to the Capital Market Law and Implementing Regulations like market manipulation or insider trading.

4.2.4 The Listing Rules (LR) 2004

Based on the Capital Market Law, the listing rules were issued in 2004 by the Board of the Capital Market Authority in 52 Articles divided into nine sections.[128] In order to allow issuers to place securities on the capital market, the listing rules govern such admission and provide the description of the information that should be disclosed before placing the securities on the official list. Even so, this piece of regulation is not the first issue of listing rules in Saudi Arabia, as the Ministry of Commerce has issued listing rules before. Like any other listing rules, the goals of the listing rules in Saudi Arabia are to provide protection to investors and serve the market’s development.[129]

According to Article 2, the objective of the listing rules is to regulate the public offering registration and admission to listing of securities’.[130] Thus, through a quick review of some decisions by the Capital Market Authority, the importance of the listing rules in the context of corporate governance and the business environment is obvious.

Article 34 clarifies the compulsory nature of the Listing Rules: ‘The issuer must comply with these rules and must provide to the Authority without delay all information, explanations, books and records that the Authority may require, which must be clear, accurate and not misleading’.[131]

A very recent case that has had a great deal of resonance in Saudi and the GCC business environments is that relating to ‘Mobily’ company case. The importance of the Mobily case relates to the size of ‘Mobily’ as it is the second largest

[128] The Listing Rules 2004 Pursuant to the CMA Resolution Number 3-11-2004.
[129] A Baamir, 'Issues of Transparency and Disclosure in the Saudi Stock Market' (2008) 22 *Arab Law Quarterly* 63.
[130] Listing Rules 2004.
[131] Ibid.

telecommunications company in Saudi Arabia and has a history of revenues and earnings since its establishment in the Saudi Market in 2004.[132] Following several procedures started to verify whether the company had violated the CML and its implemented regulations, this revealed suspicion about possible violation of section (C) of Article 42 of the Listing Rules and two Articles of the CML 49 and 50. The CMA announced the suspension of trading the shares of 'Mobily' for a few days. Moreover, the CMA announced in February 2015, the "assignment of a specialised team to review Etihad Etisalat Co. Mobily's financial statements, conduct site visits, obtain documents and hear concerned parties' statements".[133] The case is still under review at the CMA now and the results could be announced any time this year. Furthermore, there have been many cases of the enforcement of the Listing Rules since their issuance in 2004, whether it is the imposition of a penalty or suspension of trading shares such as 'Anam' and 'Bishah' in 2007, 'Almojil' in 2012, 'Albaha' in 2013 and many others.[134]

Finally, in the context of corporate governance regulations, the Listing Rules have reinforced some of the CGR's provisions; for example, Article 42 of the Listing Rules, which is about the disclosure of financial information. Another example is Article 43 which deals with the Board of Directors' report and requires them to include any issues that impact upon the company's operations and any other news or factors that are important to investors, which indicates the willingness of the CMA to promote transparency as a principle of corporate governance as well as protecting the market and investors.

4.2.5 The Corporate Governance Regulations (2006)

A positive effort towards greater certainty regarding corporate governance practices was manifested in the Corporate Governance Regulations (informally called Saudi corporate governance code) issued in November 2006 by the Capital

[132] M Rashad, 'Mobily CEO: We Hope to Start Earning again in 12 Months Time' (Reuters 2015) <http://ara.reuters.com/article/businessNews/idARAKCN0ST0V220151104> accessed 12/1/2016.
[133] The CMA's announcement dated 03/11/2014. See: <http://www.cma.org.sa/en/News/Pages/CMA_N_1676.aspx:> Accessed 12/2/2016 .
[134] The CMA's announcement dated 31/12/2014. See:<http://www.cma.org.sa/en/News/Pages/CMA_N_1674.aspx> Accessed 12/2/2016.

Market Authority. The code aims to ensure that Saudi listed companies comply with best governance practices that would ensure the protection of shareholders and stakeholders rights.

Although these Regulations (also referred to informally as the Code of Corporate Governance) are considered guidelines and are not mandatory, they enjoys a considerable recognition amongst Saudi companies. The Code mainly tackles the following three issues through its three chapters; the rights of shareholders and the general assembly, disclosure and transparency, and the board of directors. According to the mentioned code, companies are required to disclose in the board's report the provisions thereof that are implemented and those not implemented and explain the reasons for non-compliance. A more discussion on its content will be conducted in the next section of this chapter.

4.2.6 The Principles of Corporate Governance for Banks (2012)

The Saudi Arabian Monetary Authority (SAMA) has issued the Principles of Corporate Governance for Banks operating in Saudi Arabia in July 2012. The Principles were updated in March 2014. The first Article states that these principles of corporate governance for banks have been issued in accordance with the best practices recognized internationally. The members of the Board of Directors of the bank and its senior management must comply with these Principles and ensure that capital adequacy ratios and provisions are commensurate with the size of risks and levels of liquidity and lending, thereby, protecting the rights of depositors, shareholders and other stakeholders.

SAMA states that these Principles complement the regulations, rules and circulars issued by SAMA and the Capital Market Authority regarding the core principles of corporate governance.

4.2.7 The Implementing Regulation of the Law on Supervision of Finance Companies (2012)

Introduced to the market in July 2012, SAMA has issued this legislation to supervise the activities of finance companies. This role includes the following:

1. Extend license to engage in one or more finance activities in accordance with the provisions of finance laws and regulations.
2. Take necessary measures for maintaining the integrity and stability of the finance sector and fairness of transactions.
3. Take necessary measures for promoting fair and effective competition between finance companies.
4. Take proper means for the development of the finance sector, Saudization, and raising the employees' competency through regulating the obligations of the finance companies regarding the training of human resources, improving their skills and developing their knowledge.

4.2.8 Characteristics Corporate Governance Framework: earlier phase 1965 - 2012

The main field of this evaluation in this section[135] involves directors' roles, their standing and duties vis-à-vis the company and the other shareholders. In doing so, the rights of shareholders will be considered, mainly the monitory thereof, along with the earlier disclosure rules contained in the studied documents.

4.2.8.1 Director's Roles and Responsibilities

The duty to run and manage companies is legally assigned to the company directors according to the Saudi Companies Law. The directors enjoy wide discretion in the strategic planning and running of the company affairs.[136] By this power, they outline the duties of the executives and other managers in the company and influence their works and decisions.[137]

[135] This evaluation is basically devoted for the current Saudi Companies Law issued by the Royal Decree No.6 for the year 1965, and the following corporate governance codes:

1) The Corporate Governance Regulation in the Kingdom of Saudi Arabia issued by the Board of Capital Market Authority by the Regulation No. 1/212/2006 on 21/10/1427 H (12/11/2006) (as amended on 30/3/1431 H, 16/3/2110) [hereinafter referred to as CM-Code]
2) The principles of Corporate Governance for Banks Operating in Saudi Arabia, issued by the Saudi Arabian Monetary Agency in July 2012 [hereinafter referred to as BO-Code]
3) The Implementing Regulations of the Law on Supervision of Finance Companies, prepared by the Saudi Arabian Monetary Agency [hereinafter referred to as FC- Code]

[136] See Articles 24, 66, 73, 152 and 167 of the Saudi Companies Law 1965.
[137] See CM-Code Article 10(a)

Despite the huge power concentrated in the directors, the duties given to them are not defined in the Companies Law in a way showing in sufficient clarity the nature of such powers and the ultimate goals intended thereby. In the same vein, directors' duties are scattered in separate provisions without a specific unity and sometimes the duties are presented to be general and without reference to any firm standards.

For instance, the duties of loyalty, neutrality and avoidance of conflict of interest[138] of the company are expressed in many places in the Companies Law and other corporate governance codes, but they seem missing the general definitive structure, which specifies the ceiling of such duties and what constitutes a breach thereto.

Moreover, observance of these duties is not firmly required as directors can be released from the consequences of their acts by the general assembly of the company.[139] In some places in the Companies Law 1965 and other Saudi corporate governance codes, the non-competition duty is substantially diluted when directors are given the right to hold directorship offices in rival companies.[140] This exception gives rise to serious concerns on the issue of neutrality in the Saudi company structure.

More importantly, basic duties like acting in due diligence and care are rarely found in the Saudi Companies Law 1965. Despite the major importance such duties play in the theory of directors, it seems that this area is left without any serious regulation in the law. In the light of such dilution, some corporate governance codes, nevertheless, tried to fill up the gap when some due diligence and good care requirements were incorporated into the directors' general duties[141].

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[138] See for instance Articles 23, 29, 31, 69, 70, 71 and 72 of the Companies Law. See also CM-Code Article 10(b)(1), CM-Code Article 12(h), and BO-Code Articles 11, 13, 16, 20, 38 and 48, and FC-Draft Code Article 2.

[139] See for instance Articles 77 and 168 of the Companies Law 1965.

[140] See Articles 31, 69 and 70 in the Companies Law 1965, the BO-Code Article 20 and CM-Code Article 12(h).

[141] See CM-Code Article 11(c) and the BO-Code Article 16(c).

One of the major consequences for the non-imposition of a duty of care and diligence over the directors is the grey area highlighting the nature of the directors' liability under the Saudi Companies Law 1965. In fact, nothing in the Saudi corporate legislations showed a fine cut notion detailing on major questions director duty relating, specifically, to the nature of the directors' duties, and the standard of breach of director duty. This remains an important area for reform of the Saudi corporate governance laws.

4.2.8.2 The Nature of the Directors' Duties: The Fault-based Duty v. the Fiduciary Duty

Another flaw tainting the directorship theory in the Saudi corporate legislations in the early phase is the nonexistence of any provision showing in sufficient clarity the nature of the obligations that directors owe. Thus, the only available solution under the law in this phase is to make recourse to the common rules of liability in the general *Sharia* law of obligations. *Sharia* would certainly lead to application of the ordinary fault based[142] liability rules on directors' acts, regardless the action is

[142] For indicators in the Companies Law 1965 supporting a fault-based scale of liability, see, for partnerships, Article 32, which reads as follows:
"The manager shall be held accountable for compensating damages inflicted on the Company or the partners, or the others due to violation of terms of the company incorporation contract, or due to errors he commits in performing his functions; and each agreement on otherwise shall be considered null and void."
For the public shareholding companies, see also Articles 76, 77 and 78 in t the Companies Law 1965, which respectively read as follows: =

> = Article 76: "Members of the board of directors shall be jointly liable to compensate the company, shareholders or others, for damages emanating from their mismanaging the company affairs, or violating the provisions of this Law, or the stipulations of the Companies Law; and each condition ruling otherwise shall be considered null and void …."
> Article 77: "The Company shall be entitled to file a liability lawsuit against the board of directors' members due to errors that cause damages to all shareholders….."
> Article 78: "Each shareholder shall be entitled to file the liability lawsuit prescribed by the company against the board of directors' members if the error committed by them shall cause a special damage to him …"

For the limited liability companies, see also Article 168, which reads as follows:

> "…. The managers shall be jointly held liable for compensating the damage inflicted on the company, partners or others because of violating the provisions of this law, the company incorporation contract, or due to errors committed in performing their duties. Any condition ruling otherwise shall be considered null and void."

For the public shareholding companies, see also Articles 76, 77 and 78 in t the Companies Law 1965, which respectively read as follows:

> Article 76: "Members of the board of directors shall be jointly liable to compensate the company, shareholders or others, for damages emanating from their mismanaging the company affairs, or violating the provisions of this Law, or the stipulations of the Companies Law; and each condition ruling otherwise shall be considered null and void …."
> Article 77: "The Company shall be entitled to file a liability lawsuit against the board of directors' members due to errors that cause damages to all shareholders….."

tortious or contractual. The actionable fault will, therefore, be the one deviating from the reasonable directorship norms and the standard conduct in doing the duties imposed over directors by the law. Under these Saudi corporate legislations, avoiding recourse to the fault based rules is legally impossible. This is basically because such rules apply in default by virtue of law.

Under such default law rules, the director duties would be defined and judged with reference to the standard conduct of ordinary (average) man (director) and thus directors will only fall foul of the law and be liable towards the company or shareholders when they knowingly fail honouring their duties. The burden of proof will lie over the company to show such deviation and this will be a second difficulty to face on the side of application.

Moreover, under such fault based level, it would be very difficult to monitor and legally act the varied duties imposed by the modern corporate governance theories, especially those imposing a duty over the directors to consider other stakeholders' legitimate interests[143] and to put the company on the proper long term track[144].

In light of the shortfall of the fault-based theory in monitoring directors' works, modern laws of companies usually impose a fiduciary duty over the directors in a way benefiting the company itself and the shareholders. The relation would be considered in fiduciary when the law imposes more duties over the parties – or one of the parties – in a relation involving an element of trust or reliance such as in cases of agency contracts, employer-employee relations and contracts of advisory service. The liability is somehow strict and the party owing a fiduciary obligation will

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> Article 78: "Each shareholder shall be entitled to file the liability lawsuit prescribed by the company against the board of directors' members if the error committed by them shall cause a special damage to him …"

For the limited liability companies, see also Article 168, which reads as follows:

> "…. The managers shall be jointly held liable for compensating the damage inflicted on the company, partners or others because of violating the provisions of this law, the company incorporation contract, or due to errors committed in performing their duties. Any condition ruling otherwise shall be considered null and void."

[143] For the directors' duty to consider the legitimate interests of the company stakeholders, see the CM-Code Article 10(e) and the BO-Code Articles 1, 8(d), 9, 10(d), 38 and 82.
[144] For the director's duty to achieve the company strategic planning and performance of the long run objectives, see BO-Code Articles 15(d) and 74.

always be under the obligation to act honestly and achieve the interests of the other party in the relation.[145]

In corporate law terms, the fiduciary duty is the obligation to act honestly and in good faith in achieving the best interests of the company (represented in the members' interest) and to use the granted powers solely for the purposes for which they were granted.

Adoption of fiduciary standards over the directors in any proposed reform of the Saudi Companies Law will solve the insufficiency of the earlier fault-based standard of liability. There are, however, three important notes that need to be mentioned in this regard:

1) The Saudi Companies Law 1965 directorship liability looks absolutely rigid; parties' attempts to adapt or amend the liability rules by way of an agreement or a special clause in the company memorandum of association will fail and be unenforceable as the law states that agreements to the otherwise of the law-imposed liability pattern will be considered null and void.

2) For the same reasons above, the fiduciary-oriented rules and obligations scattered in the Saudi corporate governance in this phase looked merely suggestive and lacked any law enforcement ability under the complicated classical fault-based liability style; and

3) Incorporation of fiduciary obligations over directors needs a substantive reform for the Saudi Companies Law 1965.

4.2.8.3 The Standard of Breach

The standard of breach remains, for the fault based case style, the deviation from the reasonable man conduct; the fiduciary duty adopts a higher standard of liability being the honest skilled man. Additionally, honesty is a direct application for good

[145] This can be compared to the 'Business Judgment Rule' indicating the presumption that, in making business decisions, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company and its stockholders. The rule implies that Directors' actions will be upheld if it can be attributed to any rational business purpose. The presumption may, however, be overcome only if a plaintiff pleads facts showing that a board has acted: 1) Disloyally, 2) in bad faith, or 3) with gross negligence.

faith rules, and it does not import difficulty in implementation or in court monitoring. As a matter of fact, honesty will be judged with reference to the fiduciary duties the directors are subjected to.

As for the 'skill' requirement, the matter is usually tested with reference to the so called the 'business judgment rule'. Under such a rule, directors are taken as making decisions based on their business skills and full awareness of the varied facts and information involving the market and the company status. They are presumed to have collected and considered all relevant data and sought all necessary consultations. In this sense, the process of making decision will be the core element, not necessarily the result (product) of such decision.

Directors have to identify the risks of the company business and try to minimize it through proper management and decisions. They have, in some industries, a duty to outline and define the risk element in order to safeguard the company. The more the type of business involves risk, the harder is the directors' liability.

Also, the standard of liability differs depending on the executive level of the directors. Non-executive directors are deemed to benefit from their lack of information and market facts when their liability is judged. Executive directions will not simply be in the same position as they are expected to be fully aware of the same.

Unfortunately, none of these standards is available in the Saudi Companies Law 1965 although some Saudi corporate legislation imposes duties of skill, knowledge and information awareness on directors.[146] Under the earlier company style, none of the above practical considerations is likely to be judged when directors' liability becomes under court revision. A reform for the earlier law is seriously needed in this place so that the fiduciary nature of directors' obligations is recognized and the modern corporate governance duties are enforced.

[146] See BO-Code Part 2 Principle 1, and also BO-Code Articles 14 and 15.

4.2.8.4 Director's Duties and Responsibilities: The Best Practice in the Field

The international practice for directorship came as a response to the serious demand in the practical field for outlining directors' duties, responsibilities and the fiduciary duty they owe to the company. Below is an illustration for the duties that the best practice usually requires to all types of companies.

4.2.8.4.1 The Duty to Act within Powers

This is a traditional fiduciary duty pursuant where directors are required to use their powers to achieve the goals intended thereby. Also, they should not act in violation or in excess to such powers. The sources of powers remain the law of the company, the company Articles, the bylaws and the assembly decisions.

4.2.8.4.2 The Duty to Promote the Success of the Company

Under such an obligation, directors are required to devote their skills, expertise and knowledge to achieve and promote the success of the company. The law defines the success of the company by reference to the 'benefit of the company members – shareholders.' This is quite interesting as the fiduciary duties are legally owed to the company. The standard thereof will be the shareholders receivable benefit.

4.2.8.4.3 The Duty to Exercise Independent Judgment

This implies that directors should be free of any external effects while making their judgments and decisions. The obligation does not ban directors from seeking independent opinions from consultants and other management members as long as the final decision will be theirs.

4.2.8.4.4 The Duty to Exercise Reasonable Care and Diligence

Under such a duty, directors are required to exert due diligence and care in managing the company's affairs and making their varied decisions. This implies some subjective character as when questions of the special background, qualifications and personal awareness of a given director are considered by courts while deciding what does and what does not constitute a reasonable care and diligence conduct. On the other hand, the duty implies that directors must have a minimum amount of knowledge and diligence as a requirement for them to hold the office. A director is not, therefore, excused merely because he lacks the basic credentials a director must have.

4.2.8.4.5 The Duty to Avoid Conflict of Interest

This duty implies an obligation over the director not to have a private interest that is likely to conflict with the interests of the company. The practical effect of the rule is that when directors are into any situation where their own personal interests conflict or may conflict with the interests of the company they represent, the interests of the company must prevail.

4.2.8.4.6 The Duty not to Accept Benefits from Third Parties

This duty applies when the benefit is likely to raise conflict of interest issue the interests of the company. In other words, the director must not accept any benefit that is conferred upon him for the mere reason of being a director. The benefit can be anything of a beneficial value, or even a benefit of a social or political character.

4.2.8.4.7 The Duty to Declare Interest in Proposed Transactions or Arrangements

Under this duty, directors are obliged to properly report in good time the interests they have in any proposed transaction(s) for the company. The time of reporting should be before the conclusion of the arrangement, not thereafter. This is in fact a variant for the general duty not to have a conflicting interest with the interests of the company.

4.2.8.4.8 Adopting a Wider Definition: Shadow Directors and De Facto Directors

It might be beneficial for the corporate governance efficiency that governance principles enjoy a kind of flexibility in practice beyond the law-drawn 'board member' – 'non-board member' classification. As a matter of fact, addressing persons and executives not to have a directorship capacity by governance rules originally designed for board members might appear a desired fruit at the practical side, especially when such persons do appear to be very effective in the company decision-making process (*shadow directors* according to some Companies Law terminology). The extension of rules might also be beneficial to persons, regardless the titles they have, usually appearing before third parties as having a directorship capacity (the so-called a *de facto director*).

By this extension, a wider room for governance application will be allowed. Executives and other management officers will fall under the same duties imposed over directors. This is quite important as sometimes executives and other high management officers will have concentrated powers similar to the ones vested in the board of directors itself.

It is highly recommended that the Companies Regulation and the local corporate governance policies follow this functional-oriented classification when a directorship theory is drawn and addressed, especially when it comes to the privately owned companies which do not appear to usually have a clear allocation for duties within its structure and – *a fortiori* – its appearance before third parties.

4.2.8.5 Rights of Shareholders

With the exception of some flaws in the earlier body of law,[147] shareholders – taken collectively – are enjoying fair standing regarding their general rights. Some of these rights are rights of participating in the company's management, the right to receive and get access to information, the right to suggest issues and vote at the general meetings of the company, and the right to receive dividends and participate in the company's assets in case of winding up.[148]

What basically matters is the standing of the monitory shareholders being the shareholders holding an amount of shares that does not confer upon them any controlling or voting power comparing the ones enjoyed by the rest of shareholders.[149]

It is good to mention that company affairs, basically the strategic planning, management and voting, should not necessarily be seen as a 'democratic' process by which the 'minority' should always adhere to the views of the 'majority' through a democratic voting vehicle. Rather, contemporary views see the issue as 'every investor's right to monitor and seek the good of its investment – represented in the shares it holds – no matter the volume thereof'. If this view is to prevail, the minority

[147] See for example the following Articles in the KSA Companies Regulation 1992: 18 (restrictions against exit right – Partnerships), 83 (restrictions against attending general meetings – Public Shareholding Companies), 101 (restrictions against dealing in shares – Public Sharing Companies), 104 (shares redemption – Public Shareholding Companies), 165 (restrictions against exit right – Limited Liability Companies), 168 (restrictions against board member recusal – Limited Liability Companies).

[148] On the KSA corporate governance code level, see CM-Code Articles 3 to 7 and BO-Code Articles 78 to 81.

[149] In the same vein see CM-Code Article 2 and BO-Code Part I.

shareholding issue will be an interesting challenge for any law reform process in the KSA.

The law regarding the minority's shareholding is basically a 'policy' issue. To a great extent, there is no room for a radical replacement for the earlier classical voting and decision-making process styles. However, the 'policy' may only take measures to dilute the potential negative effects of the idea of the majority controls and influences the decision-making of the company.
Nothing in the Companies Regulations suggests any special regulation for the minority shareholding safeguarding measures. Moreover, the BO-Code and the CM-Code involvement in this matter are also groundless and ineffective.[150]

4.2.8.6 The Fiduciary Duty Owed by the Directors

The directors' duty of fiduciary is basically attributed to the company, not to the shareholders.[151] Directors are under the general duty not to cause harm to the shareholders. Any board action favouring any segment of shareholders without a special law support will be taken as falling short of the neutrality obligation of the directors. The minority shareholders' issue is not, therefore, a board general competence. As said, the matter is mainly a law intervention policy, which aims at finding solutions in favour of this less-favoured fraction of shareholders.[152]

4.2.8.7 Minority Shareholding Safeguarding Measures

The minority shareholders may desire to have representative(s) in the company board of directors. This is quite important as this will mainly be seen as a good tool for them to raise issues at board and vote thereon. It will be also a good tool for information gathering regarding many detailed aspects of the business and the company general affairs.

Board appointment is basically unavailable to minority shareholders electing under the earlier KSA Companies Regulation. This is because the majority will be already occupying all available offices.

[150] The FC-Draft Code does not regulate the minority shareholding issue in any sense!
[151] In fact, nothing in the KSA Companies Regulations (1992) suggests any direct relation between directors (or the board) and the rest of shareholders. Even thoughts on the existence of an assumed agency linkage between directors and shareholders are legally groundless and look highly artificial!
[152] See the discussion in section (4.2.8.2) and (4.3.1.5).

The suggested solutions should focus on how the minority votes can be heard when directors' election takes place.

The c*umulative voting*

Under this mechanism, the number which represents shares held by each shareholder, is multiplied by the number of directors available for the office. The shareholder can cast all his votes to one, or more, of the directors.

Actually, the vote accumulation technique was recommended by some KSA corporate governance instruments, because it is more equitable for addressing minor shareholders' needs.[153] However, the imminent question is whether this is a sufficient remedy for the question of minority rights. This cumulative election mode is usually seen as a useful tool enabling the minority shareholders to have a representative at the board. However, the tool does not come with a guarantee for the following reasons:

1. The other shareholders (the majority) will also be given the same right of multiplying and concentration. This will eliminate most of the advantages which the cumulative system achieves;
2. The system would be ineffective if the number of board offices is small; and
3. (*Most importantly*) the question of the minority shareholders' unity and loyalty in supporting one nominee is also a serious obstacle against making a representative for them in the board. Usually, the minority shareholders' votes are scattered amongst several nominees without any effective load in favour of any of them.

The *share class* system

One of the good solutions suggested to overcome the question of the majority dominating the board election is the adoption of the share class system. According to such system, the voting capital of the company should be divided into many categories of shares where each category will be entitled to appoint and elect a director, or directors, on its own.

[153] See CM-Code Article 6 and the BO-Code Article 79.

By recognizing the (minority shares) as one of the voting capital share classes, the holders of such shares will be certainly entitled to nominate candidates for the board and get their law-fixed number of directors to be amongst the board. Cross voting amongst the different share classes will be disallowed, and thus the obstacle of the minority shareholders' un-loyalty will be minimized to a great extent.

Unfortunately, neither the KSA Companies Regulations nor any of the earlier KSA corporate governance codes support the notion of share classification. Therefore, reform is needed in this respect.

4.2.8.8 General meeting rights

These are basically the rights vested in the minority shareholders to effectively appear and act before the general assembly of the company. It is widely agreed that minority shareholders are entitled to attend and vote at general meetings of the company. The main concern, nevertheless, should be the effectiveness of their attendance and casted votes.

The *threshold of calling general meetings*

The earlier KSA Companies Law rules on calling for general meetings are disfavouring the minority shareholders by requiring a high threshold for such calling. For the public shareholding companies, the required threshold is 5 percent of the capital shares.[154] For the limited liability companies, a bigger threshold is required, being 50 per cent of the share capital.[155]

It is obvious that the earlier trend of the law does not support any minority involving in the calling of the general meetings of the company. In order to guarantee a better participation by the minority shareholders, a lower threshold should be adopted by the law. The suggested percentage is somewhere between 1 and 2 per cent for the public shareholding companies and something around 15 per cent for the rest of company types.

The required *quorum*

[154] See Article 87.
[155] See Article 174.

The quorum earlier required by the KSA Companies Regulations for duly organized general meetings is also disfavouring the minority shareholders interest. For the public shareholding companies, the quorum required is simple the attendance of shareholders who represent 50 of the company issued capital. This applies equally to ordinary and extraordinary general assembly meetings.[156]

More dramatically, adjourned general assembly meetings will be duly organized regardless the actual number of attendees, unless the meeting is of an extra ordinary nature where the attendance of shareholders representing 25 per cent of the share capital of the company is required.[157]

The proper minority shareholders' treatment for representation in the general meetings of companies is the imposition of a super majority quorum for such meetings. When the company shares are classified into different classes of shares, the quorum (or the super quorum in case thus imposed by the law) should be present in each class of shares.

The required *decision reaching majority*

The last remedial action that can be taken to rectify the minority shareholders weaker position is majority-oriented. The earlier situation for the decision-making majority is absolutely disfavouring the minority shareholders. By requiring that most decisions are taken at a 50 simple majority[158] the minority shareholders will not have any chance to be heard in any general meeting sessions. [159]

As is the case in the quorum issue, the solution is always taking the form of raising the required decision making majority. It would be highly beneficial, especially for the privately owned companies, that a super-majority rule is imposed instead of the earlier existing simple majority rule. In addition to a super-majority rule imposition,

[156] The KSA Companies Regulation 1992, Articles 91 and 92
[157] The KSA Companies Regulation 1992, Articles 91 and 92
[158] See the KSA Companies Regulations (1992) Articles 25 (partnerships), 27 (partnerships), 28 (partnerships), 92 (public sharing companies) and 172 (limited liability companies).
[159] Some exceptions do however exist: the unanimity required for extraordinary decisions in partnerships (Article 30) and the two-third majority required in Article 92 for some extraordinary decisions at the public shareholding companies general meetings.

the minority shareholders may also be given a right of rejection (veto) in some very critical situations seriously affecting their investment and corporate standing.[160]

4.2.8.9 The Rules on Disclosure and Information Dissemination

Another important aspect of corporate governance discussed in this study is the rules concerning disclosure of information related to the company and its business. Disclosure is the tool by which the shareholders and the related stakeholders are given access to timely and efficient information related to all aspects of the company and its business. The information is important basically because they enable shareholders to better monitor their business, make decisions and even make their informed choices whether or not to keep-in or exit-from the business envisaged in the company. It is also an important tool to enable evaluation for the board and the executive employees' efficiency in running the business.

Equally, disclosure is important to the stakeholders as it relates to their general standing towards the company, its objectives and transactions, and reflect whether or not the company observe their acquired interests as persons addressed under the modern 'enlightened' approach of governance.[161]

To go straightforward, rules concerning disclosure in the earlier Companies Regulations are mainly financial[162] in nature addressing the company's financial results and standing in the market. This is primarily envisaged in the rules giving

[160] The veto should always be seen as exceptional; it can only be imposed on seriously extra ordinary matters such like the following:

- amending the charter or the bylaw of the company;
- entering into a merger transaction; or acquiring a third party company;
- the sale or lease of a substantive part of the company assets;
- filing a voluntary bankruptcy application;
- appointing external auditors;
- extending a loan to a third party;
- creating or implementing a mortgage against the company assets;
- increasing/decreasing the issued/authorized capital of the company.

[161]The matter is also important for potential investors making decisions on their future investment and is also important for the different regulatory sectors planning, and setting paces, for the markets (such as the competition authorities).

[162] With the minor exception of the rules concerning the directors' duty to report conflict of interest issues; see for instance Articles 31 (partnerships), 69 (public sharing companies), and 70 (public sharing companies).

shareholders/partners rights to get access to the company's records and other documents showing its financial standing and general transactional activities.[163]

With the exception of the requirement of a general statements about the company's activities and the requirement of disclosing the income, salaries, allowances, expenses, service fee and dividends paid (or payable) by the company to the board members,[164] the scope required for the annual reports remains primarily 'financial' to a great extent having to do with the budget, loss/profit statements, the financial standing of the company and a suggested profit (dividends) distribution plan.[165]

The earlier Companies Regulations state nothing about a duty to disclose information needed by the stakeholders. The company is generally under no duty to provide such information.

On the governance-codes side, the matter is quite clearer and wider as companies are required to make timely and sufficient disclosures to cover not only the financial status thereof but also the following important aspects missed by the Companies Regulations:

1. Scope of compliance with the applicable governance code principles, the unimplemented aspects thereof, and the reasons of such un-implementation[166];
2. the entities and parties with share ownership in the reporting company[167], and the names of the listed companies the board vacancies of which are held by any board member in the reporting company[168];

[163] For the Companies Law see Articles 24 (partnerships), 108 (public sharing companies) and 175 (limited liability companies) giving the company members the right to get access to the company's general business, records and financial standing. For the BO-Code see Articles 83 and 84. For the CM-Code See Article 9.
[164] See Articles 74, 89, and 123 of the Companies Law (1992).
[165] See the following Articles in the Companies Law (1992): 89 (public sharing companies), 128 (public sharing companies), 132 (public sharing companies), 175 (limited liability companies) and 223 (a general provision for companies under liquidation).
[166] CM-Code Article 9(a) and BO-Code Article 84(i)
[167] BO-Code Article 84(a)
[168] CM-Code Article 9(b)

3. information about reporting of the company's board of directors, its committees (including their roles and heads) and directors classifications as executives, non-executives and independents[169];
4. information about allowance, incentives and remuneration systems [170], including those extended to the board members and the executives[171];
5. the internal control framework[172] and reports on the effectiveness of the internal control system adopted by the reporting company[173];
6. penalties and remedies imposed against the reporting company by any competent regulatory[174];
7. the ethical and professional principles observed at the reporting company[175];
8. the conflict of interest policy and the conflict of interest related transactions at the reporting company[176];
9. the strategic plan of the reporting company (including for the future take-overs, mergers and subsidiary making)[177];
10. the business risks and the international rating of the reporting company[178].

Unlike the situation under the Companies Regulations, disclosure policy under the CM-Code and the BO-Code addresses the stakeholders' needs and requires the disclosure to be designed in a way satisfying their right to information.[179]

Despite the considerable advancement provided by the governance codes working side-by-side with the Companies Regulations in the KSA, the divergence separating between the proper practice of disclosure and the earlier practice under the Companies Regulations and its ancillary governance codes is still vast.

On the financial side, despite the concentration in the Companies Regulations, some vital aspects are still missing, namely disclosures regarding the accounting

[169] CM-Code Articles 9(c) and (d) and BO-Code Article 84(b)
[170] BO-Code Article 84(d)
[171] CM-Code Article 9(e) and BO-Code Article 84(c)
[172] BO-Code Article 84(e)
[173] CM-Code Article 9(g)
[174] CM-Code Article 9(f)
[175] BO-Code Article 84(f)
[176] BO-Code Article 84(g)
[177] BO-Code Article 84(h)
[178] BO-Code Articles 83 and 84(j)
[179] BO-Code Articles 82 and 83; CM-Code 10(f)

system followed in the company and the decision making process on electing and communicating with the external auditors and their scope of works, responsibilities and duration.

On the ownership structure and voting power of the company, nothing in the Regulations or the Codes gives specification on important matters like changes in the shareholders and ownership structure, control (voting) rights and structure and the general meetings processes and agendas.

The major deficiency in reporting and information dissemination requirements remains for the board and management sector. Nothing in the Regulations or Codes requires that reporting and information dissemination should include detailed data on the roles and functions of the board and other senior executives of the company and on their qualifications and duration at the service. Likewise, nothing gives any obligation on giving information about the varied processes and precautions adopted by the company for supporting the independence and loyalty of the board and the senior management (including procedures for board related transactions and how the same is internally reported, considered and cleared). There is also no obligation on giving information about the internal rules governing transactions of an extraordinary nature, risk management, and on the internal processes and manners followed in evaluating performance of the board and the senior management.

Finally, the stakeholder side in the obligatory reporting is still minor. There is no specific requirement for reporting about the internal mechanisms and precautions followed to safeguard the stakeholder interests and their right in timely information. Moreover, nothing supports reporting on the company policy adopted for dealing with the different types of stakeholders, including competitors, environment, employees and the society as a whole (including consumers).

4.3 Recent Phase: Statutory reforms 2015 - 2017

To complete the discussion and analysis of the Saudi statutory framework of corporate governance this section will focus on two legislative instruments which have recently been introduced into the legal framework in Saudi Arabia. These are namely the new Companies Law 2015 the new Corporate Governance Regulations 2017.

A number of economic and policy considerations can be regarded as the motives behind the reform resulting in the new Companies law. On one hand, it is a reflection of the evolution of the Saudi economy in the years since the Companies Law 1965 and other regulations were enacted. On the other hand, the Law culminates the efforts needed to establish a new framework compatible with a more complex business environment. The factors that affecting the Saudi Arabian economy and necessitated the more robust legal regime include the following:

1. Saudi Arabia's accession to the World Trade Organization in 2004, and the precipitous growth of foreign direct investment.
2. Growth of the Saudi Arabian stock market, including the recent opening of the stock market to foreign investment and the development of a vibrant sukuk market.
3. Diversification of the Saudi Arabian economy into new industries beyond the traditional hydrocarbon based economy.
4. The larger role small and medium enterprises play in the economy, which requires a more efficient regulatory environment for their success.
5. The need for the private sector to play a larger role in the Kingdom's economic development.

The full impact of the new companies law and the new Corporate Governance Regulations on the Saudi corporate framework can more appropriately be assessed when the law is fully implemented in the post 2017 period. However, the main driving factors of the new laws and the regulatory innovations they brings about can be described comparatively in the following two subsections.

4.3.1 Impact of the new Companies Law 2015

The Companies Law (1437H/2015G) was published by the Ministry of Commerce and Industry (MOCI) on 9 November 2015, and in the Saudi Gazette (Um Al-Qura) on 4 December 2015, and was stated to come into effect on 2 May 2016. The new Companies Law completely replaces the old Companies Law 1965. The new law provides existing companies with a period of 12 months from its effective date to make such changes as are necessary to comply fully with the new Companies Law, subject to any new rules set in respect of such existing companies by the competent regulatory authorities.

As it already transpired from the above discussion, the Companies Law 2015 can be described as a new era in the Saudi framework of corporate governance. In particular, the law determines more clearly the functions and jurisdictions of the Ministry of Commerce and Industry (Investment) and the Capital Market Authority. Moreover, there are several novel issues in the context of corporate governance which Companies Law that has dealt with for the first time. There are a number of points in terms of corporate governance which characterise the Companies Law 2015 and these can be summarised as follows:

4.3.1.1 Audit committees

The new law has introduced an audit committee to monitor the business of JSC.[180] Moreover, a whole Chapter (4) has been dedicated to dealing with this essential issue as an important tool of corporate governance. Article 101 states that the formation of this committee must be by a resolution of the General Assembly and contain non-executive members of the board of directors, whether shareholders or others; the number of this committee's members shall not be less than three and no more than five, and the decision must include determining the tasks, functions and the rewards of the committee members. For the meeting of the committee, Article 102 states that the majority of the committee must attend the meeting for it to be valid, and the decisions to be issued must gain the majority vote. However, in the case of a draw of votes, the side where the meeting chairman votes will be taken. Article 103 clarifies the specialisation and power of the committee as monitoring the company's activities. Even more so, the committee has the power to call for a general assembly if the committee is facing obstacles from the board of directors, or if the company has suffered damage or serious crisis. Finally, the Audit Committee must review the company's financial statements, reports and observations provided by the auditor; the committee must provide a report about

[180]The Ministry of Commerce and Industry and the Capital Market Authority has signed a memorandum of joint cooperation in February 2016 for cooperation and coordination of policies and procedures in the application of the provisions of the new law in accordance with the rules consistent with transparency and control and corporate governance standards.

their opinion and the adequacy of the internal control system in the company and other work within its competence, as detailed in Article 104.[181] Around ten years ago, Article 14 of Corporate governance regulations dealt in more detail with the audit committee, which was made a mandatory Article in
2009.[182]

4.3.1.2 Cumulative voting

The new law also introduced cumulative voting in the election of the Board of Directors. Accordingly, Article 95 states that cumulative voting must be used in the election of the board of directors, so that individuals may not use the right to vote more than once per share.[183] It is worth mentioning in this context that the corporate governance regulations mention cumulative voting for the election of the Board of Directors in Article 6 paragraph B. Cumulative Voting is a voting method that is used to select the members of the board of directors. It should be mentioned in this context that cumulative voting is a US idea that is not used in English Law.[184] CMA has explained this method as follows: ‘Each shareholder can cast a vote in proportion to the number of shares he owns. So he can use this power to vote for one candidate, or divide it on a number of candidates without repetition’.[185] The importance of this method is based on increasing the opportunity of the minority shareholders to have representation to be in the board of directors.[186]

4.3.1.3 Prohibition on combing the post of Board Chairman with an Executive position

The third point is that the Companies Law 2015 prohibits combining the post of Chairman of the Board of directors and any other executive position in the company in Article 81 paragraph 1. On the other hand, Article 12 paragraph D of the CGR mention the prohibition of combining the post of Chairman of the Board of directors and any executive position in the company. However, paragraph D of

[181] CL 2015.
[182] Corporate governance regulations 2006.
[183] CL 2015.
[184] See: Y Wenjia, 'Cumulative Voting: In the Us (Declining), in China (Rising) and the EU (Not-Adopted).' (2015) 12 European Company and Financial Law Review 79.
[185]CMA, 'The Official Website of the Capital Market Authority' (2015) <http://www.cma.org.sa>. accessed 1/2/2016.
[186] F AlKahtani, 'Current Practices of Saudi Shareholder's Rights: A Case for Reform' (2013) 27 Arab Law Quarterly 231.

Article 12 is still not mandatory in the corporate governance regulations, which means that from April 2016, the prohibition of combining the post of Chairman of the Board of directors and any other executive position in the company will be in force according to Article 81 paragraph 1 of the Companies Law 2015.

4.3.1.4 Types of Companies

The old Companies Law involved three rarely used forms of corporate entity under which are no longer permitted by the new Law. These are – namely - Cooperative Companies, partnerships limited by shares and Variable Capital Companies (Article 3). Accordingly, the main forms of corporate entity used will continue to be the Limited Liability Company (LLC) or Joint Stock Company (JSC).

Additionally, Articles 182-186 contain specific provisions introduced to govern the establishment of a holding company (either by way of LLC or JSC) for controlling other JSCs or LLCs by holding more than 50% of their capital or through board control. Any such new holding company will have to include the word “holding” in their name and produce annual consolidated financial accounts.

One of the most significant changes in practice is Article 154 providing that LLCs can be formed under the new law with a single shareholder, replacing the requirement pursuant to the old law for a minimum of two shareholders. Moreover, JSCs can presently be formed with two shareholders reduced from the earlier requirement of a minimum of five shareholders. Also in certain cases (JSCs formed by the Government or Government owned entities or formed by entities with a minimum of SAR 5 million) closed JSCs may be formed with a single shareholder (Articles 2 and 55).

Pursuant to Article 54, the minimum share capital requirement for JSCs is reduced from SAR 2 million to SAR 500,000. There continues to be no minimum capital requirement for LLCs, although in practice if the LLC or JSC is foreign invested the Saudi Arabian General Investment Agency (SAGIA) may impose a higher minimum capital requirement. Additionally, Article 61 provides that in-kind share contributions for both LLCs and JSCs must now be independently valued.

Another major change is the removal of the provision contained in the earlier Companies Law which makes shareholders in LLCs jointly liable for the debts of an LLC where its losses exceed 50% of its capital and the shareholders make no decision to recapitalize or liquidate the company and the company continues to trade. Instead a new provision provides for termination of the company by operation of law if either the managers of the LLC take no steps to call a shareholder meeting or the shareholders take no action (Article 181). There are also analogous revisions around the process for termination where a JSC's losses exceed 50% of its share capital (Article 150).

There continues to be a requirement for LLCs and JSCs to set aside 10% of net profits as a statutory reserve, but this is no longer needed once the reserve attains 30% of the share capital. This is a reduction from the earlier requirement of 50% of share capital (Articles 129 and 130 for JSC and Article 176 for LLCs). An LLC will be required to undertake a conversion to a JSC if the number of its shareholders increases beyond 50 (Article 151).

4.3.1.5 Absence of a general duty of loyalty

It was argued in section (4.2.8.2), that the fact that the old Companies Law did not explicitly impose a general duty of loyalty on directors to their company needs to be considered in potential corporate reforms. The new Companies Law does not, however, change the substance of the situation which prevailed under the old law. While, on the one hand, a general duty of loyalty appears to be founded in the more concrete duties bestowed on directors by the Companies Law such as Articles 71 and 72 of the Companies Law, Article 75 (1), on the other hand provides for the principle regulation on the powers of directors only to the extent that directors must have the "widest authority" to manage the company and does not limit such powers to the objective of the company.

Moreover, as discussed in section (5.3.2), a general duty of loyalty in the Saudi legal system is derived from Sharia law. This duty may be derived from the director's classification as an agent of the company's shareholders or as trustee of the shareholders' assets. Regardless which understanding of the director's position is applied, the doctrine generally accepts that Sharia law compels a director to act with loyalty towards the company and treat all shareholders fairly.

4.3.1.6 Liability under Companies Law

The issue of management liability is regulated for both JSCs and LLCs in individual sections of the new Companies Law. LLC managers responsibilities are governed by Article 165 (2), while JSC directors' liability is regulated by Article 78 (1) of the Companies Law. However, both provisions stipulate that persons engaged in the management of a company will be individually and jointly liable towards the company, its shareholders and third parties for the following acts:

- violations of their duties under the Companies Law;
- breaches of the company's articles; and
- errors of management.

It is noteworthy, however, that the above Articles (78 (1) and 165 (2)) do not expressly mention Directors liability for fraudulent acts. Nonetheless, since both articles stipulated extended statutes of limitation for fraudulent acts (Articles 78(3) and 165(4) of the Companies Law), it is clear that they both establish management liability for fraudulent acts.

Moreover, where any misconduct that would prompt liability of JSC directors under Article 78 (1) of the Companies Law is based on a unanimous decision of the board of directors, all board members will be held liable. As for majority decisions, those directors who opposes a majority decision cannot be held accountable, provided that their objection was recorded in the minutes of the relevant board meeting. A director that was absent from the board meeting during which a decision prompting management liability was made will not be released from liability under Article 78(1) of the Companies Law, unless he or she can establish that he or she was unaware of the decision or unable to object to the decision after becoming aware of it (Article 78 (2) of the Companies Law).[187]

4.3.1.7 Infringement of Director duties

The duties of a manager of an LLC are not explicitly regulated by the Companies Law. However, based on the generally accepted conventional wisdom that the

[187] Liability claims against a director or manager are time barred three years after the harmful act being discovered. Where the harmful act was conducted fraudulently, the statute of limitations is five years (Articles 78(3) and 165(4) of the Companies Law).

duties of JSC directors in the old Saudi Arabian Companies Law (Royal Decree M/6 of 1385 Hijri) applied analogously to LLC managers it could be argued that the same understanding will be applied to the new Companies Law, and the articles of the Companies Law governing the liability of JSC directors will be applied to LLC management particularly because the management liability regime was not changed within the new Companies Law.[188] This interpretation is, however, subject to confirmation by the Saudi Arabian courts when the law is fully applied. It is should be recalled though that even if the courts were to change their position with the new Companies Law, the duties imposed on JSC directors by the Companies Law are founded in Sharia law. Therefore, the same duties imposed on JSC directors under the Companies Law would apply to LLC managers under Sharia law, which remains applicable due to the priority of Sharia law over codifications of Saudi Arabian law.

4.3.1.8 Infringement of company's articles

The Companies Law does not explicitly state that the duties of a director may be expended in the company's articles. However, this follows indirectly from the fact that the articles of association of a company may deviate from the Companies Law, insofar as the articles do not conflict with any binding provisions of the Companies Law. Thus, the company's articles may not relieve the director from any duties imposed by the Companies Law though they may introduce additional duties. Considering the existing ambiguity regarding the analogous application of the provisions governing the duties of JSC directors to LLC managers, it is, for the sake of clarity, advisable to include these duties in the articles of an LLC incorporated in Saudi Arabia. In addition, foreign investors frequently choose to impose further duties and restriction of authority on directors and managers through the company's articles or other agreements to extend control over local management. As Articles 78(1) and 165(2) of the Companies Law refer only to the company's articles, their wording suggests that a breach of an obligation imposed

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[188] Article 226 of Companies Law 2015 provides that the new companies law shall replace the old law and shall repeal all inconsistent provisions thereof. This language of implies that any rules contained in Companies Law 1965 that do not contradict the rules specified in Companies Law 2015 may be used to help respective authorities, courts and companies interpret the substance of Companies Law 2015.

on a director in an agreement other than the company's articles will not prompt management liability therein. If this were the case, the relevant director(s) may be held responsible under contractual or possibly tortious liability.(19)

Error of management

Neither Article 78(1) nor Article 165(2) of the Companies Law define what constitutes an 'error of management' that would prompt liability of management under these provisions. Thus, even minor mistakes could produce management liability according to Articles 78(1) and 165(2) of the Companies Law. Since this would significantly hinder the operation of a company, economic considerations suggest that an error of management within the meaning of Articles 78(1) and 165(2) should be interpreted more restrictively. Nonetheless, since no relevant jurisprudence is available from the Saudi Arabian courts, it is unclear whether the courts would follow this interpretation.

4.3.1.9 Prohibition of competition

Pursuant to Article 72 of the new Companies Law, a director may not engage in any commercial activity that is in competition with a business activity carried out by the company or conduct business in any branch of the activities carried out by the company, unless with the permission of the company. Permission must be issued by resolution of the general assembly and renewed every year. Notably, Article 72 of the Companies Law does not address the issue of a director competing with the company for third-party accounts. However, such a duty is established by Islamic law.(15) Considering the priority of Sharia law over the Companies Law, it is immaterial whether Article 72 of the Companies Law prohibits directors from competing with the company for third-party accounts. Where a director infringes this obligation, the company may choose to seek compensation under Article 78(1) of the Companies Law or consider the relevant transaction to be executed in its name and for its benefit (Article 72 of the Companies Law). Considering that the non-competition obligation is, among other things, founded in Sharia law, the manager of an LLC is bound to it regardless of whether Article 72 of the Companies Law will apply to LLC management.

4.3.1.10 Prohibition of self-dealing

Article 71 of the Companies Law prohibits directors from having a direct or indirect interest in any transaction or contract concluded for the account of the company. Where a director contravenes this ban, he or she will be liable for any damage or loss caused to the company, its shareholders or third parties in this regard (Articles 71 and 78(1) of the Companies Law). Directors will typically be released by a resolution of the general assembly, which must be renewed annually. Whether Article 71 of the Companies Law can be applied analogously to managers of an LLC is irrelevant, since the same obligation exists under Islamic law as applied in Saudi Arabia.

4.3.1.11 Duty to call extraordinary meeting of general assembly

Article 181 of the Companies Law If the losses of an LLC reach 50% of its capital – thus, its liabilities amount to the value of its assets, plus 50% of its capital – the manager(s) must, within 90 days of becoming aware of such losses, convene an extraordinary meeting of the general assembly to consider whether to continue or dissolve the LLC. Where the shareholders resolve to continue the company, they must cover the losses of the company so that the company's assets amount to 100% of its capital.

A similar requirement exists for JSCs. Article 150 of the Companies Law requires the directors of a JSC to convene an extraordinary meeting of the company's general assembly within 45 days of discovering that the losses of the company reached 50% of its capital in order to decide whether the company will be dissolved or its capital increased. Where managers or directors fail to comply with this duty, they may not only be held liable under Articles 78(1) and 165(2) of the Companies Law, but also may face punitive penalties pursuant to Article 211(d) of the Companies Law.

4.3.1.12 Lack of statutory definition of *fraudulent act* and *abuse of authority*

The liability of JSC directors and LLC managers for damages or loss caused by their fraudulent actions is provided for by Articles 78(1), 78(3), 165(2) and 164(4) of the Companies Law. However, what constitutes a fraudulent act is not defined by the law. Under Islamic law, 'fraud' is generally understood either as the suggestion

– as a fact – of something untrue by someone who does not believe his or her statement to be true; or the suppression of that which is true by someone with knowledge of that fact.
Similarly, Directors' liability for abuse of their authority is also not mentioned in Articles 78(1) and 165(2) of the Companies Law. Further, a duty not to exploit managerial powers is not expressly mentioned in the Companies Law. Nevertheless, management liability for abuse of authority is generally considered to be established by Sharia rules.

4.3.1.13 Penalties and punitive measures

Chapter 11 of the new Companies law deals with penalties. Accordingly, directors may be subject to legal penalties pursuant to Article 212 and following of the Companies Law. The most severe penalties are provided for in Article 211 of the Companies Law, which stipulates that a director may be punished by incarceration for up to five years or a fine of up to Sr5 million for conduct (eg, misuse of funds and forgery of a company's financial records) listed in Articles 211(a) through 211(e) of the Companies Law. Notably, Article 211(d) of the Companies Law penalises directors for failing to call for an extraordinary meeting of the general assembly pursuant to Articles 150 and 181 of the Companies Law. Somewhat less severe punishments for misconducted are provided for in Article 212 of the Companies Law, which penalises making misrepresentations regarding the company to the public with imprisonment of up to one year and/or fines of up to Sr1 million. Finally, certain lesser offenses may be punishable by fines of up to SR500,000 pursuant to Article 213 of the Companies Law. These include, among other things, not calling for the regular annual general assembly or preventing a shareholder from participating in a general assembly.

While penalties under Articles 211 and 212 of the Companies Law will be imposed by public prosecution, fines according to Article 213 of the Companies Law will be imposed by the Ministry of Commerce and Industry (Investment) or the Capital Market Authority.
Some examples of criminal acts that give rise to fines of up to 500,000 Riyals under the New Companies Law include:

1. deciding, distributing or collecting, with bad intention, profits or revenues in breach of the provisions of the New Companies Law or the company's articles of association;
2. intentionally causing the delay of the invitation or meeting of the general assembly;
3. obtaining a benefit or a guarantee or a promise of a benefit or guarantee for voting in a certain way; and
4. failing to prepare meeting minutes as per the New Companies Law.

Some examples of criminal acts that give rise to fines of up to SAR 1,000,000 and/or imprisonment of up to one year under the New Companies Law include:

1. declaring, publishing, or announcing the incorporation of a company before completion of its incorporation procedures;
2. intentionally making false statements against the provisions of the law or the company's articles of association in any documents of the company, in the application for licensing, or in the documents attached with the incorporation application;
3. exaggerating or attributing to shareholders or third parties false acknowledgments regarding the evaluation of in-kind shares, distribution of dividends among shareholders, or payment of their values; and
4. using the company for a purpose other than the purpose for which the company is licensed.

Some examples of criminal acts that give rise to fines of up to SAR 5,000,000 and/or imprisonment of up to five years under the New Companies Law include:

1. Registering false or misleading information in the financial statements or in the reports prepared for the shareholders or the general assembly.
2. Using company funds, or using one's powers or votes in a way that one knows would affect the company's interests in order to achieve a personal gain for oneself or any other person or company.
3. Failing to hold the general assembly of the company or shareholders meeting when one becomes aware that the losses of the company have reached the limits established in the New Companies law, or failing to publish the occurrence thereof (note: knowledge is required only of

becoming aware of the losses; the actor does not need to know that failure to hold the meeting is a breach of the law in order to become liable).

4.3.2 The new Corporate Governance Regulations 2017

In addition to the New Companies Law 2015 discussed above, another milestone development in the Saudi legislative framework of corporate governance is the issuance of the new Corporate Governance Regulations pursuant to the resolution of CMA board dated 16/5/1438H corresponding to 13/2/2017. The new Regulations replace the earlier Corporate Governance Regulation of 2006. They have formally come into effect on 22 April 2017, although some provisions, such as those requiring corporate governance policies to be drafted and published, will only come into force on 31 December 2017.

Pursuant to Article 3, the main objectives of the new Regulations include the following:

1) enhancing the role of the company's shareholders and facilitating the exercise of their rights;
2) Stating the competencies and responsibilities of the Board and the Executive Management;
3) enhancing the role of the Board and the committees and developing their capabilities to enhance the Company's decision making mechanisms;
4) achieving transparency, impartiality and equity in the Exchange, its transactions, and the business environment and enhance disclosure therein;
5) providing effective and balanced tools to deal with conflicts of interest;
6) enhancing accountability and control mechanisms for the Company's employees;
7) establishing the general framework for dealing with Stakeholders and protecting their rights;
8) supporting the effectiveness of the system for overseeing Companies and the tools thereof; and
9) raising the awareness of Companies in respect of the concept of professional conduct and encouraging them to adopt and develop such concept in accordance with their nature.

Arguably, both the new Companies Law 2015 and CG Regulations 2017 reflect inspiration partly by corporate governance models and standards from other jurisdictions. In particular, in the drafting process both the Ministry of Commerce and Industry and the CMA took into account, amongst other things, the corporate governance recommendations articulated by the Organisation for Economic Cooperation and Development[189], the Basel Committee on Banking Supervision[190], the International Corporate Governance Network[191], the Institute of International Finance[192], the Financial Reporting Council[193], other Gulf Cooperation Council member states, and by the Saudi Arabian Monetary Agency in respect of banking institutions[194] and insurance companies.[195]

In comparison to the old Corporate Governance Regulations (2006), the main characteristics of the new Corporate Governance Regulations can be summarised in the following subsections.

4.3.2.1 The mandatory nature of the new Regulations 2017

The new Corporate Governance Regulations (2017) depart significantly from the voluntary mode of application which characterised the old Regulations.[196] Rather than being merely 'guiding principles' Article 2 (b) states that the new Regulations 'are mandatory to companies except the provisions that contain a reference of being guiding'.[197] Thus, the new Regulation can be characterised as principally 'mandatory' albeit with hybrid of voluntary provisions.

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189 See: http://www.oecd-ilibrary.org/governance/g20-oecd-principles-of-corporate-governance-2015_9789264236882-en

190 See: http://www.bis.org/bcbs/publ/d328.pdf

191 See: file:///C:/Users/zaidm/Downloads/ICGN012%20Principles%20Booklet_WEB.pdf

192 See: https://www.iif.com/news/revised-corporate-governance-principles-banks-consultation-paper-issued-basel-committee

193 See: https://frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx

194 See: http://www.sama.gov.sa/ar-sa/Laws/BankingRules/Corporate%20Governance%20%2024-2-2014%20(%D8%A7%D9%84%D9%86%D8%B3%D8%AE%D8%A9%20%D8%A7%D9%84%D9%86%D9%87%D8%A7%D8%A6%D9%8A%D8%A9).pdf

195 See: http://www.sama.gov.sa/ar-sa/Laws/insuranceRulesAndRegulations/Corporate%20Governance%20Regulation.pdf

196 Article 1 (b) of the old Regulations states that: 'These Regulations constitute guiding principles ..'.

197 There are a few Articles and paragraphs defined as 'guiding' in the new Regulations including the following: - Art 18 on the Conditions of the membership of the Boards; paragraph (b) of Art. 32 providing that 'The Board shall convene no less than four meetings per year and no less than one meeting every three months'; Art 38 on Qualifications of the Secretary; Art 39 on Training and Art 41 on Assessment of Board members; paragraph (b) of Art 54 stating: 'The chairman of the audit committee shall be an Independent Director'; paragraph (b) of Art 66 on Nomination procedure of the Remuneration Committee; Arts 70, 71 and

The new Regulations provide shareholders and board members with improved rights, greater clarity and more transparency as to their respective roles and responsibilities. In addition, they envisage shared regulatory jurisdiction to oversee their implementation. Accordingly, the MoCI shall be responsible for the implementation of the Regulations by closed joint stock companies, while the CMA shall be responsible for their implementation by public joint stock companies.

Evidently, the new Regulations demonstrate the desire to renew, emphasize and prioritize corporate governance regulations in a more practical manner in Saudi Arabia. In particular they emphasize the importance of corporate governance in ensuring the proper investment of a company's resources, with a clear statement of the objectives and of the rights and obligations of Stakeholders.

The issuing authorities stated that the rewards reaped from the implementation of proper corporate governance would extend beyond individual companies and would benefit the Saudi Arabian society and economy as a whole. Moreover, the regulations also stress the importance for companies to encourage fluid and regular interactions internally at all levels in order to achieve their best interests. Recognizing that Shareholders ordinarily do not follow a company' day-to-day activities, the regulations underline the need to regulate the relationship between, on one hand, the company's Shareholders and Board of Directors and, on the other, between its Board of Directors and its Executives. The regulations further emphasize the need to regulate individual conduct at all levels to ensure the application of high professional and moral discipline.

4.3.2.2 A new regime of greater transparency

Furthermore, the Regulations reiterate the importance for companies to adopt clear, efficient and sound decision-making processes. First and foremost, these

72 on Composition, Competencies, and Meetings of the Risk Management Committee, respectively; Arts 76, 77 and on Composition of internal audit department, internal audit plan, and internal audit reports, respectively; Art 83 on Regulating the Relationship with Stakeholders; Art 85 on Employee incentives; Arts 87 and 88 on Social responsibility and Social incentives, respective; paragraph (3) of Art 89 stating "the Company website shall include all information required to be disclosed and any details or other information that may be published through other disclosure methods'; Art 95 on Formation of Corporate Governance Committee (for the Company).

processes help protect shareholders and stakeholders. In addition, however, they also serve to advance companies' competitiveness and transparency on capital markets. According to the regulatory authorities, imposing greater transparency requirements on corporate managerial bodies would enhance companies' performance since they will be left accountable to all capital market participants, including investors, brokers and market analysts.

4.3.2.3 Shareholder Rights

Key rights are set out in Articles 4 to 15 of the Regulations and include: fair and equal treatment among shareholders, non-discrimination among shareholders of the same class, fair distributions, equal rights related to access of corporate information and communications, rights to attend and vote in general assemblies and board and audit member selections. The Regulation also provide for clear mechanisms for the distribution of dividends and insolvency pay-outs.

In particular, fair treatment of shareholders requires the following:

a) The Board is obliged to seek shareholders' rights protection to ensure fairness and equality among them.

b) The Board and the Executive Management of the Company is obliged not to discriminate among shareholders who own the same class of shares nor prevent them from accessing any of their rights.

c) The Company shall specify in its internal policies the procedures that are necessary to guarantee that all shareholders exercise their rights.

4.3.2.4 Board of Directors

Detailed rules and principles governing board of directors (which also include that of the chairman, independent directors and the secretary of the board) (together, the Board) are set out Articles 16 to 41 of the Regulations and cover matters including: board formation, composition, appointment, conditions of membership, termination, responsibilities, main functions, independence, distribution of competencies and duties (including vis-à-vis those in executive management positions), agenda setting, meeting procedures, auditing, and training. Furthermore, the Regulations enshrine the fiduciary duties to adhere to the principles of truthfulness, honesty and loyalty.

4.3.2.5 Conflicts of Interest

The Regulations also cover the Board's avoidance, assessment and disclosure of (and dealings with) conflict of interest situations. There is a need to establish policies and procedures in relation to related party transactions, conflicts scenarios (with or for the company or its competitors), conflicted persons, accepting gifts, and complying with the authorization, renewal and termination of the board and its members, as per the Companies Law.

4.3.2.6 Committees

Provisions dealing with the formation, composition, membership, powers, procedures, responsibilities, policies, meetings and announcements of committees for remuneration, risk management, audit, corporate governance and nomination are set out in Articles 83 to 88 of the Regulations.

4.3.2.7 Audit and Internal Control

Also outlined are the requirements as to the composition, appointment, roles and responsibilities of internal and external auditors. Listed companies should have internal control systems in place, along with audit plans and regular published reports. Listed companies must also maintain policies on effective corporate governance, and have an internal corporate governance committee regularly review compliance.

4.3.2.8 Stakeholder rights

Boards of listed companies are now required to produce policies on their dealings with various stakeholders, including employees and incentives given to them. These drafted policies should describe how to protect their respective rights, deal with complaints, confidentiality of information, professional conduct, social contributions, treatment of employees, and dealing with non-compliance with these policies and procedures. Employee incentive schemes and payouts must be documented. Separate policies governing professional and ethical corporate standards, social responsibilities and social initiatives are also to be made available.

4.3.2.9 General Disclosures and Transparency

There is a general requirement to disclose and make available up-to-date and accurate information to the company's various stakeholders. The board must maintain policies on information disclosure, and provide a regular board report along with that of the audit committee's report and regularly maintain information on the company's website. Remuneration of board members and the executive management must be disclosed pursuant to a standard template, as set out in the Regulations. All records of the company must be maintained for a period of ten years, or longer if, any potential claims are pending.

4.3.3 Summary of findings

As already mentioned above, the practical implementation of the new Companies Law and the Corporate Regulations 2017 will doubtless have to cascade through other relevant agencies such as SAGIA and it will take some time for custom and practice to adjust. However, by trimming the length of the primary law and enabling more detail to be addressed through subordinate regulation, it is envisaged that in future the corporate legal framework will be more responsive to wider global trends in regulation.

1. Despite the fact that many issues remain unresolved, it is fair to say that Companies Law 2015 has provided a more suitable legal framework for corporate governance that contributes towards more practical, effective, fair and sound corporate governance principles.
2. It could be argued that the Companies Law 2015 reform has reinforced some of the corporate governance issues that are already included in 2006 corporate governance regulations.
3. Without touching on the broader institutional issues and challenges of the Saudi framework of corporate governance discussed in section (3.1.1), the new Companies Law has solved the issue of a clash between Companies Law 1965 and Capital Market Law 2003 by determining the respective authorities and competence of the Ministry of Commerce and Industry and the Capital Market Authority.

4. The new Companies Law has encouraged institutional work in order to achieve sustainability and growth for companies by facilitating the requirements for establishing a joint stock company by reducing the minimum capital to 500,000 Saudi Riyal instead of 2000.000, thereby reducing the minimum number of partners to two instead of five, and introducing the one person company.
5. The new Companies Law enhanced the fair treatment for all partners, and promoting the rights of parties involved with the companies, and providing them with the necessary protection through the prohibition of combining the post of chairman of the board and any executive position of the company, and making cumulative voting in the election of the Board of Directors compulsory.
6. The new Companies Law included a number of improvements to minority shareholder protection including: (1) only permitting shareholders to nominate board members in accordance with the shareholder's share percentage; (2) mandating cumulative voting for board appointments; (3) requiring each JSC to have a general assembly-appointed audit committee separate from the JSC's board of directors; and (4) further empowering shareholders to bring actions against the board of directors, including the right of shareholders representing at least 5% of the shareholding in a JSC to require an investigation by a competent authority.
7. Compared to the old Corporate Governance Regulations 2006, the New Corporate Governance Regulations (2017) constitute a paradigmatic shift from a voluntary toward mandatory character of the regulations. Rather than being merely 'guiding principles' Article 2 (b) states that the new Regulations 'are mandatory to companies except the provisions that contain a reference of being guiding'. This also constitutes a shift from 'comply-or-explain' approach adopted in the old Corporate Governance Regulations 2006.
8. The new Companies Law does not, however, change the substance of the situation which prevailed under the old law with regard to the question of a Directors duty of loyalty. While, on the one hand, a general duty of loyalty appears to be founded in the more concrete duties bestowed on directors by the Companies Law such as Articles 71 and 72 of the Companies Law, Article 75 (1), on the other hand provides for the principle regulation on the

powers of directors only to the extent that directors must have the "widest authority" to manage the company and does not limit such powers to the objective of the company. As recommended in Chapter (8), this shortcoming could be rectified through the adoption of a Saudi Code of Sharia Principles of Corporate Governance to complement and reinforce the existing laws and regulations.

9. The new Companies Law enhanced the penalties to improve transparency and disclosure; it has increased penalties for this to 5,000,000 Saudi Riyal, and prison sentences can reach up to five years, whereas penalties used to not exceed 20,000 Saudi Riyal and no more than one year in prison for the 1965 version.

5. Chapter Five: Islamic Principles and Good Corporate Governances

The study of corporate governance within the context of the Saudi legal system raises a number of theoretical and practical challenges. On the one hand, and as already discussed in chapter 1 (section 1.1.2), the foundations of the Saudi legal system are deeply rooted in traditional Islamic Shari'a principles. In turn, Shari'a represents the Muslim religious law with historical foundations dating to the 7th century CE. Comparatively, on the other hand, and as already discussed in chapter 2, corporate governance is a modern phenomenon and a feature of contemporary societies. It has relatively recently gained widespread international attention and acceptance, particularly from the 1960s onwards. Thus, the juxtaposition of these two in the Saudi context raises the following questions: is the legal foundation of Saudi Arabia, i.e. traditional Islamic law, compatible with modern corporate governance? And to what extent are the two compatible? In other words are they reconcilable? Additionally, if Islamic law is theoretically compatible with the tenets of modern corporate governance how can this compatibility be practically implemented in the Saudi legal frameworks of corporate governance?

In response to such questions some authors maintain that there is inevitably a dichotomy between Islamic law and modern principles of corporate governance. This position is based on the view that Islamic law has for centuries been rigidified into of 'fixed corpus of doctrines considered divine and unchangeable'[198] and has thus been progressively overtaken by social and economic developments. Consequently, Islamic law is, for such authors, not merely incompatible with corporate governance but is irreconcilable with the modern way of life more generally.

In contrast, a growing number of both Muslim and non-Muslim scholars increasingly dispute the view that there is an inherent dichotomy between Islamic law and modern corporate governance. These latter authors maintain that, when correctly construed, Islamic law is essentially compatible with modernity including

[198] This critical statement is made by F. Vogel (n 21) xii.

compatibility with good corporate governance.[199] As we shall see from the discussion and analysis in this chapter this approach departs from commonly uninformed readings of Islam and elaborates arguments based on meticulous consideration of the essence of Islamic religious and legal principles.

Hence, this chapter will be particularly dedicated to the analysis of the Islamic theory of corporate governance and its compatibility or otherwise with modern corporate governance. This discussion will be developed gradually. Section 5.1 provides introductory background to the sources of Islamic law and jurisprudence. Section 5.2 analyses the Islamic concept and protection of private ownership rights particularly because their fundamental role in the conceptual edifice of corporate governance.

Section 5.3 provides in-depth analysis of the Islamic theory of corporate governance. It starts in section 5.3.1 with a discussion of the basis of corporate governance in Islam and a discussion of specifically Islamic concepts of *Wakala* (fiduciary), accountability and Trust and *Wakf*, disclosure rules and Gharar or uncertainty in subsections 5.3.2 – 5.3.4

5.1 Islamic Law and Jurisprudence

The Islamic rules and principle pertaining to legal matters are collectively known as *Shari'a* which forms a central part of the Islamic tradition.[200] According to Islamic jurisprudence, Shari'a derives its rules and principles from four sources: The Quran, the Sunnah, Qiyas and Ijma.

The Quran is the holly book of the Muslim religion and the primary source of Shari'a rules and principles. Muslims believe that it contains the actual and final words of God which the prophet Mohammad transmitted to all mankind thus forming the basic and eternal teachings of the Islamic faith. God's words speak in the Quran as follows:

[199] See e.g. Esfandiar Malekian and Abbas Ali Daryaei, 'Islamic values Forward into Better Corporate Governance Systems' (International Conference on Business and Economic Research, Malaysia, November 2010): Zulkifli Hasan, ''Corporate Governance: Western and Islamic Perspectives' (2009) 5 International Review of Business Research Papers Vol.5 No. 1, 277-293, 285.

[200] For a detailed discussion of Islamic law see N. J. Coulson, *A History of Islamic Law* (Edinburgh University Press 1964).

> **“Today I have perfected your religious law (*din*) for you, and have bestowed upon you the full measure of My blessings, and willed that self-surrender (*al-islam*) unto Me shall be your religion (*din*).” [5:3][201]**
>
> **“Unto every [community] of you have We appointed a law [*shari’a*] and a way of life …” [5:48]**
>
> **“But for people (of) certainty, who could be a better law-giver than God (*ahsanu min allahi hukman*)..” [5:50]**

The Quran was revealed verbally and gradually to the Prophet Mohamed in the period between 609 to 632 CE, the year of the Prophet’s death. During his life-time, the Prophet’s companions served as scribes and wrote down the Quranic revelations in Arabic. The Caliph Uthman, the third successor of the Prophet Mohammad, collected the various written parts into the standard version which has since been regarded as the authentic version. The text of the Quran is divided into chapters each of which is known in Arabic as *surah*, and each surah is divided into verses known as *ayah*.

The Quran also commands mankind to obey the prophet Mohammad.

“O you who have attained to faith! Pay heed unto God, and pay heed unto the Apostle and unto those from among you who have been entrusted with authority …”[4.59]

Accordingly, the *Sunnah* (authentic hadith) which is the verbally transmitted record of the teachings, deeds and sayings, silent permissions (or disapprovals) of the prophet Muhammad is regarded by Muslim as the second source of Shari’a. The Sunnah is also defined as "a path, a way, a manner of life"; "all the traditional and practical, of the prophet that "have become models to be followed" by Muslims. The Quran and the Sunnah make up the two primary sources of Islamic theology and law.

[201] Translation of Quaranic verses in this thesis are based on Muhammad Asad’s *The Message Of The Quran*, (Dar Al-Andalus Ltd, 1980). The first of the numbers in the square brackets refers to the number of *surah* and the second number to the right side of the colon refers to the number of the *ayah* in the said *surah*.

While being fundamental and primary sources, the Quran and the Sunnah may not be readily applicable to some novel situations which may arise in practical life. For this reason *qiyas* (analogical reasoning) is introduced to derive religious or legal solution to such novel situations. Accordingly, qiyas is basically a process of deductive analogy in which the teachings of the Sunnah are compared and contrasted with those of the Qur'an, in order to apply a known injunction (*nass*) to a new circumstance and create a new injunction. Here the ruling of the Sunnah and the Qur'an may be used as a means to solve or provide a response to a new problem that may arise. This, however, is only the case providing that the set precedent or paradigm and the new problem that has come about will share operative causes.

The final source of Shari'a rules is ijma (juridical consensus) which refers to the consensus or agreement of the Muslim scholars basically on religious issues. Various schools of thought within Islamic jurisprudence[202] (madhahib) may define this consensus to be that of the first generation of Muslims only; or the consensus of the first three generations of Muslims; or the consensus of the jurists and scholars of the Muslim world, or scholarly consensus; or the consensus of all the Muslim world, both scholars and laymen.

5.2 The Concept and Protection of Private Ownership in Islam

As discussed in chapter (2), the concept of corporate governance emerged and developed within the liberal capitalist economic system. It is interesting to note that it has, nonetheless, attracted attention and application also in socialist or centralized economies as well post-socialist systems.[203] Naturally, however, the application of corporate governance in the capitalist and socialist systems engendered approaches and challenges pertaining to their respective conceptual and structural differences and constraints. Notably, social and political coercion

[202] The madhahib were consolidated in the 9th and 10th centuries as a means of excluding dogmatic theologians, government officials and non-Sunni sects from religious discourse. The Sunni Islam schools include four schools: the Hanafites, Malikites, Shafi'ites and the Hanbalites. For a historical account of the emergence and development of the schools of Islamic Jurisprudence see Chapter 3 in N. J. Coulson, *A History of Islamic Law* (Edinburgh University Press 1964), pp. 36ff.
[203] See e.g. A. Sheifer and R. Vishny, The Politics of Market Socialism, *Journal of Economic Perspectives*, (1994) Volume 8, Number 2, 165-176.

coupled with the concentration of decision-making power and allocation of resources within vigorously selected elite played an important role in impeding the development of corporate governance in socialist systems. But the most important impeding factor has been the lack of transparency within the authority relations in political and managerial levels which allowed ample opportunity for abuse of power at all levels. Consequently, the socialist systems severely lacked the notion of economic rationality which is fundamental to corporate governance; it became an alien concept, or a second rate objective, the first one being political discipline.

As we shall see in the following discussion, the Islamic socio-economic precepts involve both socialist and capitalist doctrines. However, the Islamic concept of ownership and rights can more largely be approximated to a liberal, free market approach.[204] Commercial investment is an economic activity that Islam particularly encourages, and personal ownership is fully protected; therefore, economic freedom in an Islamic society necessitates that the Islamic government adopts policies and passes laws that enable all members of the Islamic society to engage in free economic activities. Consequently, the stringent socialist constraints on private ownership and social coercion are neither prescribed nor practised pursuant to Islam. According to Islamic law everyone is entitled to engage in free economic activities and to work and earn their living as Islam invariably encourages trade and commerce as long as it is conducted within the framework of Islamic law.[205]

5.2.1 Regulation of corporations in Islam

Moreover, Islam has also laid down rules for ownership and designated various rules to govern the relation of individuals when they intend to join efforts and resources together and distribute the resulting profits amongst themselves. In Islam, a company (i.e. *Sharikah*) is essentially regarded as a contract where people come to work together and eventually distribute the resulting profit between

[204] See more on this point Hayatullah Laluddin *et al*., 'Property and Ownership Right from an Islamic Perspective', *Advances in Natural and Applied Sciences*, (2012), 6(7) 1125-1129.
[205] Esfandiar Malekian and Abbas Ali Daryaei, 'Islamic values Forward into Better Corporate Governance Systems' (International Conference on Business and Economic Research, Malaysia, November 2010).

them.[206] Thus, a company is conceived in Islam as a contractual relationship, and Islam has laid out detailed rules for contracts; some notes might be needed to shed light on the law of companies from this prospective of Islamic law.

As conceived Islamic law, a contract is fundamentally the results from the exchange of offer and acceptance between given parties with the view of establishing or transferring a right (e.g. over certain thing in course of trade). Thus, there are two or more parties in the formation of a company (i.e. partners); there is the work which one or more of them assumes, the business of the company, and the profit to be distributed, all forming the subject matter of the contract. Accordingly, a company contract as per Islamic law can be defined as follows: The *Sharika* (Company) is an agreement between two or more people to do some type of work in order to make profit and then to distribute the profit ratio according to what is agreed in the contract.[207]

5.2.2 The protection of private rights in Islam

A corollary to the Islamic recognition of private property is the principle of property rights in Islam which provides a comprehensive framework to identify, recognize, respect and protect the interests and rights of every individual, community, state, and corporation. It is worth noting that ownership rights including acquisition, usage and disposition of the property itself are considered as property (*al-mal*) which is a generic Islamic law term that refers to whatever has beneficial use and value in dealing. In terms of the rights of ownership, Islam declares that Allah is the sole owner of property, and the human being is merely a trustee and custodian in whom it implies the recognition to use and manage the properties in accordance with the Islamic Law rules.[208]

Being the principal source of Islamic law, *Al-Quran* emphasizes the principle of property rights in various verses. For example, *Allah* says:

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[206] In the same meaning; seeEditorial, *Companies in Islamic systems,*<http://www.khilafah.com/index.php/the-khilafah/economy/1029-companies-in-islam>accessed on 20/05/2011

[207] ibid.

[208] Zulkifli Hasan,''Corporate Governance: Western and Islamic Perspectives' (2009) 5 International Review of Business Research Papers Vol.5 No. 1, 277-293, 285.

“BELIEVE in God and His Apostle, and spend on others out of that of which He has made you trustees ….” (57:7).

The implied meaning of this verse lays down the principle of property’s ownership, where mankind is regarded merely as a trustee of God in the things over which he enjoys temporal ownership. Islam recognizes private, society or state ownership.[209] The same concept of ownership also applies to the recognition of individual ownership of shares in corporations. At the same time, Islamic law rules provide intensive guidelines to individuals, corporations and the state on how to deal with the property ownership. Therefore, it can be fairly said that the concept of property rights in Islam is based on these fundamental principles. For instance, rights on property are subject to stipulations laid down by Islamic law; the enjoyment of rights on property is balanced with the rights of society, the state, and individual. The society and the state are stakeholders and the recognition of rights of stakeholders are granted in Islamic law.[210]

Thus, in corporate governance terms, Islam recognizes and legitimizes both shareholder and stakeholder rights. On the one hand, increasing the wealth of shareholders (owners) and their investments value is recognized as a legitimate objective. Investors provide their subscription to the capital of a company for the sake of receiving the eligible dividend, and they expect the stock price to increase. Equally, the rights of stakeholders are recognized and legitimized. Corporate activity is required to take into account other considerations just as good governance should strike the optimal balance between this consideration (shareholder value)[211] and the need to guard the interests of other stakeholders who also have interests in the business of the company (stakeholder value).[212]

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[209] Ibid 286.

[210] Ibid.

[211] Alfred Rappaport, 'Ten Ways to Create Shareholder Value' (2006) Harvard Business Review available at <http://www.spenceryoung.co.za/wp-content/uploads/2015/02/10-ways-to-create-shareholder-value.pdf > accessed 20/03/2014.

[212] Gilberto Zafran, ‘Question of Value: the Reaction Paper‘ (Ateneo Graduate School of Business, MBA-REGIS2012) <http://gilbert.zafran.us/.../REACTION-PAPER-QUESTION-OF-VALUE.docx> accessed 20/03/2014.

5.3 The Islamic Theory of Corporate Governance

As mentioned above, some authors advance the thesis that Islam is inconsistent with modern corporate governance. They suggest the existence of an unbridgeable gap between Islam and modern economic concepts which have been developed in the West. For example, E. Sivan in his book *Radical Islam: Medieval Theology and Modern Politics* asserts that Islamic revival‐while activist and militant‐is thus essentially defensive; a sort of holding operation against modernity" and accordingly concludes that: [W]estern investment means the integration of the Islamic world into the system of the multinationals, which is totally alien to Muslim concepts of interests, insurance, taxation, and so on'.[213]

William M. Watt[214] is another author who argues that the traditional Islamic worldview is incompatible with the conditions and demands of Western modernity. He asserts that the modern Muslim thinking remains determined by the epistemological rules of the early, i.e. pre-modern, phase of Islam which was formed against the background of the Qur'an, hadith and consensus.

Contrarily, Choudhary Slahudin[215] represents authors[216] who advance the thesis that Islam is essentially consistent with modernity. He maintains that "Islam strongly advocates all forms of positive governance." Arguable, this positive governance includes both political and economic governance because the Islamic values expressed in ethical conduct are an integral part of the obligations laid upon the individual and the community.

5.3.1 The basis of good corporate governance in Islam

Concerning the Islamic recognition particularly of good corporate governance, it can be said that "[W]hile there may not be an Islamic official juristic recognition of the concept of corporate governance as such, an examination of the principal legal sources of the *Qur'an* and *Sunna* reveals clear guidelines about decision-making

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213 E. Sivan, *Radical Islam: Medieval Theology and Modern Politics* (Yale University Press, 1990),10.
214 William Montgomery Watt, *Islamic Fundamentalism and Modernity* (Routledge1988).
215 Choudhary Slahudin , 'OECD Principles and the Islamic Perspective on Corporate Governance', *Review of Islamic Economics* (2008) Vol. 12, No. 1, 29–39.
216 See e.g. Abdussalam Mahmoud Abu-Tapanjeh, 'Corporate Governance from the Islamic Perspective: A Comparative Analysis with OECD Principles, (2009) *Critical Perspectives on Accounting* 20, 556–567.

processes in an Islamic context."[217] Thus, the absence of an appellation does not necessarily imply the absence of Islamic values and principles corresponding in essence to those underlying the modern concept of corporate governance. As the discussion in subsequent sections will show, the Islamic values and principles, when taken with certain values of ethical conduct, are largely comprehensive, extensive, and flexible so as to lay down the basis of what can be considered a distinctive theory for corporate governance in Islam. In particular, two dominant factors shape the nature of Islamic corporate governance. The first is that Islamic Law claims sovereignty over all aspects of conduct, individual and collective, and it encompasses civil as well as criminal jurisdiction. In addition to what is true, fair and just, its rulings define the nature of corporate responsibilities, the priorities for society and some specific governance standards. The second factor provides a set of business ethics; the law includes certain economic and financial principles (*zakat*, prohibition of *riba* and of speculation etc.) that have a direct bearing on corporate practices and policies.[218]

Islamic values expressed in ethical conduct are an integral part of the obligations laid upon the individual and the community. Rules of corporate governance are derived from the underlying principle of assuring the economic well-being of the whole community on the basis of universal brotherhood, justice, mutual accountability, truthfulness and transparency, protection of minorities, adequate disclosure and equitable distribution of wealth.[219] Islamic corporate governance includes obligations extending beyond shareholders, financiers and management to suppliers, customers, competitors and employees, embracing the spiritual as well as the temporal needs of the Islamic community. Specifically, the concepts of *shura*, *hisba* and the *shari'a* supervisory process and religious audit establish the basic building blocks of a system of Islamic corporate governance and business organization.[220]

This should not mean that the matter is entirely left for the willingness or the conscience of the parties of the transaction in question. Islam also lays down a

[217] Malekian and Daryaei (n 205) 7.
[218] See (n 215) 34.
[219] Malekian and Daryaei (n 205) 11.
[220] Ibid 7.

system for certain institutions in support of insuring the application of such principles. In Islam, the authority must ensure the fulfilment of contracts and respect of property rights, and instil in the people qualities that are necessary for social harmony and development with justice.[221]

Rooting this to the Quran, the following two verses are relevant:

“And consult them on affairs, then, when you have taken a decision, put your trust in Allah.”(3:159).

“Those who respond to their Lord, and establish regular prayers; who their affairs by mutual consultation; who spend out of what we bestow on them for sustenance.” (42:38)

The above verses, which form the source of corporate governance in Islam, emphasize the necessity of consultation with stakeholders at the time of decision-making and giving equal importance to all stakeholders, including minority shareholders.

Protection of shareholders rights is surely a major objective for corporate governance; sufficiently emphasized by the OECD principles that states: “The corporate governance framework should protect and facilitate the exercise of shareholders' rights”. According to Islamic corporate governance model, all rights of stakeholders (including shareholders) should be protected and guaranteed, and this stems from the Islamic emphasis on property rights. It is important to mention that the difference between the Islamic corporate governance model and modern relevant principles is that accountability should be to God, not only to the shareholders.[222] Participating in the stakeholder welfare, according to the Islamic concepts of *zakat* (special alms levy), the *Shari'a* board is expected to oversee the collection of *zakat* and its distribution to the relevant parties. This ensures the

[221] Slahudi (n 215) 34.
[222] Maria Bhatti and Ishaq Bhatti, ‘Toward Understanding Islamic Corporate Governance Issues in Islamic Finance’ (2010) *Asian Politics and Policy* Vol 2, Issue 1,25-38, 25.

equitable distribution of wealth to all stakeholders and disadvantaged members in the Muslim society.[223]

As is cleared above, Islam perceives company as a contractual relationship, which adds too much to the enforceability of the corporate governance theory in Islam. Contractual framework is also very unique in Islam. In the Holy Quran, Allah clearly reminds Muslims of the principle of fulfilling each of their contractual obligations where He says:

"O YOU who have attained to faith! Be true to your covenants!" (5:1).

This verse sets a basic foundation for the notion of contract. Every individual, society, corporation or state is all bound by their contracts, which define the rights and obligations of the parties.

Projecting this into the Islamic theory of corporate governance, each stakeholder has a duty to perform his/her contractual obligations in accordance with the terms stipulated in the contract whether directly or indirectly. For example, shareholders have the duty to provide business capital, the management to manage and run the business, the employees to perform their respective duties and the state to ensure enforceability of the contracts in case of violation by any party.[224]All of these duties arise through contractual framework, and they are subject to the rules of Islamic law. In short, the principle of contract in Islam establishes guidelines to identify and qualify who is the rightful stakeholder.[225] Further, the board of directors, acting on behalf of the shareholders, has a duty to monitor and oversee overall business activities, and the managers have fiduciary duty to manage the firm as a trust for all the stakeholders, not for the shareholders alone. The other stakeholders such as employees, depositors, and customers have the duty to perform all of their contractual obligations. In addition, the state as a stakeholder will be the external institution to provide regulatory framework and its enforcement.[226]

Therefore, it can be fairly said that, as regard ensuring the rights of stakeholder, Islamic corporate governance model ensures all related stakeholders who are participating in corporate governance with full rights and responsibilities. The

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[223] Ibid.

[224] Hasan (n 208) 286.

[225] Ibid.

[226] Ibid.

Islamic corporate governance model adds more value to the concept of corporate governance by including the aspect of reward and punishment by God.[227]

5.3.2 The Islamic Concept of Fiduciary (*Wakalah*) and Agency Theory

The separation of shareholder and management of corporation entails that these roles are assumed by different persons. In shareholding companies, the members of the board of directors are appointed or elected by the shareholders. The board has a legal obligation to ensure that the company is operated in a proper, legal and good-corporate style.[228] A member of the board of directors must meet certain qualifications before he/she can act as such. For example, persons who are undercharged bankrupts or who have been convicted of a criminal act or a security violation may not be allowed to serve as members of the board of directors. Particularly important for the context of this thesis, members owe a fiduciary duty to both the company and all shareholders and as such must act in the interests of all shareholders. They must act in accordance with any applicable legislation.

Being appointed by the shareholders' assembly, it is logical that such board of directors answers, reports, and is questionable towards the shareholders. Although this matter was tackled in detail in the first chapter of this research, there should be some reiteration as to the nature of the relationship between the board of directors and the shareholders.

The fiduciary duty of board members reflects mainly two duties: the duty of care and the duty of loyalty. The duty of care requires board members to act on a fully informed basis, in good faith, with due diligence and care.[229] The duty of loyalty underpins effective implementation of corporate governance principles. For example, it includes the equitable treatment of shareholders, monitoring of related party transactions and the establishment of remuneration policy for key executives and board members.[230]

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227 Bhatti and Bhatti (n 222).
228 Mike Volker, 'The Board of Directors' (Business Basics for Engineers, 2008) <http://www.sfu.ca/~mvolker/biz/bod.htm> accessed on 01/01/2015.

229 OECD, *Principles of Corporate Governance in Slovenia* (OECD Publishing 2011)), 59: Fawzi Mohammad Sami, *Commercial Companies* (Dar Al Thakafa, Amman 2005).
230 OECD 1999.

5.3.2.1 Agency Theory

As discussed earlier in this thesis (see section), the agency theory is one of the theories that aimed at defining the relation between the shareholders and the board of directors. In this context, an agency is defined as: "A relationship between the principals, such as shareholders and agents-such as the company executives and managers." Thus, it perceives owners as principals and managers as agents and consequently offers a legal basis of the relationship between the ownership (shareholders) who hires the gents to perform work (the management).[231]

According to the agency theory, the board of directors provides a monitoring of managerial actions on behalf of shareholders, and this will be the major structural mechanism to curtail managerial opportunism.[232] The model is predicated upon the notion of an in-built conflict of interests between the owner and manager following the separation of ownership and control, and this is how the principal can ensure that his agents serve shareholders' interests, rather than their own.

As a risk vested in any other principle-agent relationship, the agent may be succumbed to self-interest, opportunistic behaviour and falling short of congruence between the aspirations of the principal and agent.[233] Lack of attention to maximizing shareholder returns, or in terms of 'self-interested opportunism' (accruing wealth to themselves rather than shareholders) could be an example of self-interest, opportunistic behaviour.[234]

The remedies to this conception of the agency problems within corporate governance involve the acceptance of certain 'agency costs' involved either in creating incentives/sanctions, which will align executive self-interest with the

[231] Haslinda Abdullah and Benedict Valentine 'Fundamental and Ethics Theories of Corporate Governance' (2009) *Middle Eastern Finance and Economics*, 89: John Roberts, 'Agency Theory, Ethics and Corporate Governance' (Corporate Governance and Ethics Conference, Sydney, 2004).

[232] Eisenhardt (n 46); John Roberts, 'Agency Theory, Ethics and Corporate Governance' in Cheryl R. Lehman, Tony Tinker, Barbara Merino and Marilyn Neimark (eds), Corporate Governance: Does Any Size Fit? (Advances in Public Interest Accounting, Volume 11, Emerald Group Publishing Limited 2005); Abdullah and Valentine (n 231); Adnan Bin Haider Darwish 'Corporate Governance and the Role of the Board of Directors (2007) <http://www.diconline.org/Temp/Documents_Files/82178511-b5e6-4634-8982-5353efcfbea1.pdf> accessed on 20/01/2014.

[233] Abdullah and Valentine (n 231); Eisenhardt (n 46)

[234] Roberts (n 231) 3

interests of shareholders, or monitoring executive conduct in order to constrain their opportunism.[235] It is noted that the board is to perform a monitoring role against the company's management as well as a role of setting the company's strategy,[236] so it is in situation that can be abused; therefore, there are three main techniques that are usually adopted in order to ensure that the board of directors will serve the shareholders' interests. These techniques are [237] :

1- Giving shareholders appointment and/or dismissal rights in respect of the directors, being the most obvious way to make the board accountable to the shareholders forming the general assembly of the company; this could be achieved by making it easy for the shareholders to dismiss all or any of the board members if they did not find the member serves their interests.[238]
2- Subjecting directors to legal duties, which require them to exercise their discretion in the interests of the shareholders as a class. Imposing liability upon directors who act incompetently or disloyally would seem to be an obvious legal strategy to deal with the principal/agent problem between management and shareholders as a class. All systems in principle have provisions, which could be invoked to impose liability on directors who act incompetently.[239]
3- Structuring the incentives of the members of the board so as to induce them to promote the interests of the shareholders as a class.[240]

Beside the above mechanisms and stemming from the general fiduciary duty that board members will voluntarily be observing good governance, board members should be able to commit themselves effectively to their responsibilities. It is very important to improve board practices and the performance of its members. This could be achieved by engaging in board training and voluntary self-evaluation that

[235] Paul L Davies, 'The Board of Directors: Composition, Structure, Duties' (Conference on Company Law Reform in OECD Countries: A Comparative Outlook of Current Trends, Stockholm, December 2000); Roberts (n 231).
[236] Davies (n 235) 8.
[237] This matter will also be handled in the Chapter (**Error! Reference source not found.**) of this research from the prospective of the corporate law reform effort needed to minimise agency problems.
[238] Davies (n 235) 6.
[239] ibid 7; Aziz Al Ukeli, *Commercial law* (Part IV, Dar Al Thakafa 2002); Davies (n 235)10.
[240]Davies (n 235) 8.

meet the needs of the individual company. This might include that board members acquire appropriate skills upon appointment and thereafter remain abreast of relevant new laws, regulations, and changing commercial risks through in-house training and external courses.[241]

Members of the board should enjoy legitimacy and confidence in the eyes of shareholders. Achieving legitimacy would also be facilitated by the publication of attendance records for individual board members (e.g. whether they have missed a significant number of meetings) and any other work undertaken on behalf of the board and the associated remuneration.[242]

5.3.2.2 The Fiduciary (Wakalah)

Wakalah in Islamic law can be identified as an authorization from one person to another to do on behalf thereof a specified permissible action.[243] In the holy *Quran*, it is mentioned that:

"Let, then, one of you go with these silver coins to the town, and let him find out what food is purest there, and bring you thereof [some] provisions." (18:18).

According to the above verse, the people in the story delegated one of them to buy the food they needed. Islamic scholars concluded from the above text that the *Wakalah* is permissible[244] and have accordingly identified four components for fiduciary or *Wakalah* in Islamic law. These are:[245]

1. Principal: the person who gives the authorization.
2. The agent: the one who acts on behalf of the principal.

[241] Darwish (n 232) 66.
[242] Some countries have limited the number of board positions that can be held because Service on too many boards can interfere with the performance of board members. For more information, please see *OECD Principles of Corporate Governance* (n 336).
[243] Hamad bin Abdullah Al-Hammad, 'The agency contract in Islamic jurisprudence and its applications in the Notary dealers across the Saudi Arabia' (2004) Issue 3 Al Adel Journal <http://212.70.50.62/Adl/attach/375.pdf>accessed on 23/1/2011; Mohammed bin Ali Subaihin, '*Agency in Islamic Jurisprudence'* (MA thesis, the Higher Judicial Institute 1992) 5-6;Adnan Sarhan, *Explanation of the Civil Law* (Dar Al thakafa 1996) 103, 105.
[244] Subaihin (n 243) 8; Al-Hammad (n 243) 136
[245] Al-Hammad (n 243) 137.

3. The consent forming the contract: This is expressed by the exchange of offer and acceptance between the parties.
4. The contract's subject matter: the action to be taken by the agent for which the same is authorised by the principle.

The Islamic law laid down certain conditions that need to be available as regard to the principal, the agent and the subject matter of the *Wakalah* contract which are further illustrated below:[246]

i. Conditions pertaining to the principal:[247]

1. The principal should have the legal capacity and standing to act; i.e., to the action which is being delegated to the agent according to Islamic law. This condition refers, in particular, to the requirements of being an adult as well as of being in a healthy mental status without having any issues could prevent this ability.
2. The principal himself should be allowed to do the action of fiduciary, i.e., which is the subject matter of the *Wakalah* contract**.**

ii. Conditions pertaining to the agent:[248]

1. The identity of the agent should be identified in course of formatting the contract sufficiently clear.
2. The agent needs to be able to act according to Islamic law.
3. The agent should be allowed to do the act that is the subject matter of the contract.
4. The agent needs to approve the act that is the subject matter of the contract.

iii. Conditions pertaining to the subject matter:[249]

1. The subject matter, i.e. the act for the doing of which the agent is delegated should be identified in sufficient clarity for all the parties of the contract.
2. Such act should be possible to be done by the agent on behalf of the principal.

[246] Ibid138
[247] Ibid 138
[248] Ibid 140; Subaihin (n 243) 34.
[249] Al-Hammad (n 243) 142; Subaihin (n 243) 47.

Though the above illustration is a conventional analysis to the agent- principal relationship, as tackled by the Islamic law in the regulation of *Wakalah* contract, the same can fairly be projected to qualify as an equivalent to the agency theory in course of establishing an Islamic law theory for corporate governance. The above conditions can be applied on the relationship between the shareholders and the members of the board of directors. According to this, such *Wakalah* given by the shareholders to the board members can be seen as follows:

1- Shareholders are the owners of the company. For various considerations such as the lack of time or the experience needed to manage the company, they approach a number of persons to assume such responsibility; with the stipulation that the members of the board of directors act on the interest of the company, in accordance with the law and good practices, in order to raise the profit thereof.
2- The members of the board of directors offer to assume such responsibility in return of the incentives and remunerations set in the company's bylaw or other equivalent documents; and the members of the board of directors so accept.
3- The shareholders give their authorization to the board of members to manage the company on behalf of them.

Therefore, it can be fairly said that all of the conditions of the fiduciary in Islamic law are found in the scenario above, and as follows:

- Shareholders are the principals: they have the ability to act according to Islamic law and they own the company; therefore, they are allowed to manage it.[250]
- Members of the board are elected by the shareholders, and they have the ability to act according to Islamic law. They are identified in a clear way. Moreover, they are usually amongst the owners, therefore they are allowed to manage the company by themselves. The nomination and election process can be truly seen as the contract formation, i.e. the exchange of offer and acceptance, Nomination is an offer and election is acceptance. The board of

[250] Edward Eid, *Commercial Companies* (Alnjwa Press 1970) 568; Mustafa Kamal Taha, *Commercial Law* (Al Darr Al Jameeah 1986), 460; Al Ukeli (n 239) 305.

directors can be considered as the agents, the shareholders as the principals, and the management of the company as the subject matter of the fiduciary contract. Therefore, it can be truly concluded that the Islamic law sets the same principles of the agency theory in the application of fiduciary *(Wakalah),* as the same is regulated in Islamic Jurisprudence. However, it is noteworthy to say that this prospective of agency theory according to Islamic law is supplemented with accountability values being an alternate for the agency theory methods relevant to the agency theory.

5.3.2.3 Agency Theory and the Islamic conception of Accountability

As indicated above, according to Islamic law, all resources are given by Allah, and only Allah is the owner of all the wealth. Individuals are only trustees and that accountability is ultimately due to Allah.[251] Therefore, Islam regulates and influences all spheres of life, including governing the conduct of business and commerce. Muslims ought to conduct their business activities in accordance with the requirement of their religion to be fair, honest and just toward others. Business activity, in consequence, must be broadly inspired and guided by the concepts of Islamic law. The Islamic legal framework is committed to values such as justice and the ban of malpractices. Many verses in the Holy Qur'an encourage trade and commerce, and the attitude of Islam is that there should be no impediment to honest and legitimate trade and business, so that people earn a living, support their families and give charity to those less fortunate.[252]

Furthermore, the accountability in roles and responsibilities is not limited to business people only, but it applies to the whole of life.[253] Islamic law requires the honest fulfilment of all contracts and from all persons, and it prohibits the betrayal of trusts. The Qur’anic verses and Prophetic *Ahadith* are clear principles

[251] Rashid Mateen Khan, ‘Applications of Accountability in Islam’ (November 2014) <http://www.scribd.com/doc/22569618/Self-Accountability-in-Islam.> accessed on 02/02/2015.

[252] Mervyn K Lewis, ‘Accountability and Islam’ (Fourth International Conference on Accounting and Finance in Transition, Adelaide, 2006) <http://search.ror.unisa.edu.au/media/researcharchive/open/9915911835001831/53109298110001831> accessed 02/02/2015

[253] Slahudin(n 243) 36.

commanding accountability in roles and responsibilities. The moral values needed are clearly set out in the *Qur'an* and the *Sunnah*.[254]

"*O YOU who have attained to faith! Be ever steadfast in upholding equity, bearing witness to the truth for the sake of God, even though it be against your own selves or your parents and kinsfolk. Whether the person concerned be rich or poor, God's claim takes precedence over [the claims of] either of them. Do not, then, follow your own desires, lest you swerve from justice: for if you distort [the truth], behold, God is indeed aware of all that you do!*" (4:135).

"*O YOU who have attained to faith! Do not devour one another's possessions wrongfully – not even by way of trade based on mutual agreement - and do not destroy one another: for, behold, God is indeed a dispenser of grace unto you!*" (4:29).

***"AND DEVOUR NOT one another's possessions wrongfully, and neither employ legal artifices with a view to devouring sinfully, and knowingly, anything that by right belongs to others"*.(2:188)**

***"O you who have attained to faith! Pay heed unto God, and pay heed unto the Apostle and unto those from among you76 who have been entrusted with authority; and if you are at variance over any matter, refer it unto God and the Apostle, if you [truly] believe in God and the Last Day. This is the best [for you], and best in the end".* (4:59)**

The Prophet Mohammad made it abundantly clear in the Sunna that **"*whoever cheats is 'not one of us*'** (i.e. not a Muslim). He also said:
"*The hypocrite has three signs: when he speaks he tells lies, when he makes a promise he does not fulfil it, and when he is entrusted with something he commits a breach of trust*". And he said: "*honest and trustworthy*

[254] Ibid 37.

businessmen will be with the Prophets, the truthful ones and the martyrs on the Day of Judgment".[255]

As mentioned above, and as can be seen in any relation of agency, the agent may be succumbed to self-interest, opportunistic behaviour and falling short of congruence between the aspirations of the principal and agent.[256] Therefore, in order to prevent or eliminate that kind of action, agency theory sets the remedies illustrated above to prevent that behaviour.[257] *Wakalah* contract in Islamic law gives the principal the ability to dismiss the agent when misbehaving.[258] The issue of subjecting directors to legal duties and structuring the incentives of the members of the board of directors is harmonious with the reward and Islamic punishment theory[259] which is well rooted in various verses of the holy Quran, such as the following:

"But [remember that an attempt at] requiting evil may, too, become an evil:" (42:40)

"On that Day will all men come forward, cut off from one another, to be shown their [past] deeds. And so, he who shall have done an atom's weight of good, shall behold it; and he who shall have done an atom's weight of evil, shall behold it.." (99:7-8)

"[But,] behold, as for those who attain to faith and do righteous deeds - verily, We do not fail to requite any who persevere in doing good:" (18:30).

"But [since] good and evil cannot be equal, repel thou [evil) with something that is better - and lo! he between whom and thyself was enmity [may then become] as though he had [always] been close [unto thee], a true friend!" (41:34).

[255] Ibid.
[256] Roberts (n 231) 3.
[257] Davies (n 235) 4-8
[258] Al-Hammad (n 243) 158
[259] Mohamed Fathi Al Seed Kasem, 'Theories of motivation among management thought and Islamic thought' (Islamic Research and Training Institute Symposium, Jeddah)<http://www.kantakji.com/fiqh/Files/Manage/F232.pdf> accessed on 20/01/2014.

“Whoever does what is just and right, does so for his own good; and whoever does evil, does so to his own hurt; and in the end unto your Sustainer you all will be brought back.” (45:15).

“[but] every human being will be held in pledge for whatever he has earned.” (52:21).

The corporate governance system in Islam entails implementation of a rule-based incentive system. Compliance with the rules ensures an efficient governance system to preserve social justice and order among all members of society.[260]

The concept of accountability is consistent with the remedies and methods of the agency theory, and the Islamic law adds an important value to these methods by making responsible people accountable not only to stakeholders, but also to God – the Ultimate Authority.[261]

5.3.3 Trust in Western Jurisdictions and Islamic Law

Trust system provides a good example for fiduciary applications. This could obviously be noticed in the relation between the settlor and trustee, on the one hand, and between the settlor and beneficiary and the duties and responsibilities of the trustee, on the other hand. In this context of exploring the Islamic root of corporate governance, it would be useful to examine the fiduciary applications in trust system and tackle trust origins in Islamic law.

Trust is a legal system concerning property, assets and realty in countries utilizing English common law, which basically depends on the trusting one (The trustee) in the control and management of a certain property in favor of a second party (The beneficiary).

[260] Slahudin (n 243) 36.
[261] Ibid 37.

The geneses of such system date back to the Middle Ages that witnessed the struggle against feudalism, and the contraction of feudalists' possessions and proprietary in Britain. Feudalists transferred some of their properties to other owners against pledge of those new owners to reserve and manage such monies for the interest of the feudalists' owners.

Countering such a trend, the English courts of law have negated to enforce such contractual pledges on the back of the argument that sham property is unrecognized under a law which seeks to annihilate feudalism. Courts, which derives its legislation directly from religion (Courts of Equity or Chancellor Courts), have ratified that a contract concluded in such a way may be contrary to the (temporal) legal rules. Justice as an abstract religious concept grants the conceding owners equitable right manifesting in allocating all returns and interests of the monies to them or to the segments determined thereby, thus giving the new owners limited rights only in terms of the function.[262]

In this context, and in light of the rules of equity (a system paralleled to the ancient ages law in England), a property law of special type has emerged based on two essential issues. The first is the validity of the effectiveness of property transfer contracts in terms of such money discharge from the assignor's covenant and transfer to the assignee (which is nothing but a direct application of the non-provision of a valid "cause" in contracts). The second manifests in commissioning the new owner (assignee) with managing and reserving such monies and optimizing the same in favour of the segments determined by the assignor owner.[263]

5.3.3.1 Definition of Trust

Trust is a legal relationship in which one party holds property for the benefit of another. There are three participants in every trust relationship: a “settlor” or “trustor” who establishes the trust and provides the property to be held in trust; a

262 For more information regarding this topic, please see: Sir Frederick Pollok and Frederic William Maitland, *The History of English Law Before the Time of Edward I* (Second Edition, Volume I, Cambridge University Press 1898); Theodore F. T. Plucknett, *A Concise History of the Common Law* (Little Brown 1948); Edward Jenks, *A Short History of English Law* (Little Brown 1949).

263 Ibid.

"trustee" who is charged by the settlor with the responsibility of managing the trust in keeping with the settlor's instructions; and a "beneficiary" who receives the benefits from the property held in trust.[264]

The essence of a trust is the imposition of an equitable obligation on a person who is the legal owner of property (settlor), which requires that person to act in good conscience when dealing with that property in favour of any person (the beneficiary) who has a beneficial interest recognized by equity in the property.

In order to establish a trust, three elements are necessary: first, there must be a manifestation of intent to create a trust by the settlor. Second, there must be property that is held by the trustee (the trust "corpus" or trust "res"). Third, there must be an identified beneficiary or charitable public purpose for which the property is held in trust. Perhaps the most critical of these requirements is the manifestation of intent to create a trust or, stated differently, the intent to create a relationship that encompasses the essential elements of a trust.

In this regard, the settlor's intent to create a trust must be "clear and unequivocal" or "definite and particular." In other words, the language used in the documents or conveyance creating the trust (known as the trust instrument) must indicate the settlor's intent to create the relationship to some reasonable level of certainty.[265]

Some of the significant features of the trust are:[266]

- Once a trust is created, the settlor ceases to have any property rights in the trust or any control over the trust in his/her capacity as settlor.
- The instant that the trust is declared (or deemed to have been created in the case of a constructive or resulting trust) the legal title in the trust property is owned by the trustee(s) and the equitable interest is owned by the beneficiary.

[264] Peter Culp,Andy Laurenzi andCynthia C. Tuell 'Trust Lands in the West' (Lincoln Institute of Land Policy (2006), 19 <https://www.lincolninst.edu/pubs/dl/1151_State%20Trust%20Lands%20PF014.pdf> accessed on 02/02/2015.
[265] Ibid 20.
266 Alastair Hudson, *Equity and Trusts* (5th edition, Routledge-Cavendish 2007) 7.

- The trustee(s) hold the legal title in the trust property.
- The trustee(s) owe equitable obligations to the beneficiaries to obey the terms of the trust. The trustee(s) obligations are fiduciary in nature.
- The beneficiaries own equitable proprietary rights in the trust fund.

There can be an infinite number of beneficiaries in theory, or there may be only one beneficiary.

5.3.3.2 The Legal Nature of the Trust System

The trust system in general law countries is contractual-originated corporeal-effective system. Establishing a trust relationship in favour of the beneficiaries that does not incorporate independent legal entity.

The trust property emerges in a contractual form between the trust creator or settlor, and the trustee, under which transferring a certain property from the assignor to the trustee against the trustee's pledge to reserve, manage, and have dispose of such property or monies benefiting a certain entity is determined under the contract. Such a contract may be explicit or implicit, through which the court transpires the tendency of each party's intent for contracting based on trust (as in the case of transferring the property against a small monetary recompense or without).

Such a contract requires no writing (except for cases of property transfer where the law requires constituting a certain modality for conclusion thereof as in the case of transferring realties or companies' deed instruments).[267]

The law postulates no immediate conclusion of the contract in one session, where the assignee may express his desire to create such trust system at his sole discretion (through declaration) or in a will, while slacking with the approval as long as such offer is not withdrawn or the will being nullified before death. Furthermore, such a system may originate under judicial ruling; as such case is more often where agreements on the trust are ambiguous or implicit (unwritten).

[267] For example, Acquisition of Land United Kingdom Trustee Act 2000, Part III, Article (38) states that 'At present, although trustees of land and Settled Land Act trustees have power to buy land (with or without the aid of a mortgage in the case of trustees of land) in England and Wales for any reason (not just for investment), trustees of personal property only have power to acquire land if expressly authorized to do so in the trust instrument'.

For the arising agreement to fall under the trust system, it must contain, in addition to the preceding contract provisions, a defined and legitimate "subject matter" and an "objective" just like any other legal contract.

The subject matter of the contract is the property assigned to the trustee, which could be a real estate or an amount of money or other unsubstantial right (intellectual property right or good will), company deed instruments or a leverage voucher of government land or any other properties that may be leveraged of a substantial traded value.[268]

The agreement of property transfer does not constitute trust as mentioned without defining the beneficiaries thereof precisely, which is known as the "objective" requirement, where the contract must clearly and precisely define beneficiaries of the emerging trust. Further, the trustee himself may be assigned as the beneficiary of the assignor's property, while a beneficiary may be one or more of the third parties determined under the contract.[269]

It is left for the contracting parties to determine the other contract terms as desired, while trust contract usually includes stipulations addressing the following matters and issues:

- Determine the pecuniary recompense payable to the beneficiary against management and control of the property;[270] and
- Define the frameworks and public policies under which the property is invested and operated;[271]
- Indicate whether the contract is revocable or perpetual in terms of period;
- Indicate the modality of disposal of the property subject of the trust upon the expiration of the trust (in the case of revocable contracts);
- Define the policies governing issues of maintaining the property and insurance against loss;[272]

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[268] United Kingdom Trustee Act 2000, Part I: Articles (3-6) states that ‘General power of investment (1) Subject to the provisions of this Part, a trustee may make any kind of investment that he could make if he were absolutely entitled to the assets of the trust. (2) In this Act the power under subsection (1) is called “the general power of investment”. (3) The general power of investment does not permit a trustee to make investments in land other than in loans secured on land (but see also section 8). (4) A person invests in a loan secured on land if he has rights under any contract under which, (a) one person provides another with credit, and (b) the obligation of the borrower to repay is secured on land. (5) “Credit” includes any cash loan or other financial accommodation. (6) “Cash” includes money in any form’.

[269] In this regard, please see Article (8) United Kingdom Trustee Act 2000.

[270] Article (28) United Kingdom Trustee Act 2000.

[271] Article (4) United Kingdom Trustee Act 2000.

- Define the fate and the modality of disposal with yields and returns of the property;[273]
- Illustrate the rules of book keeping and submitting statements to the beneficiaries;
- Submitting the necessary disclosures by the trustee to the beneficiary (Governance rules) as well as beneficiaries and assignor rights in commissioning audit bodies (Auditors and such) in order to review the vouchers and accounts of the trustee;
- Define the grounds of de-positioning the trustee and reassign the contract to other trustees;
- Define litigation proceedings related to the property subject of the contract;
- Indicate the beneficiaries accruals and its maturity dates (in the case of regular pays);
- Define the consultant bodies the trustee is ought to transact with while managing and utilizing the property subject of the trust (especially when such property takes the form of commercial venture);
- Clarify the decision-making mechanism and the majority needed for the management works and actions (in case of multiple trustees); and etc….

5.3.3.3 The Rights of Beneficiaries

The law commonly grants the beneficiaries the right to claim their substantial and pecuniary accruals arising out of the trust, not in the capacity of personal beneficiaries (indebtedness) or a provision of their interest in establishing the trust contract, but as owners of the property subject of the trust as equitable ownership.[274]

Beneficiaries under such capacity may litigate the trustee in order to collect their rights granted under the instrument constituting the trust directly. Moreover, the beneficiaries' right to waive their accruals granted under the contract constituting

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[272] Article (34) United Kingdom Trustee Act 2000.
[273] Article (15) United Kingdom Trustee Act 2000.

[274] James Penner and William Swadling, 'Law of trusts' (University of London, External Programme, 2007), 58 <https://www.scribd.com/doc/229867875/Trust-Law-in-UK-Subject-Guide> accessed 02/02/2015

the trust to third parties is dubious unless such is provided for under the trust contract initially.[275]

5.3.3.4 Nature of Trust

The trust system is a hybrid system of personal and substantial rights, which has long been perceived as an independent law as "trust law" establishing a legal institution (legal position) between the concerned parties.

Such a legal position does not mean that the institution is an independent legal entity, but, on the contrary, it is a legal position that is not manifested in a company or a legal entity (unincorporated entity). Therefore, the trustee personally owns the trusted property, with the right to conduct all respective actions under his own name, including cases of litigation with third parties.

However, there are no impediments to establishing a non-profit institution (such as limited companies by guarantee under the English public law) or a non-commercial association (charitable) to take on ownership and management of the property subject of the trust, and to have disposal of yields and returns thereof for beneficiaries. In such a case, the transfer of the property subject of the trust takes one of the following forms:[276]

- Subscription in the quota constituting the company or the association, thus making such a property into an operative capital of the company/association (to the extent admissible under the law); and
- Transfer the property immediately to the company/association upon establishment, thus transferring such property into assets (whether cash or fixed as per the situation) for the company/association.
- The modality of employing and managing the trusted property or any yields thereof may also be stipulated under the memorandum of association of such company/association, as well as providing for establishing a management, investment, or trustees commission for the managing and disposing of the property and any yields thereof in realization of the initial purpose of such trust.

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[275] Ibid.

[276] In this regard, please see Article (38) United Kingdom Trustee Act 2000.

In this context, it is essential to distinguish between the company/association as an independent legal entity and the company/association in its capacity as the legal owner (trustee) of the assigned or subscribed monies. This is important to maintain trust ownership constantly contractual without creating an independent legal person of the owner company/association.

5.3.3.5 The Trustees

The trustee owner can be defined as the (legal or actual) person or group of individuals to whom the ownership of the property is transferred, for the purpose of bare ownership, reservation, management, and development thereof in realization of the interests defined under the trust deed. The owner trustee in such capacity is an owner from a legal aspect. However such ownership is limited to compliance with obligations assigned to the trustee and achieving interests of beneficiaries.[277]

The owner trustee may be an actual person or a specialized investment body. Also, owner trustees may be form a general management commission (commissioners' council or consultants), which may employ and invest the owned monies according to clearly defined fiscal rules with explicit purposes. Such a situation is often where the owned property is great in value or operatively complex such as commercial ventures.

The owner trustee may also be trusted to multiple properties, where each property is allocated for the interest of a certain group of beneficiaries, and he/she could also be assigned exclusively to specialize in one property (or a collection of properties) attributed to one group of beneficiaries.

5.3.3.5.1 Legal Obligations

The owner trustee's obligations are basically derived from the contract establishing the "trust ownership" as well as from the law governing such a type of ownership (Trust Law). Such ownership imposes duty of care on the part of the owner trustee in reservation and employment of the owned monies, as well as fiduciary duty, manifesting in taking care of the beneficiaries interests.

[277] *Review of Trust Law in New Zealand* (Law Commission issues paper 19, November 2010) 27<http://www.lawcom.govt.nz/sites/default/files/projectAvailableFormats/NZLC%20IP19.pdf> accessed 02/02/2015.

Therefore, the law binds the owner trustees to optimize their efforts towards achieving the purpose for which the trust ownership was established. That is why owner trustees are allowed to take any action they may deem necessary for achieving the same to the extent admissible by law, subject to legal accountability and indemnity in case a failure on the part of any owner trustee in performing duties was proven.

5.3.3.5.2 Powers and Duties of Trustees and Others

Trustees' duties and powers are the paradigm of fiduciary duties and powers. 'Fiduciary' refers to those duties and powers which a person must exercise in the best interest of another, not himself.[278]

Thus, the trustees' duties must be discharged and their powers exercised only with the interests of the beneficiaries in mind, and in particular, not to serve their own interests or the interests of non-beneficiaries such as their own friends and relatives whom they might otherwise be prone to favour.[279]

5.3.3.5.3 Fiduciary Duties of the Trustee

Trustees are charged with a series of fiduciary duties, which can be either express or implied, to the beneficiary of the trust. The most important of these are:

- To manage the trust in accordance with the instructions of the settlor.
- A duty of good faith, which requires the trustee to put the best interests of the trust ahead of his own.
- A duty of prudence, which requires the trustee to manage the trust property with the same degree of skill that a prudent person would exercise in his or her own affairs; and
- A duty to preserve and protect the trust assets, or trust corpus, to satisfy both present and future claims against the trust.[280]

Manage the Trust in Accordance with the Instructions of the Settlor

The trustee is normally required to follow the instructions of the settlor in administering the assets of a trust. As a general matter, no trust can exist where

[278] Penner and Swadling (n 274) 48.
[279] Ibid.
[280] Culp and others (n 264) 24.

the trustee has absolute and unqualified discretion in managing the trust assets. However, depending on the level of details associated with the restrictions established by the settlor, the trustee may have broad discretion in the trust's administration and may enjoy great flexibility in the management of trust assets, as long as this discretion is exercised in furtherance of the purposes of the trust.

The relationship between trustees and beneficiaries is generally viewed as the archetype of a fiduciary relationship. The distinguishing obligation of a fiduciary is the obligation of loyalty.[281]

The principal is entitled to the single-minded loyalty of his fiduciary. This core liability has several aspects. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal.[282]

Therefore, trustees have a duty to act honestly and in good faith, and deal with the trust property with integrity for the beneficiaries. Fiduciary duties are imposed to prevent persons acting in representative capacities with limited access to assets (such as trustees) from misusing their positions for their own advantage.[283]

In terms of what peculiarly fiduciary duties are, two are widely recognized: first, there is the principle that prohibits a fiduciary from acting in a situation where there is a conflict between the duties to his principal and his personal interests. Second, there is the principle that prohibits a fiduciary from receiving any unauthorized profit as a result of the fiduciary position.[284]

The Duty of Good Faith

This duty requires that the trustee act honestly and with fidelity in the interests of the beneficiaries. This means that the trustee cannot put his own interests (frequently referred to as self-dealing), or the interests of third parties, ahead of the interests of the trust. Common examples of violations of the duty of loyalty are

[281] Trust Law General Proposals, Law Reform Commission (Dublin, 2008) 11.
[282] Ibid.
[283] Review of Trust Law in New Zealand, 29,30.
[284] Ibid.

where the trustee attempts to secure a material advantage for himself, to a relative, or to a third party in a transaction on behalf of the trust. [285]

This duty of good faith, in turn, encompasses a myriad of sub-categories of fiduciary duties such as the duty to act in good faith, the duty to avoid conflicts of interest and the duty not to make an unauthorized profit. Other sub-categories that are important for our purposes are the general duty of care in administering the trust, the duty to take personal responsibility for the administration of the trust, the duty to treat all beneficiaries fairly and the duty to keep accounts and provide information to the beneficiaries.[286]

(i) Duty to Avoid Conflicts of Interest

The fundamental duty of exclusive loyalty operates to reduce the risk of trustees abusing their position by using their powers of management in their own interests. As could be very difficult to always determine the true motives of trustees, equity laid down the strict rule that they must not place themselves in a position where their duty and their own interests or the interests of a third party may conflict.[287]

(ii) Duty not to Make an Unauthorized Profit

The core duty of exclusive loyalty also operates to reduce the danger of trustees taking advantage of their position in order to make a personal profit.[288]

(iii) Duty to Take Personal Responsibility for the Administration of the Trust

Trustees are under a duty to take personal responsibility for administrative decisions. The rationale underpinning this duty stems from the fact that the office is viewed as one where confidence is placed in the abilities of the particular individual and it is, therefore, expected that he should personally look after the interests of the Beneficiaries.[289]

(iv) Duty to Treat all Beneficiaries Fairly

In addition to their duties to adhere to the terms of the trust instrument, it is well-established that trustees are also under a duty to be impartial in the exercise of

[285] Culp,Laurenzi, and Tuell (n 264) 17; Trust Law General Proposals (2008) 14-15.
[286] Trust Law General Proposal (2008) 14.
[287] Trust Law General Proposal (2008) 15.
[288] Ibid.
[289] Ibid.

their functions. The general principle is that trustees are bound to hold an even hand among their beneficiaries and not to favour one as against another.[290]

The Duty of Prudence

The trustee's duty of prudence descends in part from the duty of good faith, requiring that the trustee act with due care, diligence and skill in managing the trust.

The standard or measure of care, diligence and skill required of a trustee in the administration of a trust is that of an ordinarily prudent person in the conduct of his or her private affairs under similar circumstances, and with a similar object in view.[291]

The Duty to Preserve the Trust

The duty to preserve and protect the assets of the trust is closely related to the duty of prudence. In essence, it requires the trustee to manage the corpus of the trust in a manner that takes a long-term perspective and ensures that the trust can satisfy both the present and future needs of the trust beneficiary in accordance with the instructions of the settlor. In the context of a perpetual trust, this generally requires the trustee to manage the trust corpus in a manner that will ensure that the trust will remain undiminished to serve the needs of future beneficiaries in perpetuity.[292]

In this regard, there is a duty to keep accounts and provide information to beneficiaries, therefore, trustees have a duty to keep clear and accurate accounts of the trust property, and a beneficiary is entitled to inspect these accounts.[293] Furthermore, trustees have a duty to provide beneficiaries with certain information.[294]

In cases of breach of trust, the beneficiaries will also have personal rights against the errant trustee. The trustee can be sued personally to make good loss to the trust which has occurred because of the breach.

[290] Ibid.
[291] Culp and others (n 264) 18.
[292] Ibid.
[293] Trust Law General Proposal (2008) 16.
[294] Ibid.

It is important to say that the essence of the owner trustee is not contractual (as beneficiaries are not associated therewith under a direct contract, where beneficiaries are not considered "others of conditional interest" under the contract establishing the trust ownership). It is also important to clarify that the responsibility, and capacity, of the owner trustee is not determined on the basis of the legal, contractual, or proxy commission on behalf of others. This is because the assigned money is owned fully by the trustee from a subjective legal aspect (it is not possible to visualize a person as the owner and agent in his own money).[295]

In fact, the owner trustee's responsibility base comes by virtue of law and it is nothing more than the equitable title, which is legally recognized for the beneficiaries in regards to the entrusted money. Therefore, the owner trustee's responsibility takes the form of "Liability in tort" based on "missive responsibility" or "tortuous liability", which is measured by failure to perform the duties of care and fiduciary legally approved for the interest of the beneficiaries.[296]

5.3.3.6 Trust in Islam

The concept of Islamic trust requires a person entrusted with such trust to look after the trust property just as he would look after and protect his own property. The creation of Islamic trust as one of the instruments for estate planning generally involves the appointment of trustee whose duty is to look after and manage the trust property according to the terms and conditions as stipulated by the person who creates the trust (the settlor).[297] This is evident in the following verses of the Qur'an:

- **"BEHOLD, God bids you to deliver all that you have been entrusted with unto those who are entitled thereto, and whenever you judge between people, to judge with justice. Verily, most excellent is what God exhorts you to do: verily, God is all-hearing, all-seeing!" (4:58).**
- **"O you who have attained to faith, do not be false to God and the Apostle, and do not knowingly be false to the trust that has been reposed in you" (8:27).**

[295] In this regard, please see Articles (60-61) United Kingdom Trustee Act 2000.
[296] In this regard, please see Articles (60-61) United Kingdom Trustee Act 2000.
[297] Akmal Halim, 'The Legality of a Trust as an Instrument for Islamic Wealth Management, a Malaysian Perspective' (2011) Vol 19, No. 1 *International Islamic University Malaysia Law Journal*, 42.

- ***"if you trust one another, then let him who is trusted fulfil his trust, and let him be conscious of God," (2:283)***

As discussed before, Islam has laid down rules for ownership and designated various rules for when individuals come together and distribute profits amongst themselves.

In Islam, the appointment of a trustee normally exists in the form of wakãlah or agency which arises when one person authorizes another to replace him in the exercise of his civil rights. It is, therefore, submitted that in Islam, once a trust is created, the property is no longer the settlor's, and the entrusted person will administer and manage the trust property according to the terms and conditions of the trust even in cases of self-appointment as trustee. The trustee is charged with a great responsibility to guard the interest of the person on whose behalf he holds the trust and to render back the property and accounts when required according to the terms of the trust.

As mentioned before, there are four pillars of fiduciary in Islamic law. These are the principal, the agent, the contract formula and the contract object.[298]

When we apply the fiduciary conditions on the relationship between the Settlor and the Trustee, we find the following:

11. Settlors are the owners of the property and they appoint the Trustee to manage it.
12. The Settlor gives his/ her authorization to the Trustee to manage the property on behalf of him/ her.

All of the all pillars of the fiduciary in Islamic law are found in the case above as follows:

1. Settlors are the principals: they have the ability to act according to Islamic law and they own the property, therefore, they are allowed to manage it.
2. Trustees are appointed by the Settlor and he/she has the ability to act according to Islamic law. They are identified in a clear way.

[298] Al-Hammad (n 243) 137.

The appointing process can be considered as the contract formula: appointing is an offer, and accepting it is accepting.

Therefore, and based on the above, we can consider the Trustee as the agent, the Settlor as the principal, and the management of the property as the object of the contract fiduciary. Hence, it could be said that the Islamic law considers the same principles of the trust law regarding the fiduciary relationship between the Settlor and the Trustee.

The Key Parties in Wakf [299]

(i) The Settlor: This person establishes the Wakif by transferring assets to the trustees. The settlor must completely constitute the Wakif and do everything in his power to transfer the assets to the trustees.

(ii) The Trustee: The trustee is an individual or company who receives assets from the settlor and who has the SHARI'A LAW responsibility of administering them for the benefit of the beneficiaries. The trustee becomes the legal owner of the assets, but he cannot use them for his own benefit. The trustee is obliged to perform certain duties as laid down in the trust document or by the terms of the trust, and in accordance with the law.

(iii) The Wakif Deed: The terms and conditions on which the trustee is to hold the assets will generally be set out in a written document commonly known as a Wakif deed. In many instances, they are lengthy documents with extensive provisions to ensure that the trustees have the power to carry out the wishes of the settlor and to safeguard the interests of the beneficiaries.

(iv) The Beneficiaries: The beneficiaries of a Wakif may be individuals (including the settlor), classes of persons or corporate bodies who will or may become entitled to the income and capital of the Wakif. They need not to be named, but they must be identifiable or ascertainable. It is not necessary to make a list of all beneficiaries,

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[299]Trevor Norman, *Trusts and Shari'a Law, Islamic Retail Banking and Finance: Global Challenges and Opportunities* (Euro Money Books 2005), 2,3.

but certainty as to what the settlor intended the qualifications to benefit to be is essential. Where the trustees have discretion as to which group of persons is to benefit, no one beneficiary has a right to any of the trust assets.

5.3.3.7 Similarities between Trust and a Waqf

Some academics have suggested that the concept of a trust was brought back from the Middle East by the Crusaders.[300]

The creation of a trust and a waqf has several similarities. In particular, there is a similarity in the transfer of assets by the settlor or wakif to the trustees or mutawalli, and these assets are administered for the benefit of others. Many awqaf (plural of waqf) have been established for philanthropic purposes, which have parallels in the establishment of charitable trusts, whilst many family awaqf (commonly known as waqf ahli, or waqf dhurri) were established to preserve a family business as a single unit for the benefit of the family as a whole.[301]

5.3.3.8 Differences between Trust and a Waqf

In fact, there are many differences between the two concepts. The major differences are that in a trust the assets are owned by trustees, and they may transact with the assets as they deem appropriate. In a waqf, the mutawalli administers the assets, but he will not generally be able to sell the assets without express permission from a Shari"a court.[302]

It follows that a waqf will normally continue to exist indefinitely. However, for a trust, the "rule against perpetuities" or trust Law will require that the assets must vest within a certain period. Moreover, wakif does not have the power to revoke a waqf, whereas trust law permits the reservation of a power to revoke by the settlor.[303]

There are restrictions on the nature of assets that can be transferred to a waqf, e.g., usufruct, TRUSTS and SHARI'A LAW, whereas such assets can be owned through a trust. Most importantly, a wakif is generally prevented from having an

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[300] Trevor Norman, *Trusts and Shari'a Law* (Euromoney Books 2005)
[301] Ibid
[302] Ibid
[303] Ibid

interest in the assets of the waqf, whilst a settlor may be appointed as a beneficiary of trust.[304]

5.3.4 Disclosure Rules and the Concept of Gharar

In the basic and simple sense of the word, disclosure refers to the act of making information or data readily accessible and available to all interested individuals and institutions.[305]

A company's board of directors is under the duty of publishing and making available certain information relevant to the company. The most crucial information that needs to be disclosed is usually that is related to the financial standing of the company such as balance sheets, profit and loss accounts, and reports on the financial status of the company. Critical and important occurring in the lifetime of the company should also be disclosed transparently. It is noteworthy to mention in this regard that a vast spectrum of matters is also the subject of an obligation of disclosure, or at least the disclosure of which is highly recommended. Such information may include information on major share ownership and voting rights, roles and functions of the members of the board and key executives, information about remuneration policies, and issues regarding employees and other stakeholders.[306]

The duty to disclose financial and operating results of the company is a response to one of the major responsibilities of the board of directors. That is to ensure that shareholders and other stakeholders are provided with high-quality disclosures on the financial and operating results of the entity that the board of directors have entrusted with governance.[307]

The value of disclosure depends on the value of information being disclosed. In general, information being disclosed is comprised of two kinds: accounting and non-accounting information. When ownership is spread out, dispersed investors

[304] Ibid.
[305] The OECD Glossary of Statistical Terms<http://stats.oecd.org/glossary/detail.asp?ID=6139> accessed on 20/11/2014.
[306] Such issues as a subject matter for the duty of disclosure are tackled with noticeable details in the OECD principles.
[307] Corporate Governance Disclosure, 'Guidance on Good Practices in Corporate Governance' (United Nation Conference on Trade and Development, New York and Geneva, 2006) .<http://www.unctad.org/en/docs/iteteb20063_en.pdf> accessed on 30/1/2011.

face the collective action problem; therefore, the disclosure system is more valuable and more effective where investors are dispersed.[308] The quality of financial disclosure depends significantly on the robustness of the financial reporting standards on the basis of which the financial information is prepared and reported (in most circumstances).[309]

Though many shareholders and stakeholders would be interested in information that would help them to determine that management is running the enterprise with the best interest of all shareholders and stakeholders, they could find it useful in providing an additional level of comfort regarding the fact that the financial statements accurately represent the situation of the company.[310] Company objectives are a further important subject matter for the duty of disclosure. What would company objectives be? A broad line answer to this question can be the maximization of the profit of shareholders and the values of their investment. This refers us back to the values that corporate governance is likely, or supposed, to realise, i.e. the shareholders or more generally the stakeholders interest, or a hybrid of the two interests as the enlightened shareholder theory promotes. However, when it comes to the duty of disclosure, there stands a need that, beside the detailed goals themselves, the methods of achieving such goals should be adequately made clear to shareholders, either in terms of the objective itself or in terms of the methods to be applied towards the realization of such objectives. This is important for the shareholders to verify that managers are not deviating from the objectives that shareholders set for the company and to monitor the managers' efforts for the realization thereof. It is also important for the shareholders to take informed decisions as regard to their intentions to change or add to the objectives of the company, or exercise their exit option when the objectives set by the majority are no longer what certain shareholders wanted.

[308] Hideki Kanda,'Disclosure and Corporate Governance: A Japanese Perspective,' in OECD, *Corporate Governance in Asia: A Comparative Perspective* (OECD Publishing 2001),4.
[309] *Corporate Governance Disclosure in Annual Reports, A Guide to Current Requirements and Recommendations for Enhancement (Hong Kong society of accounting 2001), 5 <http://www.ecgi.org/codes/documents/hksa.pdf> accessed on 30/01/2011.*; ODEC Principles of Corporate Governance, 50.
[310] ODEC Principles of Corporate Governance (2009), 50.

Disclosure also plays a role in enabling the regulatory and the auditing official authorities from doing their works. It was, therefore, truly said that disclosure regime is a pivotal feature of market-based monitoring of corporate conduct, and it is central to the ability of shareholders to exercise their voting rights effectively. Disclosure can also be a powerful tool for influencing the behaviour of companies and protecting investors. A strong disclosure regime can help to attract capital and maintain confidence in capital markets. Shareholders and potential investors require access to regular, reliable, and comparable information in sufficient detail for them to assess the stewardship of management and make informed decisions about the value, ownership, and voting of shares.[311]

Disclosure also helps improve public understanding of the structure and activities of companies, their policies, and performance with respect to environmental and ethical standards and their relationships with the communities in which they operate.[312]

Emphasizing more the value of disclosure for the protection of investors, it is said that capital markets are operating in a highly regulated environment. Highly organized securities markets on stock exchanges also operate in a highly regulated environment. In order to protect public investors against manipulative and deceptive activities by securities brokers and others, securities law in most jurisdictions have emerged and centred upon the idea of investor protection. It could be noticed that securities laws provide a detailed and complex disclosure system for large public companies.[313]

There have been repeated attempts in economics literature to establish a body of "principles of orderly capital market information."[314] Such principles generally aim at insuring that information is provided in sufficient clarity in order to participate in the decision making process by the shareholder.

According to such principles, information should be provided in a material, clear, standardised, and forward looking. "Information is "material" if it is capable of

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[311] Corporate Governance Disclosure in Annual Reports*, A Guide to Current Requirements and Recommendations for Enhancement* (Hong Kong society of accounting 2001), 5 <http://www.ecgi.org/codes/documents/hksa.pdf> accessed on 30/01/2011.

[312]ibid.

[313] Kanda (n 308).

[314]Fiammetta Borgia, 'Corporate Governance & Transparency Role of Disclosure, How to prevent New Financial Scandals and Crimes?'(American University, 1 June 2005)<http://policytraccc.gmu.edu/resources/publications/borgia02.pdf> accessed on 20/01/2011.

causing a reasonable investor to take a different decision than he/she would have made in the absence of the information. At least three policy considerations arise in connection with material information:

- All material information should be disclosed in its entirety to the capital markets;
- Exceptions to this rule of disclosure should be strictly limited, as the same way for the protection of trade secrets;
- Immaterial information should not be disclosed to the capital markets. Optimum disclosure, not maximum disclosure, is the goal. Publication of immaterial information is not only expensive and unnecessary, but can even be counterproductive if it works to distract interested persons from material information."[315]

Such disclosure should be clear; disclosures need to be analysable, comprehensible and standardized; i.e. they must present the required information in the same format. Like the prospectus, the balance sheet and income statement must follow a standard format, which reduces the costs incurred by interested persons in obtaining corporation data. Standardization also presents another characteristic. Because investors are interested in making comparisons between various corporations, it could be advisable under certain circumstances to disclose a negative piece of information that would not reach the threshold of materiality if the corporation were viewed in isolation.[316]

Information subject to disclosure should be forward looking. If the occurrence of specific events is expected, but has not occurred yet, this must be clearly stated. Investors are also particularly interested in knowing how the management assesses future earnings and risks of the corporation.[317]

What do all these principles have in common? They all highly evaluate the consideration of clarity in order that an investor takes his/her investing decision beyond the shadow of doubt at the time such decision is to be made. Such a

[315] Ibid.
[316] Ibid.
[317] Ibid.

consideration is almost identical to one of the major principles on which the Islamic law of transaction depends, which is scrutinised below.

5.3.4.1 The Concept of *Gharar* (Uncertainty) in Islamic Law

"*Gharar*" refers to any transaction of probable items whose existence or characteristics are not certain due to lack of information, ignorance of essential elements in the transaction to either party, or uncertainty of the ability of one party to honour the contract.[318]

"*Gharar*" can be defined as any act characterized by an unknown outcome, or an act a person cannot warrant whether it will materialize or not. In other words, "*Gharar*" is implicated in any action or deal, which a person undertakes without knowing its aftermath. "*Gharar*" can also be invoked in a situation involving uncertainty such as lack of knowledge as to the nature of the subject matter of contract.[319]

The term "*Gharar*" is not directly mentioned in Quran, but a number of etymologically related words are mentioned such as delusion and deception. "*Gharar*" is also a concept that is controversial among various Islamic schools of thought.[320]

The meaning of "*Gharar*" includes deception, delusion, hazard or risk, and, within the financial industry, it can be defined as uncertainty and risk.[321]

The rationale behind the prohibition of "*Gharar*" is the need to ensure full consent and satisfaction of the parties in a contract. Without full consent, a contract may not

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[318] Mohammed Alwosabi, 'The Prohibition Of Gharar' (Bank 411) <http://staff.uob.edu.bh/files/620922311_files/Prohibition-of-Gharar.pdf> accessed on 30/01/2011.

[319] Islamic Shari'a Concepts governing Islamic Banking finance. <http://www.dradamlawfirm.com/pdf/Islamic%20Shari'a%20Concepts%20Governing%20Islamic%20Banking%20Finance.pdf> accessed on 30/01/2011.

[320] Fahad Al-Zumai, 'Corporate Governance Challenges in Islamic Finance Institutions' <http://www.essex.ac.uk/ebs/research/BAAALDEE/1stWorkshopConfPapers/IslamicCorporateGovernance1.doc>7, accessed on 22/09/2011.

[321] ibid 7.

be valid. Full consent can only be achieved through certainty, full knowledge, full disclosure and transparency.[322]

Gharar or uncertainty can take various forms that render the transaction to be nullified in case the party affected thereby so decides after being informed with the particulars that were uncertain enough. The major forms of forbidden "*Gharar*" can be summarized in the following:[323]

i. <u>Uncertainty of Ownership and Possession</u>

A clear example of this case can be the sale of an item that could not exist, or that is not in the possession of the seller. Also, there exists uncertainty as regard on whether the same will be available in the possession of the buyer in future, or when the buyer has not yet acquired ownership over the item, or that the ownership thereof is incomplete.

ii. <u>Inadequacy and Inaccuracy of Information</u>

The absence of information for either party may be due to deliberate action of the counter-party that can take the form of hiding important information or misrepresenting such information. It is also perceivable that parties enter into the contract voluntarily go under a situation of uncertainty with mutual consent. In both cases, the contract becomes susceptible to prohibition.

iii. <u>Interdependent and Conditional Contracts</u>

Islamic law does not permit interdependent contracts, which could take, for example, the form of combining two sales in one contract, or linking two sales jointly. "*Gharar*" exists if the sale price is unknown at the time of contract formation. However, it is dependent on a specific event. It also exists in the case when the parties are not sure if the sale may or may not take place.

iv. <u>Pure Games of Chance (Al-*Qimar* and Al-*Maysir*)</u>

Islamic law prohibits contracting under conditions of uncertainty and gambling.

[322] Alwosabi (n 318) 2, 4.
[323] Ibid.

As mentioned above, the reason for the prohibition of "*Gharar*" is the risk or uncertainty, which casts doubts on the delivery of the item and settlement of the contract. The rationale behind the prohibition of "*Gharar*" is to ensure full consent and satisfaction of the parties in a contract. Full consent can only be achieved in full disclosure and transparency and through perfect knowledge from contracting parties of the counter values intended to be exchanged. The prohibition of "*Gharar*" protects against unexpected losses and the possible disagreements regarding quality or incompleteness of information.[324]

Information is central to the Islamic system of contracting. All parties of contract must make accurate and adequate disclosure of all relevant information enough to make reasonable estimates of the outcomes. Lack of knowledge (*jahl, or jahala*) could be with regard to the price of the item, the characteristics of the price or of the item, the quantum of the price or the quantity of the item, or the date of future performance.[325]

All Islamic financial and business transactions must be based on transparency, accuracy, and disclosure of all necessary information, so that no one party has advantages over the other party. Islam has clearly forbidden all business transactions, which cause injustice in any form to any of the parties. Injustice may be in the form of hazard leading to uncertainty in any business, or deceit, fraud or undue advantage.[326]

Islamic law is seeking to protect the different parties from deceit and ignorance by forbidding "*Gharar*" in any commercial exchange contracts that are not free from hazard, risk, or speculation about the essential elements in the transaction to either party, or uncertainty of the ability of one party to honour its rights and obligations.[327]The holy Quran gave clear guidance for disclosure and transparency.

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[324] Institute of Islamic Banking and Insurance, 'The prohibition of Maysir and Gharar, financial Islam' <**http://www.financialislam.com/index.html**> accessed on 03/04/2011; Alwosabi (n 318) .

[325] Alwosabi (n 318) 3.

[326] Alwosabi (n 318) 1; and Institute of Islamic Banking and Insurance (n 319).

[327] Institute of Islamic Banking and Insurance (n 319).

“O YOU who have attained to faith! Whenever you give or take credit for a stated term, set it down in writing. And let a scribe write it down equitably between you;” (2:282).

This verse emphasizes the making records of each aspect of transaction so that there is full clear disclosure for all parties, which prevents misunderstanding and conflict.[328]

Coming to the application of the "*Gharar*" concept on corporate governance principles, it was clarified above that making the needed information available to the investors of a company is an important factor to give a representation of the status and the business of such a company to enable investors to make informed decisions. For example, the decision of selling or buying the stocks in question, or the decision of enforcing any of the accountability methods that the shareholders have to encounter the misbehaviour of the directors. Islamic law gives great importance for the availability of information when in course of making transactions. Therefore, the Islamic laws require that people declare all the important information pertaining to the contract in course of being formed, including all the relevant documents.

Disclosure rules as major basis for corporate governance share the same aim of the prevention of *Gharar* under Islamic Law. That is the prevention of hiding important information, as well as the requirement that all important information be clearly disclosed.

[328] Slahudin (n 243) 36.

6. Chapter Six: International Standards of Corporate Governance

This chapter will be devoted to the discussion of a range of significant international standards of good corporate governance which evolved in the last few decades. As it has already been discussed in previous chapters, a number of world-famous economic crises and corporate scandals have stimulated ardent pursuit, both on the national and international level, of standards and framework of good corporate governance. Corporate governance is a broad area and presents numerous challenges in order to create a comprehensive framework of conduct wherein all elements and players are consistent with the rule of law, ethics and the wise economic and managerial practices. Consequently, any suggested framework of corporate governance should be designed with the aim of including and regulating the overall economic activities, performance, and even benefits to be gained by all parties in the field. While the Principles of Corporate Governance issued by the Organization for Economic Co-Operation and Development (the OECD Principles for short) discussed below are widely renowned and enjoy global appeal and acceptance, the discussion here is focused on some reports of corporate governance committees published in the UK, including the Cadbury, the Greenbury, and the Humpell reports and the Combined Code of Corporate Governance which paved the way for the evolution of the OECD principles.

6.1 The Cadbury Committees report

The *Cadbury Committee* has become the short name for the Committee on the Financial Aspects of Corporate Governance, owing to chairmanship of the committee by Sir Adrian Cadbury. This Committee was set up by the Financial Reporting Council, the London Stock Exchange and the accountancy profession in the United Kingdom in May 1991 following a number of incidents of corporate failure including the Maxwell Empire, BCCI and Polly Peck. Hence, there was a perceived low level of confidence both in financial reporting by companies and in the ability of auditors to provide the safeguards required by the various users of company reports. The underlying factors of this situation were attributed to the looseness of accounting standards, the absence of a clear framework for ensuring that directors kept under review the controls in their business, and competitive pressures both on companies and on auditors which made it difficult for auditors to stand up to demanding boards.

Accordingly, the committee was charged with examining aspects of corporate governance including boards of directors and boards, executives, auditors and shareholders relationships. The committee laboured for 18 month and published the first draft of its report in the middle of 1992 and the final report on December of the same year.[329] One of the findings of Cadbury Committee was the massive incidence of lack of essential corporate disclosures in the UK corporate sector. As a result, the Cadbury Committee report stirred up a wide public debate in the UK on how to ensure ethical conduct and monitoring the activities of executives and directors of companies.

The report dealt with, and produced recommendations on, reviewing the structure and responsibilities of boards of directors; the role of auditors and the accountancy profession, and the rights and responsibilities of shareholders. By careful examination, the Cadbury Committee introduced various professional standards to improve corporate behaviour of listed companies, but also others not listed, on the stock exchange in London. In addition, the report also introduced a *Code of Best Practice* for companies consisting of principles on accountability, integrity and openness regarding boards of directors and their liability.[330] These included the following four main principles:

First: a principle, to ensure the balance between authority and power, at the head of the company, there must be a clear division of responsibilities.

Second: a sufficient number and calibre of non-executive directors should be included in the board in order to make important decisions.

Third: a positive interest in the composition of boards of directors should be taken by institutional investors.

[329] Cadbury Committee *Report of the Committee on The Financial Aspects of Corporate Governance* (Gee, division of Professional Publishing Ltd 1992).
[330] M Blowfield and A Murray, *Corporate Responsibility: A Critical Introduction* (Oxford University Press, 2008), 216.

Fourth: clear recognition should be ensured by the board structure with help of an Audit Committee to secure the significance of the function of the finance.

Thus, the Cadbury Committee in conclusion could be seen as concerned with the freedom of boards to work and compete in favour of their companies, while ensuring that the work is carried out within the accountability framework. The Cadbury committee was succeeded by the formation by two more committees, the Greenbury and Hampel committee, and the publication of the Combined Code and its revision.

6.2 The Greenbury and Hampel committees

The Greenbury Committee, named after its chairman Sir Richard Greenbury, was established in January 1995 by the initiative of the Council for British Industry (CBI) to examine the excessive remuneration packages in the corporate sector. The express remit of the Committee was "to identify good practices in determining Directors' remuneration and a Code of such practice for use by the UK PLCs".[331]

In July 1995 the Greenbury Committee published its report and a Code of Best Practice on directors' remuneration, which included the main recommendations:

First: the formation of an independent remuneration committee consisting exclusively of non-executive directors to determine the directors' remuneration. Such committee should help avoid any potential conflict of interests and should prepare annual report.

Second: information about the named directors' salaries with full disclosure. The committee annual reports should contain details of the remuneration policy including directors' level and salary scales.

Third: the requirement of disclosure and explanation if the contract period of the directors' service is more than one year.

Fourth: directors are encouraged to hold onto shares, and shares should not be vested.

[331] Richard Greenbury Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury (Gee, division of Professional Publishing Ltd 1995), 9.

Fifth: instead of capital gains on disposal, it recommends the taxation of executive share option gains as income

Following the Cadbury and Greenbury committees, and recommended by them, there was a need for a new Committee to review and revise their findings and to check the implementation of their recommendations. For this reason Committee on Corporate Governance, known as the Hampel Committee owing to its chairman Sir Ronald Campel, was established in November 1995. Unlike Cadbury and Greenbury, the establishment of the Hampel Committee contained several players in terms of initiative, which were the chairman of the Financial Reporting Council and six sponsors: the LSE, the CBI, the Institute of Directors, the Consultative Committee of Accountancy Bodies, the Association of British Insurers, and the National Association of Pension Funds. There was an obvious difference between Hampel and the previous Committees, as the Hampel Committee shifted from the restricted remits of 'Cadbury and Greenbury' to cover the whole field of corporate governance.

The committee's final report was published in January 1998[332] with a large endorsement of the Cadbury and Greenbury committees' conclusions. Moreover, the Hampel Committee's endorsement of the previous committees' conclusions about the remuneration of the directors to be put to a shareholder vote at the annual general meeting could be described as controversial at the time.

The Hampel Committee reports included two significant conclusions. **First:** instead of explicit rules, good corporate governance is a matter of behaviour and an issue of principles that aim to ease the regulatory burden on companies with flexibility that should meet the company's specific needs. **Second:** there was a concern that, in the work of the previous committees, the emphasis on accountability had neglected, to some extent, the major responsibility of the board regarding the issue of acting in the best interests of the shareholders.

Moreover, the Hampel report promotes the involvement of the shareholder in issues of governance. Remarkably, the principle of stakeholders who have an interest in the company's success, such as governments, local communities,

[332] The Committee on Corporate Governance *FinalReport* (Gee, division of Professional Publishing Ltd 1998).

customers, suppliers and employees, was later put into a statutory footing in the Companies Act 2006.

Additionally, unlike the Cadbury and Greenbury reports, the Hampel Committee report goes beyond being entirely focused on the UK to be distinguished by having experts' advice in corporate governance practice from the United States and Germany as well. The importance of the previous three Committees, Cadbury, Greenbury and Hampel, is due to the fact that the Combined Code is based on their reports and the Cadbury Committee's Code of Best Practice.

6.3 The Combined Code of Best Practice

Following the Hampel report, the Combined Code of Corporate Governance in June 1998.[333] Accordingly, as of 31 December 1998, all listed companies in the UK have been subject to the 1998 Principles of Good Governance and Code of Best Practice.

The importance of the Combined Code is that it followed the work of three important committees- Cadbury, Greenbury and Hampel- covering the main elements of corporate governance. Generally speaking, the Combined Code covers many issues, with a mix of principles and provisions regarding the board's structure and operations, for example the remuneration of directors; accountability, and the issue of institutional shareholders in regard to its relations and its responsibilities. To date, the Combined Code has witnessed a series of revisions, in 2003, 2006, 2008, 2010, 2012 and 2014, and the Financial Reporting Council (FRC) is anticipating an update of the Combined Code every two years.

In 2010, the UK Corporate Governance Code was published as the new name for the Combined Code while retaining its principles to a large extent. Since the start of the Combined Code in 1992, 'comply or explain' has gained the support of both shareholders and companies. It is fact that the scope of corporate governance code covers listed companies; however, private and unlisted companies are still encouraged to adopt the code's principles. Unlike hard law, there are several

[333] The Combined Code, available at <http://www.ecgi.org/codes/documents/combined_code.pdf> last accessed on 15 July 2017. For a detailed study of the Code see e.g Matthias Hornberg, *Corporate Governance: the Combined Code 1998 as a Standard for Directors' Duties* (Institute fur Wirtschaftsrech 2004).

advantages to the Corporate Governance Code being a soft law, including flexibility, the ability of fast modification, the ability to adapt according to the company's circumstances, and lastly, it is less costly. In relation to the corporate management performance, it can be seen nowadays that the courts when handing down judgment they are progressively referring to corporate governance practices. Therefore, the following paragraphs are an attempt to shed light on the development of the Combined Code since 1998, with more focus on the latest UK corporate governance code.

To start with, the Combined Code 1998 operates on the basis of the well-known concept of 'comply or explain', as mentioned earlier. There are two main sections that aim at covering these two issues- companies and institutional investors. The Combined

Code 1998 could be described as the Cadbury, Greenbury and Hampel reports combined. In 2003, the new revision of the Combined Code was published with the incorporation of the Higgs 2003 and Smith 2003 reviews. The chairman and the senior independent director's role are clarified in the 2003 code, and independent nonexecutive directors must make up at least half of the larger listed companies boards.

Three years later, the Combined Code's new revision was published in June 2006, with three central changes, including, the allowance of the chairman of the company to serve only on the remuneration committee- not to chair- where he or she is considered as independent, providing the option of 'vote withheld', and publishing the recommendation of proxies lodged at general meetings on the company's websites.

Two years later, the new revised Combined Code was published in June 2008 following the FRC's review of the impact of Combined Code. The 2007 FRC review found that there was general support from the 2006 Combined Code and the FRC would focus on practical application. The FRC published the UK Corporate Governance Code 2010, retaining the well-known 'comply or explain' approach and incorporating some of the Walker recommendations, as well as following the effectiveness of the combined code progress report of 2009. Notably, in the 2010 revision, 'the Combined Code' became 'the Code' thereafter. Two years later, a revised version of the UK Corporate Governance Code was issued in 2012, which included changes to section B.2.4 and B6.

Moving to the current version of the UK corporate governance code which was issued in September 2014; like the 2012 version, the last version has the same five main sections, including: leadership, effectiveness, accountability, remuneration and relations with shareholders.

First of all, the FRC has adopted changes to some of the Code's provisions, such as the requirement of making two separate statements, including the going concern statement 'Provision C.1.3' and a viability statement 'Provision C.2.2'. Thus, companies should make a statement about whether they take into account the appropriateness of adopting the going concern basis of accounting. Concerning risk management, the Code assures the risk assessment of the company's principal risks and explains how they deal with it or mitigate it, as well as stating whether the company believes it has the ability to continue working and achieve their liabilities under the main risks and current position; moreover, a minimum of one review of the company's effectiveness annually and reporting it in the annual report. In terms of remuneration, the key change was about adding more emphasis to ensuring the company's long-term success by designing remuneration policies, which is the remuneration committee's responsibility. Furthermore, arrangements should be made to enable the recovery or withholding of variable pay when needed. Moving on to shareholder engagement, in the case of a significant percentage of shareholders having voted against any resolution, during the publishing of the general meeting results, the company should explain the way in which it is intending to engage with shareholders.

6.4 OECD Principles of Corporate Governance

Established in 1961, the Organization for Economic Co-Operation and Development (OECD) is an inter-governmental organization based in Paris. It currently includes 35 Member States and has a broad range of collaboration with non-Member states and international organisations. The OECD provides a forum for governments and other international organizations to work together to share experiences and seek solutions to common problems. The OECD works with governments of both member and non-member states to understand what drives economic, social, and environmental change and sets international standards for many industries.

Corporate governance has been one of the areas in which the OECD has engaged in an active pursuit to establish international standards. These standards are intended to help policy makers in various states to evaluate and improve the legal, regulatory, and institutional framework for corporate governance, with a view to supporting economic efficiency, sustainable growth and financial stability.

The first OECD set of standard principles of corporate governance was released in 1999.[334] They focused on publicly traded companies, both financial and non-financial. However, to the extent that they are deemed applicable, they might also be a useful tool to improve corporate governance in non-traded companies, for example, privately held and state-owned enterprises.

The principles were developed and endorsed by the ministers of OECD member countries in order to help OECD and Non-OECD governments in their efforts to create legal and regulatory frameworks for corporate governance in their countries. The OECD principles have been reviewed and re-published in revised versions in 2004[335] and 2015.[336] These principles have greatly advanced the global corporate governance agenda and provided specific guidance for legislative and regulatory initiatives in both OECD and non-OECD countries worldwide.

Historically, the foundation of the OECD principles can be traced back the Cadbury, Greenbury and Hampel committees' reports in the United Kingdom which were discussed in the preceding sections.[337] Since they were first published the OECD corporate governance principles gained global acceptance have been adopted, *inter alia*, by the Financial Stability Board as one of its Key Standards for Sound Financial Systems[338] and form the basis for the World Bank Reports on the

[334] OECD, *OECD Principles of Corporate Governance*, (OECD Publishing 1999).
[335] OECD, *OECD Principles of Corporate Governance*, (OECD Publishing 2004).
[336] OECD, *G20/OECD Principles of Corporate Governance*, (OECD Publishing 2015).
[337] See e.g. I Khan, 'The role of international organisations in promoting corporate governance in developing countries - a case study of Pakistan' (2012) 23 *International Company and Commercial Law Review* 223. See also A Dignam, 'Exporting corporate governance: U.K. regulatory systems in a global economy' (2000) 21(3) *Company Lawyer* 70.
[338] See (n 336).

Observance of Standards and Codes (ROSC)[339] in the area of corporate governance.

The OECD principles are six in number and they will be analysed in the remainder of this section. The following discussion is based on the latest version published in 2015 following the review of the 2004 edition. The six OECD principles as follows:

Principle One: *Ensuring the basis for an effective corporate governance framework.*

This principle concerns the role of corporate governance framework in promoting transparent and fair markets, and the efficient allocation of resources. It is focused on the quality and consistency the different elements of regulations that influence corporate governance practices and the division of responsibilities between authorities. In particular, in the 2015 edition of the principles emphasis is placed on the quality of supervision and enforcement, and new principle on the role of stock markets in supporting good corporate governance.

Principle Two: *The rights and equitable treatment of shareholders and key ownership functions.*

This principle relates to basic shareholder rights, including the right to information and participation through the shareholder meeting in key company decisions. The scope of the principle also deals with disclosure of control structures, such as different voting rights, and the procedures for approval of related party transactions and shareholder participation in decisions on executive remuneration.

Principle Three: *Institutional investors, stock markets and other intermediaries*.

This principle addresses the need for sound economic incentives throughout the investment chain, with a particular focus on institutional investors acting in a fiduciary capacity. It also highlights the need to disclose and minimize conflicts of interest that may compromise the integrity of proxy advisors, analysts, brokers, rating agencies and others that provide analysis and advice that is relevant to

[339] <http://www.worldbank.org/en/topic/financialsector/brief/corporate-governance> last accessed on 20 July 2017.

investors. It also deals with standards regarding cross border listings and the importance of fair and effective price discovery in stock markets.

Principle Four: ***The role of stakeholders in corporate governance*.**

This Principle is designed to encourage active co-operation between corporations and stakeholders and underline the importance of recognising the rights of stakeholders established by law or through mutual agreements. It is also related to stakeholders’ access to information on a timely and regular basis and their rights to obtain redress for violations of their rights.

Principle Five: ***Disclosure and transparency.***

This principle relates to a number of key disclosure areas, such as the financial and operating results, company objectives, major share ownership, remuneration, related party transactions, risk factors, board members, etc. New related issues in this regard include the recognition of recent trends with respect to items of non-financial information that companies on a voluntary basis may include, for example in their management reports.

Principle Six: ***The responsibilities of the board.***

The sixth and last principle is intended to provide guidance with respect to key functions of the board of directors, including the review of corporate strategy, selecting and compensating management, overseeing major corporate acquisitions and divestitures, and ensuring the integrity of the corporation’s accounting and financial reporting systems. New related issues in this respect include the role of the board of directors in risk management, tax planning and internal audit. In addition, there is also a new standard recommending board training and evaluation and a recommendation on considering the establishment of specialized board committees in areas such as remuneration, audit and risk management.

The following sub-sections 6.4.1– 6.4.6 are devoted to detailed discussion and analysis of each of the OECD principles, respectively.

6.4.1 Principle One: Ensuring the basis for an effective corporate governance framework

The first OECD principle requires that the framework of corporate governance "should promote transparent and fair markets, and the efficient allocation of resources. It should be consistent with the rule of law and support effective supervision and enforcement".[340] It is worthwhile that this principle envisages a broad conception of corporate governance framework typically comprising elements of legislation, regulation, self-regulatory arrangements, voluntary commitments and business practices that are the result of a country's specific circumstances, history and tradition. Additionally, the legislative and regulatory elements of the corporate governance framework in any country can profitably be complemented by soft law elements based on the "comply or explain" principle such as corporate governance codes in order to allow for flexibility and address specificities of individual companies.

Thus, any country interested in applying the first OECD principle it should monitor its national corporate governance framework, including the regulatory and listing requirements and business practices, with the objective of maintaining and strengthening its contribution to market integrity and economic performance. It should also take into account the interactions and complementarity between different elements of the corporate governance framework and its overall ability to promote ethical, responsible and transparent corporate governance practices. Evidently, this requires an analysis of the overall corporate framework and such analysis should imperatively be viewed as an important tool in the process of developing an effective corporate governance framework for the country.

To operationalize this principle, a set of requirements or subsidiary principles must be observed, including:[341]

A. **The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and well-functioning markets.**

[340] See (n 336) p. 13.
[341] These requirements are referred to in the G20/OECD Principles, p. 14ff. (See n 336).

It should be recognized that the regulatory and legal environment within which corporations operate is central to the overall economic outcomes in the country. This implies a set of requirements on national policy makers. Accordingly, policy makers have a responsibility to put in place a framework that is proportionate and flexible enough to meet the needs of a range of corporations operating in widely different circumstances, facilitating their development of new opportunities to create value and to determine the most efficient deployment of resources. Additionally, policy makers should focus on ultimate economic outcomes and policy options must be complemented by analysis of the impact on key variables that affect the functioning of markets, for example in terms of incentive structures, the efficiency of self-regulatory systems and dealing with systemic conflicts of interest. Enhanced transparency and orderly functioning markets serve to discipline market participants and to promote accountability and responsibility.

B. The legal and regulatory requirements that affect corporate governance practices should be consistent with the rule of law, transparent and enforceable.

Any new laws and regulations needed to enhance the efficiency of the corporate governance framework should be designed to be implemented and enforced in an efficient and even handed manner covering all parties. Thus, consultation by government and other regulatory authorities with corporations, their representative organisations and other stakeholders should be conducted for the parties to protect their rights. In order to avoid over-regulation, unenforceable laws, and unintended consequences that may impede or distort business dynamics, policy measures should be designed with a view to their overall costs and benefits. Additionally, public authorities should have effective enforcement and sanctioning powers to deter dishonest behaviour and provide for sound corporate governance practices. Noting that corporate governance objectives are also formulated in voluntary codes which do not have the status of law or regulation, such codes play might leave shareholders and other stakeholders with uncertainty concerning their status and implementation. When codes and principles are used as a national standard or as a complement to legal or regulatory provisions, market credibility requires that their status in terms of coverage, implementation, compliance and sanctions is clearly specified.

C. **The division of responsibilities among different authorities should be clearly articulated and designed to serve the public interest.**

The regulatory scope of corporate governance in any country is relatively broad and includes requirements and practices typically influenced various legal domains, such as company law, securities regulation, accounting and auditing standards, insolvency law, contract law, labour law and tax law. Corporate governance practices of individual companies are also often influenced by a wide range of considerations such as standards of corporate social responsibility, human rights and environmental laws. Accordingly, there is a risk that the variety of legal influences may cause unintentional overlaps and even conflicts, which may frustrate the ability to pursue key corporate governance objectives. Therefore, policy makers must be particularly aware of this risk and take measures to mitigate and limit its effects.

Effective enforcement of corporate standards requires appropriate allocation of responsibilities for supervision, and implementation and enforcement among by authorities should be clearly defined to avoid conflict of competencies of complementary bodies and agencies. Overlapping or contradictory regulations between jurisdictions is also an issue that should be monitored so that no regulatory vacuum is allowed to develop (i.e. issues slipping through in which no authority has explicit responsibility) and to minimise the cost of compliance with multiple systems by corporations. Additionally, delegation of regulatory responsibilities or oversight to non-public bodies should be cautiously exercised and measured, and with oversight over implementation.

D. **Stock market regulation should support effective corporate governance.**

It should be noted that stock markets have the potential to play an important role in enhancing corporate governance by establishing and enforcing requirements that promote effective corporate governance by their listed issuers. Also, stock markets provide facilities by which investors can express interest or disinterest in a particular issuer’s governance by allowing them to buy or sell the issuer’s securities, as appropriate.

Accordingly, the quality of the stock market's rules and regulations that establish listing criteria for issuers and that govern trading on its facilities is therefore an important element of the corporate governance framework. The traditional "stock exchanges" nowadays have a variety of shapes and forms. Regardless of the particular structure of the stock market, policy makers and regulators should assess the proper role of stock exchanges and trading venues in terms of standard setting, supervision and enforcement of corporate governance rules. This requires from policy makers and regulators an analysis of how the particular business models of stock exchanges affect the incentives and ability to carry out these functions

E. Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfil their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.

Evidently, the supervisory, regulatory and enforcement responsibilities in any country should be vested with operationally independent and accountable bodies which have adequate powers, proper resources, and the capacity to perform their functions and exercise their powers, including with respect to corporate governance. Experience from many countries shows that political independence of the securities supervisor were addressed through the creation of a formal governing body (a board, council, or commission) whose members are given fixed terms of appointment. These bodies should be able to pursue their functions without conflicts of interest and their decisions should be subject to judicial or administrative review. Equally, they should be staffed with properly qualified personnel to carry out their responsibilities.

F. Cross-border co-operation should be enhanced, including through bilateral and multilateral arrangements for exchange of information.

High levels of cross-border ownership and trading require strong international co-operation among regulators, including through bilateral and multilateral arrangements for exchange of information. International co-operation is becoming increasingly relevant for corporate governance, notably where companies are active in many jurisdictions through both listed and unlisted entities, and seek multiple stock market listings on exchanges in different jurisdictions.

6.4.2 Principle Two: The rights and equitable treatment of shareholders and key ownership functions.

Corporate governance, as a universal idea, mainly aims at the proper vindication of shareholders' rights and interests. In doing so, a well-balanced reference for the minimum rights and interests of shareholders must be defined and adopted. The corporate governance framework should therefore 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.

The main right of shareholders should be securing that their ownership and dealing in shares are decided and practiced according to their free wills and without dictation from others. The shareholders will not be able to make informed decisions unless all related information is available to them; access to information related to the company is therefore a genuine right to all shareholders. Information should be served on regular basis and in sufficient clarity.

The other core matter that needs protection is the voting right vested in shareholders, especially when an outstanding matter involves the company (such as the increase of capital, merger, acquisition, amendment of the articles/by-laws, and even dissolution). In order to enable shareholders to practice their voting right, meetings should be conveyed properly and held with sufficient quorum and voting procedures should be well-informed to all attendees. Release of comprehensive information related to the voting subject matter is very important in order to enable shareholders to practice their voting rights in a correct manner. Information should be clear, comprehensive and provided in good time. In order to guarantee flexibility, the voting system should be practical; shareholders should be able to vote in person or by proxy when they are not available for meetings. Votes in person or by proxy should be of equal legal value.

Shareholders should be fully enabled to freely elect and decide (as the case may be) the recusal of the board members. In addition, shareholders should have the opportunity to monitor management activities and the varied board acts. This includes their official entitlement to ask the boards the queries they have, including questions of the listing of the company in the stock market, the value of the same and the major deals thereon. Shareholders should be given the chance, in some instances, to give advices, and even make necessary decisions in respect of essential matters of the company such as the appointment of auditors and the selection of the control committee members.

Central to the discourse of this matter, shareholders should be able to make rules for the board and senior executives' remuneration. Personnel retirement and compensation schemes should be subject to the shareholders' review and approval.

Finally, the free exercise of ownership rights by all shareholders, including founding investors, should be encouraged and facilitated. Shareholders should be allowed to consult with each other and reach the voting agreements/arrangements they deem appropriate. The law will not generally be supposed to suspect voting agreements or nullify the same because of breaching public order. To sum up, the requirements to protect shareholder rights in relation to Principle Two could be summarised as follows:

A. Basic shareholder rights should include the right to: 1) secure methods of ownership registration; 2) convey or transfer shares; 3) obtain relevant and material information on the corporation on 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.

B. Shareholders should be sufficiently informed about, and have the right to approve or participate in, 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.

C. 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:

   1. 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.

2. Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.
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 be able to make their views known, including through votes at shareholder meetings, on the remuneration of board members and/or key executives, as applicable. 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.
6. Impediments to cross border voting should be eliminated.

D. Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse.

E. All shareholders of the same series of a class should be treated equally. Capital structures and arrangements that enable certain shareholders to obtain a degree of influence or control disproportionate to their equity ownership should be disclosed.

1. Within any series of a class, all shares should carry the same rights. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase. Any changes in economic or voting rights should be subject to approval by those classes of shares which are negatively affected.
2. The disclosure of capital structures and control arrangements should be required.

F. Related-party transactions should be approved and conducted in a manner that ensures proper management of conflict of interest and protects the interest of the company and its shareholders.
   1 Conflicts of interest inherent in related-party transactions should be addressed.
   2 Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.
G. 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.
H. Markets for corporate control should be allowed to function in an efficient and transparent manner.
   1. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.
   2. Anti-take-over devices should not be used to shield management and the board from accountability.

6.4.3 Principle Three: Institutional investors, stock markets and other intermediaries

Corporate governance operates in a broad environment of interrelated interests. Careful consideration should therefore be placed on the variable elements and their peculiar requirements. In particular, the corporate governance framework should provide sound incentives throughout the investment chain and provide for stock markets to function in a way that contributes to good corporate governance. In order to be effective, the legal and regulatory framework for corporate governance must be developed with a view to the economic reality in which it is to be implemented.

A number of recommendations are made under this principle including:

A. Institutional investors acting in a fiduciary capacity should disclose their corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights.
B. Votes should be cast by custodians or nominees in line with the directions of the beneficial owner of the shares.
C. Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments.
D. The corporate governance framework should require that proxy advisors, analysts, brokers, rating agencies and others that provide analysis or advice relevant to decisions by investors, disclose and minimise conflicts of interest that might compromise the integrity of their analysis or advice.
E. Insider trading and market manipulation should be prohibited and the applicable rules enforced.
F. For companies who are listed in a jurisdiction other than their jurisdiction of incorporation, the applicable corporate governance laws and regulations should be clearly disclosed. In the case of cross listings, the criteria and procedure for recognising the listing requirements of the primary listing should be transparent and documented.
G. Stock markets should provide fair and efficient price discovery as a means to help promote effective corporate governance.

6.4.4 Principle Four: The role of stakeholders in corporate governance.

Corporate governance should adhere to the legitimate interests of the stakeholders and it should stress that stakeholders’ rights should be reasonably respected, and their legitimate concerns should also be properly addressed, in all corporate activities.

One of the main methods to achieve the rights and interests of the stakeholders is to encourage meetings and exchange of viewpoints between the company (represented by the board or the management as the case may be) and the stakeholders. In some companies, an advisory stakeholders committee could be found. This is much enhanced institutional body which aims at keeping the relation between the company and the stakeholders always active, and, as will be seen later in this research (section 7.1.5), such a practice gained particular importance in Germany that it is a statutory requirement.

Stakeholders should be entitled to receive sufficient and reliable information about the company. Information varies depending on the class of stakeholders concerned, but it should generally be in the form of economic information, which is usually provided by classification agencies and stock market bulletins.

The principle of free flow of information may clash with the principle of confidentiality of data. The corporate governance does not aim at disclosing information of operational or commercial value to others, including stakeholders, since this will not benefit the stakeholders in practicing their rights; while at the same time is detrimental to the competitiveness of the company. What is meant by information disclosure as a corporate governance principle is the disclosure which is necessary to enable the players to consider their position and practice their rights accordingly, and it is in no way extendable to include information of financial/business value of the company.

Finally, the law should guarantee the possibility to institute claims by stakeholders in vindication of their interests and rights vis-à-vis the company. The lawsuit should not always require establishment of contract breach or tort. Additionally, lawsuits for precautionary measures should also be allowed.

Accordingly, this principle recommends a number of requirements that need to be observed in relation to the role of stakeholders in respect of corporate governance, including:

A. The rights of stakeholders that are established by law or through mutual agreements are to be respected.

B. Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

C. Mechanisms for employee participation should be permitted to develop.

D. Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.

E. Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and to the competent public authorities and their rights should not be compromised for doing this.

F. The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.

6.4.5 Principle Five: Disclosure and transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company. A central idea of corporate governance is the information system. It enables all players to know and get the reliable information they need so that decisions and actions can be enlightened and well-informed.

The information spectrum claimed by the corporate governance is so wide and generally covers the financial and operating results of the company, managers/directors conflict of interest issues, company objectives, and the voting position prevailing in the company including the majority of shareholders.

As indicated above, information about the management of the company and the board is of key importance to this matter. Remuneration policy for, and other benefits granted to, members of the board and executives should be transparent and known to shareholders.

Information should also include disclosure of the general activities of the company, the general strategy of the company, the general outline of the marketing plans, the current market share and the company's varied levels of responding to business risks. The importance of information becomes greater when an extraordinary matter faces the company such as expansion into new markets, merger with another company, acquisition of another entity and, of course, dissolution.

The financial record of the company is another area that needs concentration. The financial statements and records show in numeric language how the company operates in general, its unsettled dues, liability, long-term and short-term obligations, loss and profit margins, inventory and stock and the other assets and cash the company possesses at different time intervals. Apart from these internal financial reporting, external auditing is also of vital importance. The annual audit should be conducted by an independent competent qualified auditor in order to provide neutral and comprehensive view on the financial standing of the company and on whether the internal financial records are accurate, honest and valid. Auditing should be made in accordance with the internationally recognized accounting and auditing standards.

As a source of information accreditation, external auditors should be accountable to the shareholders and owe a duty to exercise due professional care and diligence while working and making their reports.

Finally, information should be free of charge (or at least against relatively cheap value), comprehensive and clear; it should come in the good time, be accurate and of high quality. Channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users.

Accordingly, the recommended requirements pursuant to this principle include:

A. Disclosure should include, but not be limited to, material information on:

1. The financial and operating results of the company.
2. Company objectives and non-financial information.
3. Major share ownership, including beneficial owners, and voting rights.
4. Remuneration of members of the board and key executives.
5. Information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board.

6. Related party transactions. To ensure that the company is being run with due regard to the interests of all its investors, it is essential to fully disclose all material related party transactions and the terms of such transactions to the market individually. In many jurisdictions this is indeed already a legal requirement.
7. Foreseeable risk factors. The Principles envision the disclosure of sufficient and comprehensive information to fully inform investors of the material and foreseeable risks of the enterprise. Disclosure of risk is most effective when it is tailored to the particular company and industry in question. Disclosure about the system for monitoring and managing risk is increasingly regarded as good practice.
8. Issues regarding employees and other stakeholders. Companies are encouraged, and in some countries even obliged, to provide information on key issues relevant to employees and other stakeholders that may materially affect the performance of the company or that may have significant impacts upon them. Disclosure may include management/employee relations, including remuneration, collective bargaining coverage, and mechanisms for employee representation, and relations with other stakeholders such as creditors, suppliers, and local communities.
9. Governance structures and policies, including the content of any corporate governance code or policy and the process by which it is implemented.

B. Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial reporting.

C. An annual audit should be conducted by an independent, competent and qualified, auditor in accordance with high-quality auditing standards in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.

D. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.

E. Channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users.

6.4.6 Principle Six: The responsibilities of the board

The corporate governance framework should ensure principles of the strategic guidance of the company by the board, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders. The board should exercise continuous monitoring for the management in terms of performance, actions, decisions taken and commitment to the company's general business plan decided by the board. The board should regularly report to shareholders' concise reports about management performance, activities and efficiency-level.

The board should give equal attention and care to all shareholders. Where board decisions may affect different shareholder groups, the board should treat all shareholders within the same class fairly. The board should apply high ethical standards when the interests of shareholders/stakeholders are at stake.

The board should also be skilled enough to fulfil certain key functions. This includes drawing and reviewing the company strategic policy and general objectives, and monitoring the implantation thereof; drawing and revising, from time to time, the company's plans of action, risk policy, annual estimated budgets and business plans, hiring for the company the key executives and managers and deciding on their contract nature, compensation and other benefits. The board duty also includes monitoring the performance of the hired executives and managers and replacing them when deemed necessary. The board should endeavour, possibly via choosing the proper contracts and benefits, to align executives/managers with the longer-term interests of the company and the shareholders. The board should also monitor and manage potential conflict of interest issues of its members and executives, and it should take appropriate actions in respect of the same (including elimination of transactions arranged via biased means or otherwise driven by the self-interests of any manager/executive/board member).

Another important obligation vested in the board is the duty to ensure the integrity of the corporation's bookkeeping, accounts and the financial reporting systems. This also includes the obligation to build all company-related control systems such as systems of risk identification, analysis and management; systems of financial and operational control; and systems of pricing, quality control and invoicing.

The board should build a good and intensive nexus with the different stakeholders concerned with the company's work and business, and it should endeavour to maintain a long-term relation with the different categories of the stakeholders (including the community as a whole).

Finally, the board should be accountable toward all those interests. There must be no obstacles banning the accountability processes, including allegations of non-existence of direct legal/contractual relation with the board. Board directors are fiduciary in nature and are built on principles of good faith and due diligence. Stakeholders should not be required to show a duty emerged by contract; they are just required to show that they fall under the general duty of care required from the board.

To sum up, the requirements recommended pursuant to this principle include:

A. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

B. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

C. The board should apply high ethical standards. It should take into account the interests of stakeholders.

D. The board should fulfil certain key functions, including:

Reviewing and guiding corporate strategy, major plans of action, risk management policies and procedures, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

Monitoring the effectiveness of the company's governance practices and making changes as needed.

Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.

Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.

Ensuring a formal and transparent board nomination and election process.

Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.

Overseeing the process of disclosure and communications.

E. The board should be able to exercise objective independent judgement on corporate affairs.
    1. Boards should consider assigning a sufficient number of nonexecutive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration.
    2. Boards should consider setting up specialised committees to support the full board in performing its functions, particularly in respect to audit, and, depending upon the company's size and risk profile, also in respect to risk management and remuneration. When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.
    3. Board members should be able to commit themselves effectively to their responsibilities.
    4. Boards should regularly carry out evaluations to appraise their performance and assess whether they possess the right mix of background and competences.

F. In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information.

G. When employee representation on the board is mandated, mechanisms should be developed to facilitate access to information and training for employee representatives, so that this representation is exercised effectively and best contributes to the enhancement of board skills, information and independence.

6.4.7 Motivation and Rationale of OECD

The subsections above discussed and summarised the main OECD principles of corporate governance. This section is devoted to discussing the motivation and rationale for employing OECD principles as evaluative standards in this research. It will be argued here that these principles have a number of characteristics which offer them a peculiar position globally, including:

1. The OECD principles as intended as benchmarks to policy makers in their pursuit to strengthen and enhance the efficiency of their national corporate governance systems. In comparison to other international standards, such as the Cadbury and Greenbury reports discussed in section 0 the OECD principle address the standards which national corporate systems should attain whereas those reports contain Best Practice Codes which corporations are required or encouraged to comply with. The point is not simply the whether the standards are imperative or optional. Rather the main point of difference between the OECD and other standards is hierarchical in the sense that other standards provide what may be called primary obligations whereas the OECD could more appropriately be described as met-legal standards in the sense that they do not apply directly to corporation; rather they do so through the medium of the national legislative and regulative framework of corporate governance.
2. In addition, the OECD principles have engendered global interest and are widely being incorporated into regional and national regulatory framework. As it has already been mentioned, these principles have been adopted, *inter alia*, by the Financial Stability Board as one of its Key Standards for Sound Financial Systems[342] and form the basis for the World Bank Reports on the Observance of Standards and Codes (ROSC)[343] in the area of corporate governance.
3. While they are designed to set globally applicable standards, the OECD principles are characterised by flexibility and attention to the requirements of

[342] See (n 336).
[343] See (n 339).

particular legislative or regulatory systems of corporate governance. Therefore instead of rigid uniform application the principles allow adaptation and tailoring to the needs and requirements of various national systems.

4. The principles are also characterised by being regularly reviewed and developed. There are also discursive in the sense that consultation is an essential characteristic of their development. In addition to this, the principles are characterised by accessibility. For example, there are around 17 language texts- including Arabic- which can be downloaded from the official website of the OECD.

6.5 Islamic and OECD principles: a comparison

The discussion in the preceding sections in this chapter demonstrates substantial comparability between Islamic values and principles pertaining to good corporate governance and the international standards codified into the OECD principles discussed in section6.4. Yet, there are also some differences. This section will accordingly be devoted to a summary comparison between the compatibility and the differences between the Islamic and the OECD principles of good corporate governance.

6.5.1 Compatibility between Islamic and OECD Principles

The issue of compatibility between Islamic and OECD principles has been discussed by a number of authors[344] albeit with a characteristic focus exclusively on the similarities of their respective regulative import, i.e. *substantive* compatibility. In this thesis a distinction is proposed between *formal* and *substantive* compatibility in order to shed light on another dimension of compatibility between Islamic and OECD principles which has not been explicitly noted by previous students of the subject.

6.5.1.1 Formal Compatibility

As mentioned above, substantive compatibility between Islamic and OECD principles has been the dominant trend in comparative efforts of these two sets of principles. However, the generic model of corporate governance proposed in

[344] See e.g. (n 208).

section (2.4.1) lends a distinct perspective through which another aspect of compatibility emerges, namely a formal compatibility between Islam and OCED principles.

The OECD principles and their underlying pillars of corporate governance are both regarded as meta-legal principles as discussed in sections 2.4.2. As such these principles designate the basic principles which underlie corporate legal frameworks, or upon which national corporate laws are to be formulated.

This same characteristic also applies to Islamic principles of corporate governance since the legal character of these principles should equally constitute the Islamic foundation on which national corporate governance frameworks may be established. Thus, the Islamic principles may be applied across a broad range of national jurisdictions. The ensuing national laws need not necessarily be uniform since the operationalization of the Islamic principles can be adapted to the conditions and requirements of individual national jurisdiction.

6.5.1.2 Substantive compatibility

As already noted above, substantive compatibility relates to similarity of the regulative import of Islamic and OECD principles. These similarities can be summarised in the following table:

Table 2 Substantive similarities between Islamic and OECD Principles

OECD Principle	Islamic Principle
Principle One: Ensuring 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 Shari'a • Believes in profit and loss • Primacy of Justice and social welfare with social and spiritual obligations • Prohibition of interest
Principle Two: The rights and equitable treatment 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
Principle Three: Institutional investors, stock markets and other intermediaries. • Protection to minority and foreign shareholders	• Just and fairness of value • Equitable distribution of wealth to all stakeholders and disadvantages members in the form of Zakat and Sadqa • Social and individual welfare with both spiritual and moral obligation • Sensation of Equality
Principle Four: The role of stakeholders in corporate governance.	• Islamic accountability with social welfare orientation

• In creating wealth, jobs and sustainability of financially sound enterprises.	• Conciouness of permitted and prohibited acts • Social and individual welfare from both spiritual and material perspectives. • Consideration to whole community.
Principle Five: Disclosure and transparency. • Matters regarding corporation • Financial situation • Socio-economic objectives related to firms' control and accountability to all its stakeholders • Performance, ownership and governance	• Accountability with Shari'a compliance • Justice, equality, truthfulness transparency • Wider accountability with written as well as oral disclosure.
Principle Six: 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 co-operation • Consultation and consensus seeking for each decision with related stakeholders

7. Models of National Corporate Governance Systems

An important methodology in this thesis is to employ comparative analysis of cross-country experiences of corporate governance implementation in order to inform and enlighten policy options for the reform of the Saudi corporate governance system. However, the sheer number of corporate governance application in national jurisdictions of Muslim, European, African, American and other countries renders comparison with individual countries impracticable for the purpose of this thesis, especially as it has already been remarked that there are as many corporate governance systems as there are countries.[345] Another more reasonable alternative is to restrict comparison to a limited set of selected countries. However, this latter option raises the question of the appropriate selection criteria of inclusion and exclusion of countries.

An even more reasonable option is to undertake the comparison not with individual jurisdictions but rather between models of national applications of corporate governance. This approach is considered more efficient and methodologically more sound since each model of corporate governance applies to a considerable number of countries. Thus, the experience of a great number of countries worldwide can be covered through the discussion and analysis of a handful number of models.

Naturally, the application of corporate governance standards in national jurisdictions varies considerably from one country to another. This is due to differences in history, economics considerations but also due to differences in legal and political culture. This chapter will be devoted to the discussion of the main and widely discussed national application models of corporate governance including the following:

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[345] See (n 19)

- The 'Legal Origins' model discussed in section (7.1)
- The institutional v the legislative (section 7.2)
- The enabling v the mandatory model (section 7.4)
- Emerging economies model (section 7.5)

There are a few remarks about these models worthy noting from the outset. First, there is substantial overlap between the various models mentioned above to the extent that they me be regarded as different facets of essentially the same argument, varying in emphasis or in respect of the supporting evidence. Second, the models are almost invariably discussed in binary opposition between alternatives such as e.g. the common v the civil law model, etc. Notwithstanding, the matter should not be understood as a black- or- white kind of choice, as the characteristics of the opposed models seem to overlap in some instances, i.e. jurisdictions of the institutional approach might for certain purposes adopt certain treatment that fall classically under the characteristics of the legislative approach and vice versa.

7.1 The Legal Origins Model

The analysts Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny (known as LLSV for short) argued in a number of articles[346] for a model of corporate governance defined by what they term as 'the legal origin' of the system. The authors focus their analysis on the distinction, broadly made, between the 'common law'

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[346] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny. 1997. "Legal Determinants of External Finance." *Journal of Finance*, 52(3): 1131– 50. ; 1998. "Law and Finance." *Journal of Political Economy*, 106(6): 1113–55. ; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny. 1999. "The Quality of Government." *Journal of Law, Economics, and Organization*, 15(1): 222–79. ; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny. 2000. "Agency Prob- lems and Dividend Policies around the World." *Jour- nal of Finance*, 55(1): 1–33. ; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny. 2002. "Investor Protection and Corporate Valuation." *Journal of Finance*, 57(3): 1147–70. Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer The Economic Consequences of Legal Origins, (June 2008) *Journal of Economic Literature, Vol. XLVI*.

and the civil law. While the 'legal origins' thesis discussed in this section overlaps with other models discussed subsequently in this chapter, the LLSV approach is defined by the following main characteristics:

First, the LLSV approach is based on the difference in legal culture which underlies the common and civil law traditions. Admittedly, the common and civil law may be distinguished from varying perspectives with respect to their intrinsic attributes. The emphasis of the LLSV in more on the legal tradition and legal culture or 'origin' which determines certain legal orientation and regulation.

Second, while other authors tend to rely more on theoretical arguments and evidence, the approach of LLSV is characteristically empirical rather being merely theoretical.

7.1.1 The main thesis of LLSV

The LLSV thesis is centered on the main argument, supported by empirical evidence, that legal rules protecting investors vary systematically among legal traditions or origins and that rules originating in English law are more protective of investors than the laws of civil law generally and French civil law particularly. While legal tradition and culture may extend beyond legal rules[347], the LLSV conclusion is evidently based on the assumption that legal rules governing investor protection can be measured and coded for many countries using national commercial and corporate laws.[348]

It is worth noting that while the common is defined as 'the English' and the civil law as 'the French', both legal traditions were introduced into various countries around the globe through conquest and colonization but also through voluntary adoption,[349] these

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[347] See e.g. the distinction between legal rules ad principles in (2.4.4.1).
[348] Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer The Economic Consequences of Legal Origins, (June 2008) *Journal of Economic Literature, Vol. XLVI* p 285-6.
[349] The transplantation of the French civil law system into commercial laws in Saudi Arabia (see section 1.1.2.1) is an example of voluntary adoption of this system.

systems are regarded as largely exogenous to the majority to which they currently apply.

Moreover, LLSV adopt a broad conception of legal origin defined as a style of social control of economic life. They strongly argue that common law stands for the strategy of social control that seeks to support private market outcomes, whereas the civil law, contrarily, seeks to replace such outcomes with state-desired allocations.

The civil law tradition is regarded as historically the oldest, the most influential, and the most widely distributed around the world, especially after so many transition economies particularly in Eastern Europe have returned to it. It originates in Roman law, uses statutes and comprehensive codes as a primary means of ordering legal material, and relies heavily on legal scholars to ascertain and formulate rules. Furthermore, the process of dispute resolution in the civil law tends to be inquisitorial rather than adversarial.

In contrast to common law, “French civil law developed as it did because the revolutionary generation, and Napoleon after it, wished to use state power to alter property rights and attempted to insure that judges did not interfere. Thus, quite apart from the substance of legal rules, there is a sharp difference between the ideologies underlying common and civil law, with the latter notably more comfortable with the centralized and activist government”.[350]

[350] Paul G Mahoney, “The Common Law and Eco- nomic Growth: Hayek Might Be Right.” (2001) *Journal of Legal Studies*, 30(2): 503–25. (quoted in LLSV The Economic Consequences of Legal Origins, (June 2008) *Journal of Economic Literature, Vol. XLVI*).

7.1.2 Empirical outcomes of legal origins

In both the common and the civil law, the links between the underlying legal origins to economic outcomes in the real world is not direct but is mediated through particular legal rules. Thus, LLSV follow a two stage procedure: they first consider the effect of legal origins on particular laws and regulations, and then the effects of these laws and regulations on the economic outcomes that they might influence most directly. The evidence out of this procedure showed the following:

1. That legal investor protection is a strong predictor of financial development. The authors found that the protection of investors, i.e. shareholders and creditors, is not only strongly related with financial development but also that differences can be explained by legal origin. Having examined 49 countries, their result was that Common Law countries protect shareholders and creditors better than Civil Law countries (especially the French ones).
2. That the influence of legal origins on laws and regulations is not restricted to finance. Several studies conducted jointly by LLSV and other revealed that such outcomes as government ownership of banks, the burden of entry regulations, regulation of labor markets, incidence of military conscription, and government ownership of the media vary across legal families.
3. In all the above spheres, which extend beyond the finance sector, the civil law is associated with a heavier hand of government ownership and regulation than common law. Many of these indicators of government ownership and regulation are associated with adverse impacts on markets, such as greater corruption, larger unofficial economy, and higher unemployment.
4. In other LLSV studies, the evidence shows that common law is associated with lower formalism of judicial procedures) and greater judicial independence than civil law. The authors further argue that these indicators are in turn associated with better contract enforcement and greater security of property rights.

In summary, compared to French civil law, common law is associated with (a) better investor protection, which in turn is associated with improved financial development, better access to finance, and higher ownership dispersion, (b) lighter government ownership and regulation, which are in turn associated with less corruption, better functioning labor markets, and smaller unofficial economies, and (c) less formalized and more independent judicial systems, which are in turn associated with more secure property rights and better contract enforcement.

Moreover, distinguishing feature of the two systems is articulated as follows: the, civil law is "policy implementing," while common law is "dispute resolving".[351] In the words of Katharina Pistor[352], the French civil law embraces "socially-conditioned private contracting," in contrast to common law's support for "unconditioned private contracting". The German legal system of corporate gveornance will be discussed in the section (7.1.5) as an example of the civil law tradition.[353]

7.1.3 Criticism: the legal origins thesis reinterpreted

The legal origin thesis has generated significant interest, debate and criticism in the literature. The major criticism came from a theoretical[354] and an empirical[355]

[351] Mirjan R. Damaška, *The Faces of Justice and State Authority: A Comparative Approach to the Legal Process*. (1986).New Haven and London: Yale Uni- versity Press quoted in LLSV The Economic Consequences of Legal Origins, (June 2008) *Journal of Economic Literature, Vol. XLVI*).

[352] Katharina Pistor, 2006. "Legal Ground Rules in Coordinated and Liberal Market Economies." In *Corporate Governance in Context: Corporations, States, and Markets in Europe, Japan, and the US*, ed. Klaus J. Hopt, Eddy Wymeersch, Hideki Kanda, and Harald Baum, 249–280. Oxford and New York: Oxford University Press.

[353] The German legal has basis in both the French legal system (due to invasion by Napoleon) and the Roman Law, see. LLSV (n 351 p 289-90).

[354] Mathias M. Siems, Legal Origins: *Reconciling Law & Finance and Comparative Law*, Center for Business Research, University of Cambridge (March 2006), Working paper No. 321.

perspective. These criticism challenge the categorization of legal families and the legal origin belonging of individual countries as well as the outcome of the legal origin thesis.

7.1.3.1 Challenges

One of the main theoretical critic came from comparative law comentators. Mathias Siems contributed a number of articles challenging and reinterpreting the legal origins thesis.

For modern comparative lawyers, this revival of “legal families” through the “legal origins” debate is considered surprising as they increasingly emphasize that law is becoming international, transnational, or even global, so that looking at legal families is seen as less important one could first of all doubt the explanatory force of legal families. Indeed there are scholars who emphasize that other aspects, such as politics, culture, religion, and geography, are considerably more important than the belonging to a particular legal family. The main criticism of the legal origins can be summarised in the following points:

1. Improper categorization of countries and their legal origin belonging. The legal origins thesis is criticised for improper classification of individual countries with legal families (Common and civl law). As a result, it appears strange that according to legal origins advocates that Latvia and Taiwan as well as Lithuania and Syria are, for example, put into the same legal box, but Latvia and Lithuania are categorized differently. This insight can also be extended to other Eastern European countries because here too there is often a mixture of different influencing factors as well as specific features which are dissimilar to the established Western European legal families.

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[355] John Armour, Simon Deakin, Prabirjit Sarkar, Mathias Siems, and Ajit Singh, *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis*, Center for Business Research, University of Cambridge (December 2007), Working paper No. 358.

2. A mere categorization of a system as English Common Law or French Civil Law disregards again deeper legal structures, such as the question how courts work or how new law, old law and customs interact. Thus, the fundamental question how the imposed new legal traditions mixed with chthonic and Islamic legal traditions.
3. As a result, Mathias Siems concludes that the law and finance categorization of legal families which aims to cover most countries of the world, is to a large extent just arbitrary.[356]

7.1.3.2 Reinterpretation

It is worth noting, however, that Siems does not dispute the essential contention of the legal origins thesis that "a country's legal heritage shapes its approach to property rights, private contracting, investor protection, and hence financial development'. Rather, his criticism is about the categorization of countries and the use of legal families as explanatory tools. According, Siems looks for characteristic features which are more precise than the use of legal families as such in explaining the outcomes claimed by the legal origins thesis.

It is difficult, Siems claims, to establish commonalities and heritage between legal systems. It is difficult to establish in equal terms the Roman Law origin of both the French and the German systems. Moreover, even the common law could be argued to have some Roman law influence. Equally, laws of different countries categorized within the same family are distinctly influenced by local variables such as culture and language which influences their legal language vocabulary and concepts differently.

Thus, Siems suggest alternative variables used to reinterpret the data including: countries by "colonization", "language", "importance of statutory and case law" and "formality and flexibility of legal systems" as proxies for legal origin.

[356] Siems (n 354) p. 7.

7.1.4 Relevance of legal origin to the analysis of the Saudi legal system

Worldwide expansion of the common and civil law represents voluntary and involuntary transmission legal origins or traditions across human populations. One of the consequences of this expansion is that some national legal systems are sufficiently similar in some critical respects to others to permit classification of national legal systems into major families of law characterized be the following criteria: (1) its historical background and development, (2) its predominant and characteristic mode of thought in legal matters, (3) especially distinctive institutions, (4) the kind of legal sources it acknowledges and the way it handles them, and (5) its ideology.

Notwithstanding the mixed nature of the Saudi legal system indicated in section (1.1.2.1), the adoption of some laws from one legal tradition into another with a different legal culture is not equivalent but rather leaves a particular tradition (usually the indigenous tradition) as the dominant one the country. It is therefore important to pose the question of the impact of legal origins debate on the Saudi legal system. In this respect, there are a number of factor which need to be taken into account, including:

1. In principle, there is agreement between the main presupposition of this thesis and a basic tenet of the legal origins thesis to the effect that there is a correlation between the quality of legal rules and positive economic impact. This thesis argues for an enhanced and a robust legal framework of corporate governance in Saudi Arabia to attract investment, increase growth and realize development goals. The correlation argued for by LSSV goes much deeper in claiming that the quality and economic efficiency of corporate governance rules is determined by their legal origin.
2. The Saudi system is based fundamentally on the Islamic legal system. Thus, Islamic principles constitute the foundations of Saudi legal culture which may not be surpassed or superseded by legal transplantation from the French civil law.

3. The Saudi legal system has a religious base. This is in contradistinction to the mainly secular base of both the common law and civil law, and several sub-traditions—French, German, socialist, and Scandinavian—within civil law.
4. Thus, the scope of influence of the legal origin and the French civil law in particular on the Saudi legal system can be expected to be confined to the commercial sphere. Moreover, even within this limitation, it should be remembered, that Islamic law constitutes the background against which particular rules and to be interpreted and applied.

7.1.5 Corporate Governance in Germany: Too Little Room for Change

Germany was always seen as a very traditional jurisdiction, which holds on certain traditions and inherited principles that cannot be eliminated without facing a grave public resistance. On the top of such traditions are the principles of co- determination that can be simply defined as the legal requirement that employers in a company participate in the decision making process, as well as the two-tier control over the company. The mentioned traditions, taken with the structure of ownership and control in the German market, imposed serious limitations that strongly tied the reform of corporate law and adaptation of corporate governance principles and norms.

This part of the research will start by giving a brief on the structure of ownership in the German economy to find out how this structure revealed the shortcomings of the system. However, as expected, such structure found many commentators to defend. Then, the research will advance to describe the two-tier system as well as the co-determination systems as legal requirements that give the corporate law in Germany its unique character. The research will also highlight the major drivers for reform and report on some of the efforts been made, on the top of which is the Corporate Governance Code, though it might be fair to say that the reform was very limited.

7.1.5.1 The Structure of Ownership and Control in German Market

A brief on the structure of ownership and control in Germany at the time reform was called for is important and of relevance to this research from two angles. On one hand, it shows how different the market is for a country that is well developed with regard to other aspects of doing business, and on the other, it shows the extent to which an effort for reform was needed.

The economy of companies limited by shares in Germany was very much concentrated. "There were 2,682 *Aktiengesellschaften* [(Companies limited by shares)] of which 501 were stock exchange listed. It seems that 90 percent of these listed companies are majorly owned by one or more active or controlling shareholders. Only sixty to seventy companies are really publicly traded companies, representing the largest German corporation. Institutional investors were present in the market; however they preferred investing in bonds, particularly governmental bonds over investing on shares."[357]

To look for such controllers over companies, it was not a surprise that such control was finance driven. Indeed, control was in the hand of banks. "Banks participation in industry and bank representatives sitting on supervisory boards happens frequently in Germany."[358] By this, banks were enjoying importance greater than they enjoyed in other countries. Another characteristic of German companies was the existence of greater number of large shareholders on the account of minor shareholders' participation, opposed to a small number of corporations.

Taking the above structure of the market in Germany into consideration, it seems that such institutional shareholders are not playing the 'market player' role they usually enjoy in a typical financial market.

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[357] Eddy Wymeersch, 'The Corporate Governance Discussion in Some European States', In Daniel Prentice and Peter Holland, (eds), *Contemporary Issues in Corporate Governance* (Clarendon Press 1993), 5.

[358] Klaus J. Hopt, 'Corporate Governance in Germany', In Klaus J Hopt and Eddy Wymeersch (eds) *Capital Markets and Company Law* (Oxford University Press 2005), 290.

7.1.5.2 Historical Traditions, the Inherited Becoming Inherent

There are certain aspects relevant to the structure and the method by which German companies were established and operated. These aspects are of historical origin and have become inherited in the system and conscience of all market players. Those factors, some being more important than others, need to be highlighted in the context of this research, as they might be a serious challenge for reform. On one hand, some of them are participating to some of the weak points of the system, and on the other hand, those may not be touched without resistance as they are seen as social necessities and sources of national pride.

Those factors are the obligatory two-tier board, the system of co-determination, and the lack of an effective legal treatment for takeovers.

While, as mentioned above, such factors are considered inherent in the culture of German economy, they are perceived by some observers to be "fossils from another age."[359] However, the bottom line is that such matters, in any effort for reformation, should be handled with caution. These factors will be further illustrated below.

7.1.5.3 The Two-Tier Board

Company boards in Germany have two organs, the supervisory board, or the *Aufsichtsrat*, and the management board, or the *Vorstand.*

The board of management is responsible for conducting the affairs of the corporation and representing the corporation in all matters. This is seen necessary to protect the shareholders from harmful decisions and to safeguard the interests of shareholders. What greatly aids in this is the great authority and control the board enjoys by virtue of law, while the supervisory board "has the responsibility of appointing the members of the second tier… The supervisory board is statutorily responsible for overseeing the

[359] Hopt (n 358) 290.

board of management, examining the operation books, reviewing its assets, giving approval for certain management decisions and calling shareholders' meetings when they are in the corporation's best interest."[360]

In what seems to be a projection of the agency theory into the situation in Germany to describe the two-tier board system, it was said that "In the German system, the shareholders have delegated the day-to-day management to the management board and have entrusted the monitoring to the supervisory board."[361]

"This separation of tasks between two organs – which is mandatory- is more than a hundred years old, and has never been seriously questioned in any reform of corporate law in Germany."[362] Therefore, it is legitimate to imagine that such a matter may not be subject to any reform, and that any relevant effort for reform will need to find a way around such a norm without changing the status.

One of the features that make the above illustrated board structure in Germany unique is that it is a statutory requirement in the full sense of the word as per the provisions of law which impose the two-tire board, composed of the *Aufsichtsrat* and the *Vorstand* as an inevitable requirement.

The rationale behind such an approach was to give shareholders the opportunity to have a representative body (*Aufsichtsrat* – supervisory board) to look after their rights and interests against the management board (*Vorstand*), with a view, back to the projection of the agency theory, to negate the agency problems between investment and management.[363]

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[360] Franck Chantayan, 'An Examination of American and German Corporate Law Norms' (2002) St. John's J. Legal Comment, 431ff.
[361] Hopt (n 358) 292.
[362] Ibid.
[363] In similar meaning Theodor Baums, 'Corporate Law Reform in Germany' (September 25, 2002) <www.ssrn.com/abstract=329962> accessed on 20/11/2012

Unsurprisingly, a great debate has taken place as regard to such a system, but it was also said that "According to the overwhelming view in German practice and legal theory has clear merits and should not be questioned"[364] as it is likely to contribute to a healthy relation between employees and investors; thanks to the principle of co-determination.

7.1.5.4 The Principle of Co-Determination

The principle of co-determination as known in the German corporate law can be defined as the right of employees to participate in the decision making process with regard to the companies in which they work. More particularly, it refers to their right to elect their representatives in the supervisory boards in certain companies, such as large enterprises and enterprises which belong to the coal and steel sectors in specific.

Therefore, the discussion of such a feature is closely relevant to the above description of the system of two-tier boards, "essential to the understanding of the system are the rules relating to co determination… half of the *Aufsichtsrat* members have to be elected by the shareholders, the other half by the employees. However, the shareholders maintain the last say, whether as a consequence of the chairman's casting vote, or due to the rule subjecting major company related decisions to their agreement."[365]

Again, such a feature is highly supported and defended in the German society where the work force is a great segment of the public, and they have their influence on the decisions of a company, perhaps on the account of shareholders who do not enjoy such an influence in company's decision making

In defending such a norm by German corporate law, as opposed to the applicable norms in the UK, it was said that, "the co-determination system means that elected workers' representatives have more far reaching information, consultation, and veto

[364] Hopt (n 358) 303.
[365] Wymeersch (n 357) 11.

rights on certain issues than those in a country like Britain where there is only one board of directors representing the shareholders' interests."[366]

7.1.5.5 Drivers for Reform

The reasons that called for corporate law reform in Germany were not a surprise. Some of the major drivers for reform are similar to the reasons which call for reform in the traditional case, i.e. companies collapsing on the ground of criminal behaviour from the part of insiders. There is a greater merit in the competition of regulators, that is, to provide an appealing profile for investors to have their companies based in Germany, and the desire to greaten the value of assets for the benefit of right holders.[367]

Beside the above 'classical' reasons calling for corporate law reform, there are other reasons that stem from the locality of the German experience to a great extent. Such reasons relate, either directly or indirectly, to the inherited traditional features of corporate law system that Germany have had, as was illustrated above. Such reasons were best summarized by Theodor Baums in his article 'Company Reform in Germany':

German companies were expanding and at certain point in time, some German companies looked for listing in financial markets of other countries, and at this point in time in particular, the German companies realized that they apply different norms from those internationally recognized norms, and therefore needed to effort to develop norms that are more homogeneous with those applied in the rest of the World.

Multinational institutional investors based outside Germany were engaged in the acquiring shares and interests in German companies, indeed, they "bring their

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[366] Ulrich Jürgens and Joachim Rupp, 'The German System of Corporate Governance: Characteristics and Changes' (2002) WZB Discussion Paper, No. FS II 02-203, 11 <http://www.econstor.eu/handle/10419/50757> accessed on 22/12/2012

[367] For further details on these reasons, see Baums (n 363).

international market expectations into the German market"[368] thus needing to be assured and comforted that such rights and participations enjoy no less protection than that the same enjoy in other countries in the World.

Relevant to the reason above, Germany was heading more towards a pension system that is based on institutional investors, thus influencing the above illustrated structure of capital and ownership in the German market.

Last but not the least, more harmonization of corporate law is taking place all across the continental Europe as regard to the application of the relevant directives.

7.1.5.6 Acknowledging the Need for Reform, Finding the Elephant in the Room

There were certain shortcomings and areas for improvement that faced less resistance when they have been examined for reform. Many commentators admitted the need for introducing amendments to the then in force framework. These amendments are the following:

Modest Confidence amongst the Public in the German Financial Market, or More Particularly the Market for Shares; and the Less Developed Market.

In the study of De La Porta and others, there were links between development of the financial market and certain factors that indicate the protection of the shareholders; Germany did not enjoy an advanced rank. Many of the factors discussed herein contributed in such a result.

This modest confidence is a reflection for the structure of the market. At some point in time, there were only 501 limited by shares companies that were listed in the market, out of 2682 total number of such companies.[369]

[368] Ibid 3.

In Germany, share ownership is heavily concentrated with over half of all shares being owned by (non-financial) companies, banks and insurance companies. Whether companies are financial or non-financial, they are often part of networks of cross holdings where the main motive of shareholding is to strengthen long-term relationships and business interdependencies, which is a behaviour that involves long-term commitment. In Germany, only a minor role is played by the value orientation that focuses on return on equity and the value-based behaviour of trading stocks.[370]

The Need to Create an Appropriate Framework for Takeovers or for the Market for Control

Companies are being taken over, not on the public market, but because of private negotiation between present and future controlling shareholders.[371]

The Influence that Banks Had

The influence that banks have had was illustrated when describing the structure of the market in Germany above. In particular, "the critics… find faults with the combination of lending, bank participation, chair, and seats on many supervisory boards, and the 'depository vote', i.e. the banks exercise through their investment company subsidiaries."[372]

The Dominance of Obligatory Rules

The scene in Germany was indeed marked with "too much regulation and jurisdiction." The corporate governance system in Germany is based heavily on mandatory law that was likely to result into the absence of flexibility and "paralysis of initiative and the

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369 Wymeersch (n 357).
370 For more details, see Jürgens and Rupp (n 366).
371 Wymeersch (n 357) 5.
372 Hopt (n 358).

market forces."[373] A clear example of this is the above illustrated two-tier board system, which is still obligatory in Germany.

7.1.5.7 Reform Efforts

It might be strange that, in the case of Germany, the description of the problem was more important than highlighting on the efforts for solution, as the *status quo* represented major challenge that reformers needed to take for granted and find their way around it. There were various efforts that took place in Germany to find solutions to the above problems. The introduction of the Code of Corporate Governance was an important effort, but, with the dominance of the obligatory rules in the system, the introduction of such a code might be strange, i.e. as per the above experience of the UK. A code is usually introduced to fill the gaps that a less mandatory system leaves.

This part of the research will give a little brief on the Code and shed light on the efforts made to deal with the major problems illustrated above.

The Corporate Governance Code

The Corporate Governance Code is the result of the work of a governmental committee formed for this purpose; it was adopted on February 26, 2002, and was last amended in May 26, 2010. Its major purpose was to govern the issues concerning German listed companies and give a considerable deal of attention to the matter of the board and its duties. The code contains two categories of provisions; the obligatory provisions that apply on comply- or- explain basis, and the recommendations.[374]

The code addresses the issue of the need of building confidence in the German stock market by providing for the rights of shareholders to vote as well as their rights with regard to the general meetings.

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[373] Hopt (n 358) 298.
[374] The Forward of the Code <http://www.corporate-governance-code.de/eng/kodex/1.html.> accessed on 20/12/2012

The code then addresses the issue of the two-tier board. It maintains it with no amendment, and provides in Section 3.1 thereof that the two boards shall cooperate closely to the benefit of the enterprise.

The code describes the duties of the two boards as stated above, and it provides that the members of the two boards should cooperate, which in general gives the more important mandates to the supervisory board. Other than that, the code goes too little behind listing ordinary and internationally recognized norms.

It also provides for the composition of the two boards and the financial entitlements of its members, and then it advances to tackle the issue of members of the boards having conflicting interests, the transparency and the flow of information, and then the matter of auditing financial statements.

The Co Determination

As regard to the principle of co-determination, it still survives as it is with commentators strongly supporting it. It was even defended by saying that "getting rid of the system will do nothing to improve the quality of the supervisory boards that are supposed to monitor company performance."[375] However, it will remain a matter of deep debate with too little to be done.

The Influence of the Banks

As regard to the great influence that banks enjoyed, an initiative to dismantle the power of banks was rejected by the Parliament. The Takeover Regulation and for the regulation of takeovers, Germany introduced some amendments on the ground of the need to modernize the law to make available a market for control, as well as to stay in

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[375] 'In defence of Germany's economic dinosaur' *The Telegraph* (London, 24 May 2007) <http://www.telegraph.co.uk/finance/economics/2809429/In-defence-of-Germanys-economic-dinosaur.html> accessed on 25/12/2012

pace with the relevant EC Directives. It, therefore, replaced the non-binding takeover code with the takeover act of 2002.

7.1.5.8 The German Experience: A Note of Assessment

Germany is a clear example were the resistance for change is high, and the traditions and social pressures impose great challenge for any effort for reform. With regard to the above illustrated norms that might need to be adjusted with the international best practices, many studies were made and recommendations were published, but advancement in change was very little.

An important remark was the high dependence of the German System on the mandatory rules. However, when the corporate law reform was an international trend, Germany introduced a Code of Corporate Governance that difficultly found its way in the obligatory system.

Taking into consideration all the opinions that favours the traditional approaches, what should separate an effective norm from a less effective norm should be the participation of such a norm in greatening the value of the company, as per the thesis of De La Porta and others. This value needs certain attention in Germany.

7.2 The Institutional v the Legislative Model

However, two major approaches can be seen in the international experience in this regard; the institutional approach, which is a 'market-oriented model that relies on relatively little mandatory law to protect shareholders …. [and] depends on a host of other formal and informal mechanisms, such as incentive-based compensation and hostile takeovers, to hold managers and directors accountable'.[376] The legal approach depends on a mandatory model of corporate law in which the state, as opposed to the

[376] Troy A. Paredes,'Corporate Governance and Economic Development' (2005) *Regulation*, Vol. 28, No. 1, pp. 34-39.

marketplace, plays a central role in shoring up shareholder protections by fashioning mandatory rules that define shareholder property rights.[377]

The institutional model of corporate governance is characterised by its reliance more primarily on market institutions and non-official methods than on official statutory laws to regulate the conduct of corporate governance. Such methods can be rooted either in practices that constitute customs developed over time and recognised by case law, or in practices that depend on the moral and conscious determination of the managers and directors on what is considered right and wrong, i.e. norms. Such methods might also be oriented by incentives granted to motivate managers' compliance and endeavours in working for the good of the company and for the realization of profits for shareholders. A good example of the institutional model prevailed under the Corporate Law of Delaware in the USA discussed below (7.3.1).

Contrarily, the legislative or legal model is characterised by the substantial weight it gives to mandatory and regulatory provisions dictating managers and officers' duties and obligations. Unlike the institutional model it relies more on the use or legal instruments to regulate and implement corporate governance.

7.2.1 Characteristic of the institutional model

7.2.1.1 This Model Suits Developed Economies

As stated above, the institutional approach consists of a number of elements that participate in forming an integrated governance system that exists beside the law. The law in this regard is 'simply one part of a much more complex set of formal and informal institutions'.[378] It can even be said that such a role that the law plays is even secondary,

[377] Ibid 34.
[378] See (n 476).

meaning that the law will not function in the absence of such other factors, which 'work together to create a whole that is greater than the sum of its parts'.[379]

The USA model of corporate governance under the Corporate Law of Delaware[380] is often discussed as a primary example of the institutional model for two main reasons:

1. The U.S. market is considered an advanced market to a degree that it developed mechanisms that compensated for the absence of mandatory rules, and it provides a good a degree of protection for shareholders' rights through certain powers that they can exercise.
2. It was foreseen that companies should also be given some liberty to tailor their mechanisms and rules to their own needs. It was, therefore, fairly said that 'companies have different business needs, different corporate cultures and ways of doing things, and different people and personalities, all of which are subject to change'.[381] Reflecting this understanding, Section 141 (a) of Delaware General Corporation Law provided that 'business and affairs of every corporation ... shall be managed by or under the direction of a board of directors', giving director so wide discretion, that is however not left without any caps. Such caps will be further detailed below.

As stated above in discussing the components and the complements of the institutional model, such an approach consists of a wide spectrum of components that are spread over legislations, case law, personal consciousness of directors and managers, market factors, institutions, fiduciary duty, etc. markets develop The combination of these mechanisms are developed gradually by markets over time. The economic activity always comes to existence before the law thereof, which then comes to cure any

[379] Ibid.
[380] See section 7.3.1
[381] Parades (n 476); Manning, Bayless 'The Business Judgment Rule and the Director's Duty of Attention: Time for Reality'(1984) *Business Lawyer* - BUS LAWYER. 39. 1477-1501.

distortions. Economic activity in this sense advances the legislation; therefore, a system may not depend on such factors unless these factors are well rooted. For example, an important character of the institutional system is the *autonomy* that is given to the managers to run the company though such an obligation was stated by the less extensive provisions of law. It is the set of customs, which were well-developed over time that set for directors how this duty is to be discharged. It is fair to say that directors should do so with *observing their fiduciary duties.* Again, fiduciary duties relevant to the execution of the mandate of the directors and officers are a concept that developed over hundreds of years in time.

7.2.1.2 The institutional model suits common law countries

The distinctive feature of common law that is relevant to the subject matter of this research is that it consists of the law of the courts as expressed in judicial decisions. The grounds for deciding cases are found in precedents provided by past decisions, as contrasted to the civil law system, which is based on statutes and prescribed texts.[382]

The common law is formed by judges, who have to resolve specific disputes in particular cases. Precedents from judicial decisions, as opposed to contributions by scholars, shape common law.[383] However, it has been remarked that common law courts are not absolutely bound by precedent, but can, for demonstrably good reason, reinterpret and revise the law, without legislative intervention, to adapt to new trends in political, legal and social philosophy.[384] In this sense, the difference between the institutional and the legislative approach of corporate governance seems to be a reflection to this classical difference between Civil law and Common law approaches. What is considered as good governance is a concept that develops over time.

[382] William Tetley, 'Mixed Jurisdictions: Common Law vs. Civil Law (Codified and Uncodified)' (2000) LA. L. REV. 591
[383] Porta and others (n 479)
[384] Sarah Owen, *The Complete Guide to Investigations and Enforcement* (Lulu.com 2010), 33.

Therefore, what courts consider to be a good observation to the fiduciary duty also develops in the eyes of common law judges who actually state what is right and what is not. Common law judges can use flexible fiduciary duties to root out more effectively insider abuses by filling the inevitable gaps left by statutes. Civil law judges, on the other hand, are relegated to interpreting the relevant code and have less flexibility to apply general standards of loyalty, due care, and good faith to fill problematic gaps.[385]

Parades also expressed a view that, when compared to civil law countries, the common law countries demonstrate greater respect for individual autonomy over governmental authority. Accordingly, property rights are more secure, particularly from state expropriation, in common law systems, and the state is less intrusive in economic and commercial affairs, leaving these matters to the private sector.[386]

7.2.1.3 The contractual character of the model

As already discussed, shareholders own the corporation and accordingly, directors and officers are regarded merely as stewards for the shareholders' interests. An alternative view describes the shareholders as merely one of many factors of productions bound together in a complex web of explicit and implicit contracts. However, as per the agency theory discussed in this research, others perceive directors and officers as agents of the shareholders, with fiduciary obligations to maximise shareholders wealth. Accordingly, shareholders retain a privileged position among the corporation's various constituencies, because their contract with the firm has ownership- like features, including the right to vote and the fiduciary obligations of directors and officers.[387]

[385] Parades (n 476), 1069.
[386] Ibid. 1070.
[387] See Stephen M. Bainbridge, 'The Board of Directors as Nexus of Contracts: A Critique of Gualti, Klein and Zolt's "Connected Contracts" Model' (January 2002) .<http://papers.ssrn.com/sol3/papers.cfm?abstract_id=299743> accessed on 01/01/2012.

Management can be perceived as a correlative relation. That is, it is simultaneously a duty on managers and a right that is vested with shareholders. However, for the lack of time and experience[388], the shareholders delegate the management to a board of directors who will supervise the operation of the company, as such operation is executed by managers. In return of their efforts in executing such delegated duties, managers are granted a set of incentives, but they are under the supervision of the shareholders as can be exercised, for example, in general assembly meetings.

The contractual approach in this meaning refers to the liberty that founders of a company (naturally institutional founders in particular can be more influential in this regard) have in order to set what they believe better serves the good governance of the company. Legislation may contain voluntary rules and leave to the founders and the shareholders the liberty to decide on the articles of incorporation of the company. Founders can also choose the way in which they intend to fill the gaps that are left by the less comprehensive pieces of legislations when a company founders are willing to set certain rules that go beyond that minimum standards set by the law. Further, and as the institutional approach is more described as an enabling approach, it leaves some room for the parties to contract against such terms without this be seen as a breach of the law, and without this resulting into the imposition of a penalty.

7.2.1.4 Managers autonomy and non- legislative compliance tools

In a well-established, mature financial market, managers are expected to possess and demonstrate awareness of what their mandate implies in terms of professional capabilities or ethics. It can be said that certain values have autonomously developed with time to form an integral part of the consciousness of managers to observe good governance practices. The U.S. corporate governance system relies on directors and

[388] In the same meaning, Parades (n 476).

officers to do the right thing" by voluntarily taking steps to maximize firm value even when nobody is watching and there is little of any risk of market or legal sanction'.[389]

What makes a right thing in this context may vary. Such a notion is 'defined by circumstance, psychology, and culture'[390] and, therefore, such a concept might be difficult to shape or describe precisely. However, these notions of norms and professionalism are softer and less well understood than the other institutions, but that doesn't mean that they're absent, or that they're unimportant.[391]

Another factor that might be relevant in this regard is the incentives that the institutional system grants to managers. Managers are compensated with financial and non-financial packages that make the good of the company a good for the managers at the same time; thus, motivating the managers to act in the best interest of the company in order to indirectly expand the benefits that they acquire.

Further, market forces and trends can also be seen as influencing factors in this regard. Taken with the reaction shareholders can take to respond to it, either through general assembly meetings or through exercising their choice in selling out the shares they own, shareholders still retain an important role to play. A well-stated example on the importance of such a factor was given by Parades;

> Companies need to be run efficiently and managed properly to succeed in a competitive marketplace. Further, if profits drop, a company should face a higher cost of capital, which could further impede its competitiveness against companies with lower cost structures and perhaps less constraining debt covenants and less burdensome principal and interest payments. If a company

[389] Ibid 1086.
[390] Mark J. Roe, 'The institutions of Corporate Governance' (Harvard, John M. Olin Center for Law, Economics, and Business, Discussion paper No. 488, 2004).
<http://www.law.harvard.edu/programs/olin_center/papers/pdf/Roe_488.pdf> accessed on 20/05/2012
[391] Ibid 13.

is not run well or its governance is questionable, its shareholders can always follow the "Wall Street Rule" and sell into the market, putting downward pressure on the company's share price. At some point the company might become a takeover target, in which case the board and top executives are likely to be ousted. Short of the company being acquired, the board might remove senior executives if the company's share price continues to fall. It is also possible for shareholders to elect new directors if they become dissatisfied with the direction in which the incumbent board is taking the company.[392]

7.2.1.5 The model does not imply the absence of a role for law

It should be first clarified that the description of the model as '*institutional*', and the fact that the approach does not give major importance to legal provisions may not mean that the law has no role at all to play. The United States, with its mature and well established financial market, represents a classical example of an institutional corporate governance system. Notwithstanding this fact, a major component of such a system is the law in a number of ways.

For example, corporate law plays a significant role in 'lighting the way' for directors and managers in practicing their duties and responsibility, and on the other, the U.S executed a *sui generis* act for corporate governance. To distinguish the role that law, in particular corporate law, plays in the institutional approach from that it plays in the legal-mandatory approach, and by taking the corporate law of Delaware as an example, it can be said that the role that the law generally plays under an institutional system is more an enabling role. In other words, it provides for the officers and the managers of a company the necessary freedom to manage the company the way they deem fit. The law in this context, unlike in the legislative- mandatory approach, will not look over-detailed to tell the directors what to do, but it may tell them what they should not do.

[392]Parades (n 476) 1086.

The role that the law plays differently in the two models was also linked to the timing on which the judiciary or even regulatory authorities as entities entrusted with the enforcement of good practices intervene to enforce the rules of corporate governance. The mandatory approach can be said to be more *ex ante,* meaning that it states what should be done in advance. The enabling approach concentrates more on examining the legitimacy of the actions taken in light of the parameters of good practices on an *ex poste* basis. It means that it gives weight for the enforcement efforts that take place after the actions were taken in the frame of dispute resolution procedures, either before courts regulatory authorities or alternative dispute resolution methods.[393]

Although this classical differentiation between the roles that the law plays in both approaches might be seen as logical and reasoned, it can be seen that the law is playing recently a more important role even in the countries with institutional approach.

The United States governance system responded to the economic scandals in the early years of the 2000s. For example, it responded to the scandals of Enron and WorldCom that raised questions and worries on the integrity of managers and officers and their observation of the good practices they are supposed to observe. Consequently, the protection that shareholders in publicly held companies enjoy against the misuses and the abuses of the managers, by further intervention from the side of the legislators in a more mandatory- like piece of legislation that aimed to restore confidence on the integrity of the U.S financial market after the mentioned scandals by issuing what is commonly called as "Sarbanes–Oxley" act, that was enacted on July 30, 2002.

Therefore, it was rightfully said that, 'many economists and legal academics contend that the law has a central role to play in protecting shareholders, especially minority shareholders, and thus in influencing corporate finance and ownership structures

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[393] For more on the differentiation between *ex poste* and *ex ante* intervention, see Cally Jordan, 'The Conundrum of Corporate Governance*'* (2005) Brooklyn. J. Int'l L, Vol .30, Issue 3, 983.

around the globe'.[394] Without such a result, the institutional approach loses its primer character, which is the voluntary commitment with the sound practices as opposed to the mandatory role of law.

7.2.1.6 The Role of Judiciary

Judges also play an important role in covering the matters that are left uncovered by the relevant pieces of legislation. When judges intervene to decide on whether certain practices are sound corporate practices or not, they are supposed to identify the rules constituting the standards for separating good practices from those that are not. They are also required to give the sufficient analysis and reasoning, by which they do not only decide on the particular matter in question, but they also set precedents that become a reference for good and sound practices for future instances alike. Therefore, they participate in the integration of the fresco of an institutional corporate governance complete system. As it has been remarked:

> [J]udges often express their views of the best corporate practices in dicta, laying out "roadmaps" instructing management how to conduct itself, while at the same time finding the defendants in the particular case at hand not liable.[395]

As to be further discussed below, judges in common law jurisdictions are expected to play a greater role in this regard, with less extensive pieces of legislations. Precedence, rules of equity, and most importantly, the overtime-shaped fiduciary duties, become sources of the commitment of good governance, as crystallised by judiciary into a considerable body of case law.

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[394] See (n 476), 1076.
[395] Ibid. 1090.

Again, reflecting this role that judiciary plays in the U.S corporate governance system, and in particular the experience of the judges of Delaware in this regard, it can be said that: ‘Delaware has a very well-developed body of case law, making it more rule-like. More importantly, a very sophisticated and experienced judiciary administers the law of fiduciary duties against the background norm of shareholder primacy’.[396]

It was seen as a draw back in this regard that such judicial control is ‘about procedural due care and not substantive due care’.[397] Courts review the decision-making process of directors and officers, but generally do not regulate the substance of their business decisions.[398] Though if this was considered to be right, I believe that this character can be seen coherent with the considerable degree of liberty granted to managers and officers to reasonably manage the company in the way they reasonably deem fit. Further, the following examples may be given as acts found in contradiction with fiduciary duties though they are not procedural in nature:

> Controllers who steal from the firm have typically violated one of those duties. Controllers who divert business opportunities from the firm to themselves will typically violate one of those duties. Controllers who force the firm to sell a product at a low price to the controller’s (or the controller’s relative’s) wholly-owned private firm will typically violate one of those duties.[399]

7.2.1.7 Supporting Institutions

As suggested by its name, the institutional approach will not be so without the role that various institutions will have to play in this regard. In this sense, institutions are among

[396] Ibid. 1082.
[397] Ibid. 1083.
[398] Roe (n 390).
[399] Ibid.

the various elements that the combination of which forms the integrated governance system in the institutional model.

The institutional model involves a number of institutions, including: the body of shareholders (both influential and non-influential), directors and managers, and each of which represents an 'institution'. However, for such institutions to play their role in corporate governance, every one of which should be aware of its roles and responsibilities. Such bodies can be and were described as influential, so as the well-developed relevant markets, i.e. a product market, a capital market, and a labour market. Add to these are the markets of management and control. Further, other private parties such as lawyers, auditors, accountants, consultants, bankers and other financial facility providers all play an important role in this regard and in forming an institutional approach of corporate governance.

Without denying the influential roles that the above mentioned *institutions* play in disciplining company controllers, there also exist official institutions that were formed and crystallized over time in developed markets to play a regulatory - supervisory role over the activities of company controllers.

7.2.1.8 Supporting Legal Duties

As already discussed, the adaptation of the institutional model does not mean the absence of any role for the law to play. As mentioned before, the institutional model is the result of combining various aspects and elements that are joint together to set what the discipline of managers and officers should look like. The Corporation Law of Delaware, which represents a remarkable example of the laws existing in the institutional corporate governance jurisdiction, provided the following:

> In addition to the powers enumerated in § 122 of this title, every corporation, its officers, directors and stockholders shall possess and may exercise all the

> powers and privileges granted by this chapter or by any other law or by its certificate of incorporation, together with any powers incidental thereto, so far as such powers and privileges are necessary or convenient to the conduct, promotion or attainment of the business or purposes set forth in its certificate of incorporation.[400]

It can be inferred from the above text that, while officers, managers, and shareholders enjoy all the powers and privileges provided under the relevant part of the law such authority is not absolute as it is tied with the condition that exercise of such powers is, as the text provides, necessary or convenient to the conduct, promotion or attainment of the business or purposes set forth in its certificate of incorporation.

Also, in the particular case of the United States, certain duties that Sarbanes- Oxley's act imposes some obligations on the officers which are not, as such, directly related to the powers of directors and officers. For example, section (303) of the mentioned act prohibits on officers and directors any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.

What can also be considered a good example of the mentioned is the enhanced requirements of disclosure and prevention of conflict of interest as provided for under title IV of the mentioned act. The same is also supplemented with the obligations imposed on directors by virtue of the Federal Securities Law, which "plays a critical role in U.S. corporate governance by ensuring that investors, with the assistance of the supporting institutions described above, have adequate information to exercise their rights to vote, sell, and sue."[401]

[400] 8 Del. C. 1953, § 121; 56 Del. Laws, c., 50.
[401] Parades (n 476), 1097.

7.2.2 Characteristics of the Legislative Model

The legislative or legal model for corporate governance application, as defined above, is characterised by the substantial weight it gives to mandatory and regulatory provisions dictating managers and officers' duties and obligations. It is a mandatory model of corporate law in which the state, as opposed to the marketplace, plays a central role in shoring up shareholder protections by fashioning mandatory rules that define shareholder property rights'.[402]

The crucial word in the above description of this approach is the word "mandatory." The term "mandatory" as used here means *legally mandated*, with penalties applying to those who fail to comply with the legal rule in question'.[403] Thus, it differs essentially from the institutional model which gives a considerable degree of freedom for the controllers of the companies to apply what they consider good, and enables decision makers of the company to apply what they deem most appropriate regarding the best interest of the shareholders. The role that law plays within the legislative model was rightly characterised as follows: 'the established legal regime is a command - and - control structure in which public officials establish the law and market actors either comply or face penalties'.[404]

With less liberty given to officers and managers to manage the affairs of the company, it can be said that this model is better described as a set of legislative and regulatory provisions that put, in mandatory way, what is permitted and what is not with regard to managing the affairs of a company. In doing so, the legislation can vary from being intensive subject, in the terms that it provides detailed description of what is permitted

[402] T. Parades 'Corporate Governance and Economic Development'(2005) *Regulation*, Vol. 28, No. 1, pp. 34-39.
[403] Anita Indira Anand, 'An Analysis of Enabling vs. Mandatory Corporate Governance: Structures Post Sarbanes Oxley' (2006) *Delaware Journal of Corporate Law* Vol 31, 229.
[404] Anita I. Anand, 'Voluntary vs. Mandatory Corporate Governance: Towards an Optimal Regulatory Framework' (2005- 06) Bepress Legal Series, Paper No. 566, 8 <http://law.bepress.com/expresso/eps/566> accessed on 20/06/2012.

and what is not, to the imposition of the applicable penalty in the case of non-compliance, or it can adopt a more enabling approach. In this last mentioned approach, the tool that contains the corporate governance provisions can best be described as a guideline, or a code of best practices rather than being legislation in the obligatory sense of the word.

7.2.2.1 Legal model Can be Prohibiting

The corporate governance system of the United States can be classified as an institutional jurisdiction, in particular with regard to the corporate law of Delaware as a clear example of such an approach, where a considerable number of U.S companies are registered. As the mentioned jurisdiction grants fewer rights to shareholders in favour of more freedom to officers and directors, the system of Delaware is frequently given as a classical book example of this approach. However, Sarbanes-Oxley Act that was enacted in the U.S on the federal level in the aftermath of a number of corporate crises gives a good example of a prohibiting and legally binding corporate governance law.[405]

7.2.2.2 Suitability for developing countries

Various streams of literature support the idea that a mandatory model is more appropriate for developing countries that lack the *complements* that make altogether the institutional corporate governance system. Developing countries are also keen, at the same time, to develop financial markets so that such markets will ensure the needed access to financing, and ultimately for financial markets in such developing countries to play their role in economic development. It was said in the regard of describing the behaviour of developing countries for adopting the legal approach that:

[405] Alan Calder, *A Practical Guide to the Legal Frameworks and International Codes of Practice* (Kagan Page 2008), 16.

> [I]f the state accords primary importance to a certain objective, such as investor protection, it will likely seek to ensure that this objective is achieved through mandatory legislation. The assumption is that the mandatory law is a means to achieve the goal directly because market participants will be compelled to comply with the law, not wishing to face the regulatory penalties for non-compliance.[406]

Shareholders still need to have the incentive to invest their savings in the financial markets in order to offer the needed financing for new companies to be established or for current companies to expand. Therefore, the law needs to provide a concrete, firm, and certain legal system to ensure such protection.

It was, therefore, said that the law is the element that matters in the development of financial markets and the protection of shareholders, which is commonly known as 'the *law matters* thesis'. Since non-controlling shareholders do not typically run the company day- today, the “law matters thesis” argues for legal protections that shield these shareholders from abusive practices at the hands of the insiders and controlling officers who actually run the business. For example, the law may protect shareholders from the following: excessive executive compensation; insiders’ placing friends and family in high-ranking positions; self-dealing transactions involving management; theft; and shirking by executives.[407]

7.2.2.3 Legal Approach Can Be Self-Enforcing

Jurisdictions can vary as regard to the approaches taken towards corporate governance. As indicated above, it is not a black -or– white kind of option. Even the jurisdictions that are considered classical examples of institutional approaches give certain weight to legally binding sets of legislations to tackle some certain matters that

[406] Ibid. 10.
[407] Parades (n 476).

should not be left to the company executives. The jurisdictions that adopt the legal approach can vary with regard to the degree to which the legal rules are intensive and mandatory.

In some countries, *corporate governance codes* were issued to address managers and directors. Those mentioned codes were issued in the form of recommendations or guidance for the controllers of listed companies to observe. A good example of the mentioned codes is the United Kingdom Corporate Governance Code issued by the Financial Reporting Council,[408] which was issued in June 2010. The code was described in paragraph four of the introduction thereof as a guide to a number of key components of effective board practice. It is based on the underlying principles of all good governance: accountability, transparency, probity and focuses on the sustainable success of an entity over the long term.

The Dutch Corporate Governance Code drawn by the Committee on Corporate Governance was also indicated as an example of this self-enforcing characteristic since it contains what can be described as recommendations for sound management, effective supervision and accountability.[409]

7.2.2.4 Characteristics of Developing Economies in Favour of the Legal model

The differentiation between institutional v legal model of corporate governance has enjoyed a considerable attention in literature in the context of discussing the matter of the suitability of the institutional approach, where law is only one element among the various elements that constitute the system, to the application in developing countries and emerging economies. Therefore, the characteristics of the legal model have always

[408] See section (7.4.1)

[409] Cornelis de Groot, *Corporate Governance as a Limited Legal Concept* (Kluwer Law International 2009) 57.

been linked to certain characteristics that exist in developing countries. It is worthwhile to highlight in this subsection additional elements and their link to the characteristics of developing countries in favour of the legal model towards corporate governance.

1. Immature Capital Markets

Many of the developing countries have a very short history of liberalising markets, and their economies are not equipped with the needed experience to deal with capital markets efficiently. Such developing countries are either ex- communist countries, as is the case of the member states of the former Soviet Union, or countries that are starting to adopt free market approaches where the state itself is withdrawing from being a market player by itself or from being an institutional holder of a considerable portion of publicly held companies.

This situation was best described by Troy Parades as follows:

> ‘to the extent developing countries have closed economies, protectionist trade policies, or businesses otherwise subsidized by the state, managers are insulated from the pressures of stiff competition for goods and services. ….. There is no reason to assume that the majority of companies in developing economies will be capitalized by selling common stock to public investors. Not every company is ready to be publicly held. Indeed, not every company capital needs merit a public offering’.[410]

Further, if the separation between ownership and control is an important value that the endeavours of corporate governance seriously focus on, such a matter does not enjoy

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[410] Parades (n 476) 1121.

the same important value where companies are, to a wide scale, privately held with considerable share either held by the government, an individual, or a family.

Therefore, Parades represents a trend of literature, in particular with regard to the well-established practices within the market. In this literature, it was argued that companies in developing countries are ready to turn into being publicly held and gain access to a pool of funding. Importantly, the state itself is not ready to surrender certain historical roles that it plays within financial markets.[411]

2. Lack of Institutions in Support of Good Governance

Similar to the above illustrated immaturity of capital markets in developing countries, it was also truly said that

> '[D]eveloping countries lack most of the formal and informal institutions that are necessary to complement an enabling corporate law, characterized as having relatively few shareholder protections to create an effective system of governance. Developing countries lack the capital markets and markets for corporate control that are keys to the U.S. system. Indeed, the whole point of the reform efforts is to create securities markets'.[412]

Therefore, a legal system should be available to compensate the lack of such institutions if a developing country is willing to adopt sound governance measures.

3. Limited Expertise

An institutional approach towards corporate governance is also supplemented with what is called a second-line institutions, which should be well educated, mannered, and

[411] Ibid.
[412] Ibid1105.

experienced in order to offer the needed support to the endeavours towards corporate governance. "The "second-order" institutions, such as investment bankers, accountants, lawyers, and the like, are largely non-existent in developing economies. At the very least, they are not as experienced and ubiquitous as in developed economies.[413]

Even investors who are turning to the financial markets to generate the profit that they are looking for might need some guidance, may be in the form of legal provisions, to be accustomed to the requirements and the ethics of financial dealings, and for their own protection alike. In a comparison in favour of the U.S market as a well-developed financial market, it was said that:

> U.S. capital markets are populated by sophisticated entrepreneurs, directors, officers, and financiers, not to mention sophisticated judges. Equally important is that U.S. capital markets are populated by what Ron Gilson calls "transaction cost engineers. Broadly speaking, these are the investment bankers, securities analysts, accountants, and lawyers.[414]

7.2.2.5 Nature of the Role of Judiciary in Civil Law Jurisdictions

A number of commentators argue that there the civil law tradition offer weak protection of shareholders. The generalized terms of this argument put forward by Parades and others seems to me questionable, in particular with regard to putting all the civil law countries in one basket and being labelled as developing countries with less shareholders' protection and applauding common law jurisdictions on the account of civil law jurisdictions. The differences between the two systems of law, and the role that judiciary plays in each, were the subject of deep and continued discussion.[415]

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[413] Ibid1107.
[414] Ibid 1111.
[415] See for discussion in this matter: *Legal Approach of Corporate Governance*, the French case, Regis Plazy and others<http://www.idep-fr.org/IMG/pdf/Blazy_-_Boughanmi_-_Deffains_-_Guigou.pdf> accessed on 01/02/2012.

According to Parades, developing economies characteristically lack an effective judicial system, including basic property right in addition to contract enforcement mechanisms, let alone a highly regarded judiciary with the sophistication and experience of the Delaware courts. In his view, judges in a civil law system may be reluctant to exercise the kind of discretion required to apply open-ended fiduciary duties. The law of fiduciary duties is ineffectual if judges are not willing to exercise their discretion when called on to apply those standards or if the judges are not respected enough for their decisions to have legitimacy.

Major Supporters of this idea are Rafael de La Porta and others, who concluded to say that:

> [C]ommon law countries generally have the strongest, and French civil law countries the weakest, legal protection of investors, with German and Scandinavian civil law countries located in the middle. … Civil laws give investors weaker legal rights than common laws do, independent of the level of per capita income …. The quality of law enforcement is the highest in Scandinavian and German civil law countries, next highest in common law countries, and again the lowest in French civil law countries."[416]

This view, which under- estimates civil law jurisdiction in favour of the superiority of common law jurisdictions in providing better protection to shareholders and in providing basis for financial and economic development, was challenged. However, it can be said that the role judiciary plays in a legal approach environment is commensurate with the overall character of the legal approach towards corporate governance itself. A judge in a common law country plays dual roles. He/she establishes the rule then applies it. By

[416] Porta and others (n 479).

this application, he/she also lays down the precedent to apply on future similar instances, while the role of the civil law judge in establishing the rule is not equivalent, as he/she plays limited role in creating the rule.

While I see the logic in acknowledging the role of judiciary in forming the institutional approach, I do not agree with the suggested necessary link between economic development and protection of shareholders, on one hand, and common law, on the other hand. The law itself, as applied by civil law judges, can be formed in a way that grants the needed protection and participates in economic development.

7.2.3 Approximating the Two Approaches

7.2.3.1 Institutional Approach is the Ultimate Goal for the Legal Approach

The institutional approach was always perceived as the superior approach that best realizes the goals of corporate governance. Parades and other commentators, who argue against the transplantation of the institutional approach into developing countries, believe, as noted severally above, that the developing countries are not ready to accommodate such a system in a way that suggests the superiority of the institutional approach. The ultimate goal for choosing the legal approach is to pave the way towards the institutional approach as the markets in the developing countries develop. It was said, in regard of the role that various market players play in corporate governance that some intermediaries can only gain experience over time as the private sector develops and as they are repeatedly called on to structure transactions, evaluate business opportunities, and resolve disputes. Accordingly it can be suggested it may be overly optimistic to expect many of the "transaction cost engineers" who work in developing economies to have the experience and sophistication on which private ordering depends.[417]

[417] Parades (n 476) 1112.

7.2.3.2 Legislative Approach is Perceived Transitional (Gradual Forbearance)

Building on the above idea, the same commentators suggest that the legislative approach is needed to fill the need for firm and well defined legal provisions and obligations that set the firm basis for corporate governance. Also, governments, legislators, and regulators should have to withdraw, i.e. gradually forebear, from the roles they play in favour of a greater freedom on the side of chief company executives.

It was, therefore, said that "a corporate governance regime based on private ordering and market monitoring cannot be achieved overnight. Even under the best of circumstances, it can take decades to develop the necessary institutions. As Douglass North explained, institutions are the "product of a long gestation" and the "process of [institutional] change is overwhelmingly incremental …. nothing assures that by privatizing or adopting market-based corporate governance model today that the requisite market institutions will follow to fill the gaps left by an enabling corporate law that offers relatively few shareholder protections as investors enter the market in response to strong legal protections, market-supporting institutions are likely to follow, though it could take years.[418]

Parades himself and other commentators, who support the advantages of the institutional approach, acknowledge a value that this approach has proven and acquired with time.

The enactment of the Sarbanes- Oxley's Act was a step on the right way to restore the public confidence in the financial markets that faced extraordinary cases that raised public worries as to the integrity of the behaviour of managers. However, it is a shortcoming in the institutional system that imposed the introduction of legislative

[418] Ibid.

mandatory tool to fill a gap left by the absence of non-mandatory rules, which, in my opinion, negate the myth of the superiority of the institutional approach.

7.3 The USA: From Delaware to the Sarbanes-Oxley Act

7.3.1 Delaware Corporate Law: Why Most US Companies Are Incorporated in Delaware?

A phenomenon that can be clearly observed in the US scene is that the greater share of US companies is incorporated in the State of Delaware. In term of numbers, there are currently over 680000 companies incorporated in Delaware[419] , including more than half the corporations that make up the Fortune 500.[420]

It is then legitimate to pose the following question: what are the reasons that make Delaware so attractive to investors to incorporate their companies in it? Before giving the straightforward answer that is actually stemming from the *'marketing'* of Delaware in the *market for incorporation,*[421] it can be said that there are two sides of the coin. On one hand, the authorities in Delaware are, as normally expected, promoting the benefits of incorporating companies in Delaware, and they are highlighting the benefits that large investors and majority shareholders can enjoy. On the other side of the fence, there is little guidance on how such benefits are in the favour of (or may be, not in the favour of) other stakeholders. Therefore, the Delaware Corporate 'environment for doing business' will be taken from these two points of view.

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[419] <http://www.theprocessservers.com>

[420] Lewis S. Black, Jr. 'Why do Corporations Chose Delaware' (2007) Delaware Department of State Division of Corporations <http://corp.delaware.gov/whycorporations_web.pdf> accessed on 10/09/2012

[421] This metaphor 'the market for incorporation' is inspired by the neoclassical economics and aims to describe the efforts that various countries and jurisdictions are exerting to compete in attracting capital and investors to incorporate within their jurisdiction; sellers are legislators; buyers are investors; currency- price is the capital; and goods are business opportunities, facilities and exemptions.

The Delaware Department of State- Division of Corporations takes some kind of a promoting standing. "There is a mix that makes Delaware appealing to corporations and other business forms."[422] It includes the Delaware General Corporation Law, which is one of the most advanced and flexible corporation statutes in the nation. It includes the Delaware courts and, in particular, Delaware's highly respected corporations court, the Court of Chancery. It includes the state legislature, which takes seriously its role in keeping the corporation statute and other business laws current. It includes the Secretary of State's Office, which thinks and acts more like one of the corporations it administers than a government bureaucracy.[423]

Delaware judicial system enjoys a national and international renown. For the seventh year in a row, the opinions of the US lawyers polled by the US Chamber of Commerce revealed that the judicial system of Delaware is ranked the first in the United States.[424] Examples of the strength points of the judicial system of Delaware were "judicial competence, judicial impartiality, timeliness of summary judgment or dismissal, treatment of class action suits, and overall treatment of tort and contract litigation."[425]

From the investors' point of view, Delaware is particularly preferred as a domicile for corporations for a number of other benefits, including the flexibility of the system to the extent that a corporation can be incorporated in one day without stipulating a minimum number in terms of capital. One person may hold all the corporation offices. The fact is that there is no state residency required, and that a number of taxes that are imposed on a number of other states do not exist in Delaware.

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[422] Black (n 420) 1.

[423] Ibid 1; it is noteworthy that the leaflet containing such quotation contained a disclaimer that it does not necessarily represent the standing of the Delaware Department of State Division of Corporations; however, it does not deviate from the standing of the Division in promoting the incorporation of corporations in Delaware.

[424] Francis Pileggi, and Sophia Siddiqui, Esquire, 'Benefits of Being a Delaware Company and Recent Developments in the Governance of LLCs' (2008) *Bloomberg Law Reports, 1.*

[425] Pileggi (n 424).

Over and above, the dominant character of the Delaware Corporate Law that makes it particularly appealing to investors lays in the fact that the Delaware Corporate law, including as well the application thereof by courts, represents the classical book example of an enabling approach towards corporate governance as was explained in the fourth chapter of this research. The corporate system in the State of Delaware "depends on a host of other formal and informal mechanisms, such as incentive-based compensation and hostile takeovers, to hold managers and directors accountable; … [and] "that parties can opt out of in crafting their governance structures … Corporate law in Delaware allows directors, officers, and shareholders to order their affairs as they see fit."[426]

This 'advantage' that the Delaware Corporate Law provides for investors was seen to some extent detrimental to the rights of minority shareholders and other stakeholders. It is not a surprise in the light of the conflicting interests in the grid of any corporation that the Corporate Law of Delaware was seen to fall short in guarding the interests of stakeholders. "Section 141(a) of the code provides that the "business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors." Section 141(a) grants expansive authority to the board and, in effect, to the officers to whom the board delegates managerial control. Thus, the Section deprives shareholders of any legal control over day-to-day business affairs and overall corporate policy, although shareholders, particularly institutional investors, can and do involve themselves informally on those matters."[427]

The legal and corporate system of the United States, and particularly prior to the introduction of the Sarbanes Oxley's Act, depended largely on the traditional sources of

[426] Parade (n 476) 34.
[427] Ibid 35.

law establishing the fiduciary duties and encountering the breach of trust. Some of these examples are the common law and the general principles of equity as established by courts, in particular those of the State of Delaware to fill the need for detailed provisions gapped by the Corporate Law of Delaware.

The courts in Delaware are acting briskly to fill the gap that is left with the absence of affirmative, clear-cut and detailed legal provisions. A clear example that can be given in this regard is the enhancement of the well-known 'business judgment rule'. It was ideally defined in *Gimbel v. Signal Cos.*[428] as an American case law-derived concept in corporations law whereby the "directors of a corporation . . . are clothed with [the] presumption, which the law accords to them, of being [motivated] in their conduct by a bona fide regard for the interests of the corporation whose affairs the stockholders have committed to their charge."[429]

However, even courts application of those doctrines, which were intended to capture the freedom and the autonomy of company insiders in the management of the company, have sent confusing messages to the observers by adopting a relatively lenient treatment. For example, back to the business judgment rule in a famous precedent before the Delaware Chancellery Court, it was decided that "while boards of directors should be encouraged to embrace “best practices” of ideal corporate governance as those practices evolve from time to time, Delaware law does not hold fiduciaries liable for a failure to comply with what the court termed “inspirational ideals."[430]

The principle itself might even be confusing if taken from the perspective of the stakeholders or other parties seeking to counter the authority of the insiders, or, say,

[428] *Gimbel v Signal Cos* 316 A2d 599, 608 (Del Ch 1974).
[429] Ibid.
[430] Paul Weiss, ‘Delaware Chancery Court In Disney Affirms Business Judgment Rule Deference, Failure to Abide by Best Practices not Tantamount to Fiduciary Duty Breach’ (August 2005), 1 <http://www.paulweiss.com/media/2281182/ma081805.pdf> accessed on 01/09/2012.

from the perspective of the plaintiff in the manner it allocates the onus of proof. No matter what the behaviour was, the plaintiff needs to prove that the way the directors perform their duties is in fact breaching the fiduciary duties and the requirements of good faith.

The above illustrated method of application could not prevent certain instances of abuse of such directors and other professionals' duties that such abuses were likely to be destructive to the national US economy and the international economy alike. This reveals that the existing legal tools need to undergo a serious revision.

7.3.2 A Free Fall in the Market in 2002 and the Need for Serious Intervention

After a considerable deal of prosperity in the US financial market during the nineties of the previous century, the market faced a serious crash in the beginning of the current century. What was at that time called 'accounting scandals' was in fact an accounting malpractice that created false impression on the factual financial situation of a number of the leading companies in the US financial market at that time, in a manner that might even account into fraud. This even caused the value of the shares of certain companies to increase radically without any factual support. Early at this century, this phenomenon was commonly called 'the internet bubble'[431], and in fact, this bubble burst in the collapse of a number of the biggest companies at that time. The substance of the problem was in fact a scandal of serious misbehaviours of company insiders and other professionals. "Global Crossing, Enron, and WorldCom were each guilty of destroying significant amounts of shareholders wealth as well as negatively impacting a host of other stakeholders."[432] For the sake of further description of the reasons behind such

[431] A 'bubble in this context was ideally defined as "a situation in which temporarily high prices are sustained largely by investor's enthusiasm rather than by consistent estimation of real value."; see Robert Shiller, *Irrational Exuberance*(2nd ed, Doubleday2005).

[432] Alan Calder, *A Practical Guide to the Legal Frameworks and International Codes of Practice* (London and Philadelphia 2008) 16,17.

collapse and though opinions split, it can be said that the description of the causes really differed due to the different points of view in looking into the matter. Therefore, most of what was said was factual. Among the given reasons for the collapse were the following quotations: "the principal causes of the corporate scandals of 2002 and the accompanying collapse in the stock market can be traced to the development over several decades of an investing and managing ethic that favours short-term increases in stock prices over the long-run profitability and well-being of corporation."[433]

"Recent scandals at Enron and elsewhere highlight a core concern about boards of directors that has preoccupied corporate law … Concerns about director accountability and independence are not new. What the disasters at Enron, WorldCom, Adelphia, Tyco, and elsewhere suggest, however, is that the problems relating to board structure and performance are more widespread— and the consequences of board failure are more serious—than people had thought. In short, there is a new realization that corporate governance really matters… Note, though, that all of these corporate governance devices were in place when the wave of corporate scandals, led by Enron, broke in 2001 and 2002."[434]

"Enron's collapse boiled down to massive accounting fraud and irregularities, a principal feature of which was the use of structured finance techniques designed to get debt off Enron's balance sheet and inflate Enron's profits"[435]

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[433] Lawrence E. Mitchell, 'The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?'(2003) *Villanova Law Review*, 1190.

[434] Troy A. Parades, 'Enron: The Board, Corporate Governance, and Some Thoughts on the Role of Congress', In Nancy B. Rapoport and Bala G. Dharan (eds), *Enron: Corporate Fiascos and Their Implications* (Foundation Press 2004), 501.

[435] Ibid 503.

What can be outstanding is that corporate governance norms were in place at the time the scandal happened, but it was admitted that the norms then in place fell short in addressing the problem and in curing deficiencies in the relations of the agency.

The US legislature was urged to intervene, and it was found necessary to introduce a compulsory body of law. This was an important attempt to discipline the market players and other professional people, whose misbehaviour was the cause of such scandals. It was also an attempt to prevent the reoccurrence of such detrimental situations and fill the gap that was left by a lenient corporate law that gives a great deal of autonomy and flexibility for insiders in the management of the company,

While such introduction might look in the opposite side of the usual trend of the US free market and the light laws therein, "some might say that corporate governance could not be much worse than in recent years."[436] Furthermore, a distinctive feature of the distorted reality at that time was the involvement of the 'gate keepers' who were not observing their professional duties, and who used to be bound by the provisions covering their professions only without being subject to particular provisions covering their duties towards the corporation to which they are providing their services. "Many things contributed to Enron’s demise. There were breakdowns all around accountants, lawyers, securities analysts, and credit rating agencies (the “gatekeepers”)".[437]It is in response to all this chaos, that the Sarbanes Oxley's act came to existence.

7.3.3 The Sarbanes Oxley's Act

Beside the reasons mentioned above that called for the legal intervention, and once the new piece of legislation came to existence and became a given fact, it was hoped that the new act would also participate in achieving certain further goals. This was based on

[436] Ibid 502.
[437] Ibid 503.

good governance. For example, there should be effective flow of information from inside to outside of the corporation, setting responsibilities in clear- cut provisions, and putting greater responsibilities on supporting professionals, such as lawyers, auditors, and analysts, in reversing a trending behaviour in the financial market. That is to look for the increase in the share value rather than the good of the company in term of real and tangible advancement, thus hoping to increase the interest in investing as opposed to trading. However, "there any evidence yet that investment and managerial norms have changed in this respect as a result of the crisis, it remains the most complete and cogent explanation of an era in which managing earnings, often to the brink of fraud and sometimes crossing that line, and the domination of finance over management."[438]

The Sarbanes–Oxley Act of 2002, enacted July 30, 2002, is 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) and is commonly called Sarbanes–Oxley, Sarbox or SOX. It is a United States federal law enacted on July 30, 2002[439], which set new or enhanced standards for all U.S. public company boards, management and public accounting firms. It is named after sponsors U.S. Senator Paul S Sarbanes and U.S. Representative Michael G. Oxley.[440]It was enacted "in response of the series of corporate scandals that followed the bursting of the internet bubble … [it] was probably the most radical and dramatic change to US federal securities laws since the 1930s legislations."[441]

The introduction of the Sarbanes- Oxley's Act marked various fundamental changes in the way the United States do business. For example, it brings into the realm of internal

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438 Mitchell (n 433) 1190.
439 (Pub.L. 107-204, 116 Stat. 745, enacted July 30, 2002; the issuance thereof was urged on the aftermath of the corporate scandals early 2000s, e.g. those of Enron, WorldCom, etc…
440 Marcia Cornett, e-Study Guide for: Finance: Application and Theory (Cram101 Textbook Reviews 2012).
441 Calder (n 432) 17.

governance the gatekeepers that once stood outside the box, including auditors, analysts and lawyers. Second, it significantly enhances the legal status and centrality of corporate governance to the chief executive officer and the audit committee...Third, it federalizes an important dimension of the internal laws of corporate governance, creating a new (albeit arguably narrow) duty of care for the CEO and audit committee and reintroducing serious prohibitions on conflict of interest transactions that have eroded to nothingness in the hands of the Delaware judiciary and legislature.[442]

7.3.3.1 The Sarbanes Oxley's Act: A Closer Glance on the Content

The Sarbanes Oxley's Act can be truly described as the first piece of legislation that is fully devoted to tackle corporate governance issued from its various aspects in an extensive way. This part of the research aims at spotting light on the major aspects of the act that gave its particular character.

7.3.3.2 Disclosure Controls

Explicitly spelled out, Section 302 of the Act requires the officers of a company to acknowledge, with regard to each periodic mandatory disclosure that the same certify that the signing officer has reviewed the report. The report should not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading. Also, the financial statements and other financial information included in the report fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report. This section also establishes the responsibility of the officers for the internal control, and it leaves no room for companies to bypass the compliance by the mentioned provisions by foreign reincorporation.

[442] Mitchell(n 433) 1190.

Such commitment of the officers has also a criminal aspect; Section 906 of the Act subjected the certification of any statement knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $1,000,000 or imprisoned not more than 10 years. The section also punishes for the wilful certification of any statement knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in the section with a fine not more than $5,000,000, or imprisoned not more than 20 years, or both.

7.3.3.3 Internal Control

This matter is dealt under section 404 of the Act. Within the annual report, management is required to provide a report on the management for establishing and maintaining of an adequate internal control structure and procedures for financial reporting, and on the effectiveness of the internal control structure and procedures of the issuer for financial reporting. It will be attested by the general accounting firm, which handles the accounts of the company.

Section 404 of the Act also gives a mandate to the SEC to "prescribe rules requiring each annual report required", and for this particular sake, "the SEC imposed a recognized internal control framework that has been developed through a due process… One widely used framework is known as the COSO framework, which contains the recommendations of the Committee of Sponsoring Organization of the Tread way Commission.

Indeed, such a system will not be what it is without the existence of such institutions that support and ensure the execution and the enforcement thereof. One of these entities that the Act provided for the establishment of, to oversee the application of one of the unique features of the Act, that is, the establishment of the responsibility of gatekeepers; is the Public Company Accounting Oversight Board (PCAOB).

The PCAOB was established to oversee the application of the requirement that the act introduces for the first time in history that is to subject the auditors of U.S. public companies to external and independent oversight, after a prolonged period of time during which the profession was self-regulated.[443] The PCAOB aims to "protect investors and the public interest by promoting informative, accurate, and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection."[444]

7.3.3.4 Criminal Penalties

Enough controversial, the Act came with new provisions that penalize for the breach thereof with imprisonment. Section 802 of the Act provides that whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both. Also, section 1107 of the Act provides that whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any federal offense, shall be fined under this title, imprisoned not more than 10 years, or both.

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443 In the same meaning, see the official website of the PCAOB, <http://pcaobus.org/About/Pages/default.aspx> accessed on 20/10/2012
444 ibid.

7.3.3.5 The U.S. Experience: A Closing Note

Much of what can be said in the assessment of the experience of the United States of America in corporate law reform might look no more than a reiteration of what was concluded in the Chapter Four of this research. The law of companies in the United States was very lenient, and this idea was the character that marked the U.S system for a long period of time. That was supported and applauded by many commentators, who, in some instances, were implying an idea of the superiority of the U.S free model in doing business.

When shocked by the well-known financial scandals, the U.S found no other way to cure what was admitted to be a distortion other than introducing a mandatory piece of legislation. It is the Sarbanes Oxley's Act, which was very strict in terms of compliance and bringing into its scope the supportive profusions, i.e. gatekeepers. It penalized, as shown above, with fine and imprisonment cases of non-conformity with the Act. By this, it has created a new form of a raw model for developing markets to transplant; i.e. a *sui genres* act that came to existence and that many developing economies were likely to adopt. For this particular regard, the thesis of Troy A. Parades on the suitability or non-suitability of such an Act for transplantation in developing markets would again seem relevant.

A legitimate question to ask in this regard is whether the introduction of such an Act is effective in serving the objective for which such an Act came into existence in first place. That is the prevention of the reoccurrence of the well-known financial scandals, or, if seen from the confronting prospective, providing the needed degree of protection for shareholders, in particular, minority shareholders, and in the wider sense, stakeholders. It was truly said in implying a comparison between the situation before and after the act comes into existence that "It is difficult for anyone to argue, cogently, that shareholders' interests were better served in the days when corporate officers could, in effect, allow the numbers to be made up and then file an 'I didn't know defiance."[445]

However, the introduction of the new obligations under the Act was seen to add substantially to the burdens of the U.S companies, costing them great amounts of monies to conform therewith. It can in some instances "[kill] the creation of new public companies in America, hamstrung the NYSE and Nasdaq (while making the London Stock Exchange rich), and cost U.S. industry more than $ 200 billion by some estimates."[446]

It might be appropriate in this regard to subject the Act to a cost-benefit analysis. Whereas the result of such analysis can vary and look very different from the prospective of the shareholders if compared to the prospective of the companies and their insiders themselves, it can be confidently said that the almost free self-regulated companies before the introduction of the Act failed the test of the internet bubble, by this assuming credit and advantage to any effort that aim to discipline the companies and their insiders.

7.4 The Enabling v Mandatory Model: The United Kingdom

Some commentators[447] debate what is characterised as the *enabling v the mandatory* models of corporate governance. These models share essential features overlapping with the Legal Origins and the institutional v the legislative models discussed in sections

[445] Calder (n 432) 20.
[446] Michelle S. Malone, 'Washington is Killing Silicon Valley' *The Wall Street Journal* (USA, Dec. 22, 2008).
[447] Anand, Anita and Milne, Frank and Purda, Lynnette D., Voluntary Adoption of Corporate Governance Mechanisms (April 29, 2006). Available at SSRN: https://ssrn.com/abstract=921450 or http://dx.doi.org/10.2139/ssrn.921450; Anita Anand 'An Analysis of Enabling vs. Mandatory Corporate Governance: Structures Post Sarbanes Oxley' (2006) *Delaware Journal of Corporate Law* Vol 31, 229.

(240) and (7.2), respectively. This section discusses the enabling v the mandatory model and provides analysis of the corporate governance system on the United Kingdom as major example of the enabling model.

7.4.1 The UK model of corporate governance

The regulatory framework of corporate governance in the UK is established through a combination of two sources. The first of these is parliamentary acts enacted by the legislative power, and the second consist in rules established by self-regulatory (non-official) organizations, such as the Securities and Investment Board, which is responsible for oversight of the securities market.

Unlike the case in USA, and unlike the case for non-statutory framework in the UK itself, statutory framework for corporate governance in the UK is limited and straightforward. As a matter of law, the consecutive revisions of the UK Companies Act opted, as a general rule, to limit the role of the law in having regard to 'the' enabling role'. That is allowing for doing business through corporations and partnerships. However, some limited statutory interference to touch on corporate governance norms can be seen in the Companies Act of 2006, particularly in parts 15-16 & 43.[448]

Part 15 of the Act (Accounts and reports) contained notable extensively detailed provisions on how a company should prepare its accounts, reports and reviews that need to be published. Part 16 of the Act (Audit) came with no less detailing on the auditors and their duties, remarkably giving, in Chapter 5 of the act, the right for a member in the company to raise audit concerns at audit meetings, and having as obligation on the company, to make available a website on which the statements shall be published.

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[448] UK Companies Act 2006. Available at Legislation.gov.uk. (2015). *Companies Act 2006*. [online] Available at: http://www.legislation.gov.uk/ukpga/2006/46/section/993 [Accessed 20 May 2015].

Part 43 of the Act came to codify an interesting principle of transparency, incorporating "the transparency obligations directive" 2004/109/EC of the European Parliament and of the Council relating to the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market." [449] It also gives the competent authority the mandate to issue detailed provisions to insure transparency and availability of information.

7.4.1.1 "The Phenomenon of Codes"

The major landscape in the UK non-statutory framework is the Combined Code of Corporate Governance[450]. However, since 1992 and in line with the consecutive reviews of the Companies Act, a considerable number of efforts or initiatives have aimed at tuning up the scene, in a trend that was best described by Alan Calder as "hyperactivity."[451] It is truly a trend that, whenever a failure or a shortcoming arises, a committee appears to report on recommendations or to draw a guideline to avoid the reoccurrence of such failure.

Following some serious failures in the performance of corporations in the UK, the Combined Code of Corporate Governance came into existence to be a good example of the continuous efforts that UK faced, which took the form of forming groups or committees to report on certain recommendations to cure such instances of shortcomings, being the work of Cadbury Committee. "At the heart of the committee

[449] As defined in Paragraph (1265) of the introductory provision of Part (43)
[450] This expression was used by Ben Pettet, 'Do Good Governance Recommendations Change the Rules for the Board of Directors', In Klaus J. Hopt, *and others*, (eds) *Capital Markets and Companies Law* (Oxford University Press 2005), 506.
[451] Calder (n 432) 42.

recommendations is the Code of Best Practice which is to apply to all listed companies registered in the UK.[452]

"The report embodied recommendations based on practical experiences and with an eye on the US experience, further elaborated after a process of consultation and widely accepted. The final report was released in December 1992 and then applied to listed companies reporting their accounts after 30th June 1993."[453]

Sir Cadbury described the major concern of the Code in the provision of "guidance on the board's role including in particular the need to insure that the board is not dominated by one individual."[454] It is also to ensure that "boards have an appropriate balance of external non executive directors and internal executive directors…"[455] though it is remarkable that the Code did not recommend that the chairman and Chief Executive Officer should be necessarily split.

Sir Cadbury himself described the recommendations and the code by saying that "The Code itself is based on the need for openness, integrity, and accountability."[456]

Following on the same trend, "[t]he second stage in the development of good governance recommendations in the UK was the establishment in 1995 of the Study

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[452] Sir Adrian Cadbury, 'Highlights of the Proposals of the Committee on Financial Aspects of Corporate Governance', In Daniel Prentice and Peter Holland, *Contemporary Issues in Corporate Governance* (Clarendon Press 2001) 48.

[453] In similar meaning and for further details on the Cadbury report and reasons calling therefore,Sridhar Arcot and Valentina Bruno, 'In Letter but not in Spirit: An Analysis of Corporate Governance in the UK' (2006) RICAFE Working Paper No. 031<http://ssrn.com/abstract=819784> accessed on 30/11/2012

[454] Cadbury Code, 1.2, as sited in: Jonathan Rickford, Do Good Governance Recommendations Change the Rules for the Board of Directors', In Klaus J. Hopt, *and others*, (eds) *Capital Markets and Companies Law* (Oxford University Press 2005), 467.

[455] Cadbury (n 452) 50.

[456]ibid 48.

Group on Directors' Remuneration."[457] The Greenbury report, which came to deal with a shortcoming concerning the non-reasonable privileges that board members might enjoy, "focused on the directors of UK listed companies and recommended a code of best practice on executive remuneration that was based on the principles of accountability, transparency, and linkage of rewards to performance."[458]

Such two major initiatives were truly described as "responses to issues of public concern, and made recommendations that if they had been in place earlier, might have prevented the series of abuses, malpractice, and fraud that had taken place."[459] In fact, the rationale behind such efforts was highlighted by Sir Cadbury himself as curing the "perceived low level of confidence in financial reporting and in the value of audits. The underlying factors were seen as the absence of clear framework for insuring that directors kept under review the controls in their business…"[460]

While such efforts were described as backward looking[461], there were also some sets of recommendations that were the fruit of a fresh forward looking prospective. The efforts of the Hampel Committee, which aimed at assessing the compliance with the above mentioned reports and arriving into the appropriate recommendations on Code, are a good example here.

It can be fairly said that the above-mentioned efforts of Cadbury and Greenbury are, indeed, a reaction to an emerging particular need, taking this with the non-statutory nature of the recommendations. It was normal that, in course of implementation, some application difficulties might arise, and this called to the effort of further committees to

[457] Rickford (n 454) 467.
[458]Price Waterhouse Coppers, 'Monitoring of Corporate Governance Aspects of Directors' Remuneration' (1999) <http://www.bis.gov.uk/files/file13428.pdf> accessed on 02/12/2012.
[459] Calder (n 432) 40.
[460] Cadbury (n 452) 45.
[461]Calder (n 432).

recommend on the particular issues for which the difficulty arise. Here, the guidance in internal control by Turnbul Committee can be a good example, so as the recommendations of Myners as regard to institutional investment.

7.4.1.2 The 'Phenomenon of Codes' Scrutinized

It is clear, then, that such codes came to fill in an emergent need that the statutory framework fell short to fill in light of not only "events [that] led concern about the reputation of London markets but also to widespread public and political concern."[462] Indeed, no wonder that they were "regarded as recognition of deficiencies in a legal framework for governance which is so flexible that it leaves gaps in the framework of board and other governance processes. On this analysis one might expect the recommendations and norms emerging to be likely to graduate, as a result of public policy pressures towards Corporate Law."[463]

By saying this, it can be fairly astonishing that such shortcomings did not literally into provisions to be incorporated into the Companies act, as long as the conditions calling therefore are that serious!

The effort of Cadbury Committee, in particular, which marked the launch of such a phenomenon, will be used severally in this Chapter as a case study representing such efforts. These efforts were a response to a major wakeup call with great expectations being awaited by the public and the financial business sector from the committee to the extent that "The Committee found itself the centre of unanticipated public attention, […] it also become a convenient parking place for new problems in the governance filed as they arose."[464]

[462]Rickford (n 454) 466.
[463] Ibid 487.
[464] Cadbury (n 452) 45.

While the question of what, in particular, called for such trend to take place can be given the above straight forward answer; it seems to raise certain doubts amongst commentators, and was really perceived as opinion splitting. While some see it the result of "pressures from capital markets and institutional investors, and their rationale as investor protection in response to market failures…."[465] others, like Ben Pettet; commenting on the idea of Mr. Rickford, see that "[t]he main begetter of British Corporate Law since its origin has been financial scandal, where I feel the emphasis is inappropriate"[466] in support of the idea that the codes just came to facilitate business rather than to react to scandals; responding assertively to a statement that Corporate Law; and the aligning initiatives, can work as a record for the series of historical corporate scandals![467]

How effective was such an approach and to what extent it paid back? Though such a trend, as shown above, was seen to be adaptive to the needs of the business, leaving a room for a flexibility that cannot be found on a rigid statutory framework. As even was expressed with regard to the works of Cadbury Committee: "The committee has recognized the diversity of companies and of those responsible for running them. It has not attempted to impose a single pattern of governance, but rather to state the principles on which it considers good governance should be based, leaving it to those responsible to decide how best to implement it."[468] However, Guido Rossi does not seem to be a defender of such trend. "All the corporate governance recommendations have been drafted as self-regulatory rules, but the inconsistent provisions of statutes and case law regarding the nature of the corporation can also be found in these rules. There is no resolution of questions about the appropriate constituents and concerns of corporations…. It appears to be extremely difficult to examine one by one the rules of all

[465] Rickford (n 454) 463.
[466]Pettet (n 450) 506.
[467]As expressed by Rickford (n 454).
[468] Cadbury (n 452) 55.

the codes of best practice in order to determine what could be considered a "good recommendation" and what would not be."[469]

A remarkable fact about such codes, recommendations, and guidelines is that they were all the fruit of the efforts of private sector players, and, in particular, senior figures in well-known companies that were even market makers. This might legitimately raise concerns of impartiality and conflicts of interest[470], but it seems truly as was interestingly said that "The government has liked the development of corporate codes, it is getting much of regulation of the corporate sector very cheaply. Overall, its role has been that of an enthusiastic spectator rather than a driving force."[471]

Contrary to the above arguments of Guido Ferririni, Rickford asserts that "While the governance codes may have demonstrated weaknesses in areas not covered by the British legislation, it by no means follows that legislation is the best response."[472] Additionally, Sir Adrian Cadbury himself stated that "It is hard to frame legislation which will frame governance standards."[473] It worth noting, however, that "Voluntary codes of best practice seem to be most influential in countries such as the UK, where institutional shareholders are powerful and the financial press is sensitive to governance issues"[474] not to forget the popularity and the deep historically rooted economies of scale and scope.

7.5 Models from Emerging Economies: Russia and Malaysia

As discussed in the preceding chapters the concept of corporate governance refers to the system by which the control over a company takes place, and how such control

[469] Guido Rossi, 'Do Good Governance Recommendations Change the Rules for the Board of Directors', In Klaus J. Hopt, *and others*, (eds) *Capital Markets and Companies Law* (Oxford University Press 2005), 499.

[470] For example Sir Cadbury was the Chairman of Cadbury and Cadbury Schweppes, Greenbury wasthe chairman and chief executive officer of Marks and Spenser.

[471] Pettet (n 450) 513.

[472] Rickford (n 454) 488.

[473] Quoted by Rickford (n 454) 479.

[474] Reinier Kraakmanand et al, *The Anatomy of Corporate Law* (Oxford University Press 2009) 67.

corresponds to the risk assumed by each player in the chain of corporate control (managers, directors, and shareholders).[475]

The concept is also driven by various factors and aspects including historical, social, and economic factors which play a considerable role in shaping what is considered a good or sound governance practice in a given economy. More and more economies might be following on the footsteps of the United States, or more generally the "Western" style in market liberalization. This started after more particularly after the collapse of the Soviet Union and the transformation of the countries thereof to a liberal market style, leaving behind the days when government used to play the roles of the three players along the control chain altogether. Companies now are growing a big and influential market power that is usually exercised by managements. Then, it would be fair to say that the chosen approach toward corporate governance may vary according to the characteristics of capital markets and the degree of maturity and development thereof. This chapter aims at highlighting these approaches and the relevance of market characteristics to such approaches.

7.5.1 The Role of Capital Markets in Economic Development

The transforming markets described above are undergoing reform programs towards more privatisation. Privatisation in this sense refers to the need to replace governmental ownership and financing of corporations with private ones. Naturally, transforming economies are expected to maintain a degree of subsidy that should be withdrawn gradually or subside with time. At the same time, it can be fairly said that fostering economic growth in the developing countries can depend on the development of a well-established securities market which affords a source of financing. Accordingly, a well-

[475] See Jeswald W Salacuse, 'The Cultural Roots of Corporate Governance', in Joseph J. Norton, Jonathan Rickford and Jan Kleineman (eds.), *Corporate Goverance Post-Enron: Comparative and International Perspectives* (British Institute of International and Comparative Law 2006) p. 66. According to Salacuse, this approach reflects how corporate governance can be defined from a legal prospective. However, he provided various definitions from the various insights that influence corporate governance.

established securities market will attract corporations who have a surplus to give it up to other corporations in need of financing to support their productivity in return of an expected profit. A well-established securities market will also be attractive to small investors who would be more interested in holding stakes in companies and buying securities. In this meaning, savings will finance the activities and the endeavours of companies with the attendant economic and social gains.[476]

Towards that end, there should be some assurance to comfort both corporate and individual investors to surrender their savings and surpluses to invest in securities without fearing that such monies be misused or expropriated by insiders, who might abuse their powers and at the same time for shareholders and other stakeholders to surrender a portion of their shares. In some other instances, new securities may be issued to enhance economic development and even to build greater confidence when dealing with other *stranger* market players.[477] What matters in this regard is the notion of corporate governance that is established to contribute to capital market development and all the attendant benefits mentioned above.

A central feature of corporate governance is the separation between ownership and control, at least in common law countries where this idea enjoys greater attention and importance. It is a pivotal idea around which revolve all practices aiming at ensuring the sound commitments of insiders such as managers towards shareholders and other outsiders and the rights of shareholders to limit the authority of managers. Where did such commitments come from? This could be a difficult question to answer. Some

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[476] Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer* (Wm. & Mary L. Rev. 1055, 2004) ;Ovidiu Stoica, 'The Role of the Capital Market in the Economic Development' (2002) SSRN Electronic Journal <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=951278.> accessed on 02/06/2011.
[477] Paredes (n 476).

commentators see that the law plays a vital role in this regard by insuring that shareholders rights are enforceable and adequately influential.[478]

It was said that empirical studies in various jurisdictions have shown a direct relation between the degree of shareholder protection and enforceability of such rights, on one hand, and the securities market development, on the other hand. By assessing factors that relate to the abilities that shareholders, particularly small shareholders have to influence the decision of a corporation. For example, shareholders who hold fewer than ten percent of a company's shares are able to call for a special shareholders' meeting, and they might have the ability to challenge perceived directors' oppression.[479]

Though the above mentioned rights were described to be "determined by laws; they are not inherent in securities themselves."[480] Others believe it is not only the law that matters, rather there are some other influencing factors, such as the political factors which, as commentators say, are more important than the law itself.[481] It can be said that all these factors contribute to what is to be considered a good or sound governance notwithstanding where such rules are coming from, and they all, therefore, complement each other in insuring the good practices and the prospers of corporate governance on economic development.

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[478] This argument is usually described as the "law matters thesis"; see Brian R Cheffins, 'Does the Law Matter?: The Separation of Ownership and Control in the United Kingdom' (2000) University of Cambridge Working Paper No. 172 <http://www.cbr.cam.ac.uk/pdf/wp172.pdf> accessed on 02/01/2012

[479] See Parades (n 476) for the discussion of the study of Rafael La Porta, Florencio Lopez-de-Silanes and Robert W. Vishny, 'Law and Finance' (1998) *The Journal of Political Economy*, 1113.

[480] Porta and others (n 479).

[481] Parades (n 476) 68-70.

7.5.2 Capital Market Development as an Influencing Factor for Choosing the Approach towards Corporate Governance

While countries with transforming economies can now make their choice on which approach can be better for them, the matter looks different for countries with economies and markets that developed over a considerable period of time. In a developed economy, for example the U.K market, the statute may not be as important as other factors. The market is mature enough to give greater room for the managers to decide on the matters of the company, while at the same time maintaining good protection for the rights of shareholders. How this balance was achieved? It can be said that a considerable set of practices, norms, and customs that companies followed for their integrity developed as the market itself was developing over a considerable period of time. There are also the set of fiduciary duties highlighted early in this research that such managers observe though the same may not necessarily be codified, not to forget the existence of institutions that regulate the relevant practices on *ex poste* basis as pre requirements for adopting the institutional approach. Moreover, while 'legal and regulatory structures are essential, the capital market, with adequate transparency and accountability in place, can ultimately reward or punish firms for their governance practices'.[482] It is clear that the existence of established factors like transparency, accountability and other *voluntary* practices for compliance, beside reflecting a developed market, will make up for the law not being so detailed or not so mandatory.

For countries with a transforming economy may face a number of challenges in establishing and institutional approach.

[482]Stijn Claessens,'Corporate Governance and Development' (Global Corporate Governance Forum Focus 1, 2003). <http://www.ifc.org/ifcext/cgf.nsf/AttachmentsByTitle/Focus_1_CG_and_Development/$FILE/Focus_1_Corp_Governance_and_Development.pdf> accessed on 20/10/2011.

First, such countries often as already discussed, where a country's overall corporate governance and property rights system are weak, voluntary and market corporate governance mechanisms would consequently have limited effectiveness.

Moreover, 'developing and emerging economies are constantly confronted with issues such as the lack of property rights, the abuse of minority shareholders, contract violations, asset stripping and self-dealing'.[483] This inherent factor in its turn may impose the need for a more extensive body of law to tackle.

lack such factors, making it difficult, therefore, to depend on less extensive role for the law to play.

7.5.3 Russian Corporations and the Transplantation of Western Corporate Law Norms

Russia is a unique example for two of the major models that were discussed in this research. On one hand, Russia is a good manifestation of the political and economic factors that could influence corporate law reform and twist the applicable norms. On the other hand, Russia can be a real life evidence that elements other than the law in the books matter such as social, political, and economic norms. Such a situation agrees with the thesis of Troy A. Parades[484], i.e. transplantation of the corporate law of developed economies into less developed markets is not the answer for corporate governance reform makes a lot of sense.

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[483] Centre for International Private Enterprise, 'Instituting Corporate Governance in Developing, Emerging, and Transitional Economies' (March 2002), 7 <www.cipe.org/programs/corp_gov/pdf/CGHANDBOOK.pdf> accessed on 20/10/2011.

[484] Parades (n 476).

7.5.3.1 A Glance on History

Russia has undergone serious efforts to apply corporate governance norms, though there is a lot to be done down the way. The present situation is that Russia might be better than ever before, thanks to a series of trials and errors. This part of the research will shed light on a particular era in the evolution of the Russian sphere for doing business that is the most relevant to this research.[485] That would show how a less prudent effort was more backfiring than beneficial until some corrective measures were put in place.

The transformation of Russia from being a communist country into a free market economy was not expected to take place in a period of days. A history of being the extreme opposite to a free market economy approach will for sure influence the effort of transformation over the two decades since the disintegration of the Soviet Union of the Soviet Union; however, such element was not ideally considered when the reform was planned.

Away from a detailed examination of the history of Tsarist Russia and Soviet Russia, it can be said that Tsarist Russia had a remarkable acknowledgement of corporate forms of corporation similar to those known in Western Europe at that time. However, what came afterwards was "70 years of communism and central planning… [then] during the early years of perestroika and glasnost, there was no private ownership of commercial or industrial enterprises. There were no shareholders, since the State was the owner of all productive assets and organizations, and thus, there was no role for corporate governance in the sense that it is generally understood in a market economy."[486]

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[485] For an intensive prospective on the historical development of corporate law in Russia, see Alexander Molotnikov, 'History of the Russian Corporate Law' (March 1, 2010) <http://ssrn.com/abstract=1598595> accessed on 20/02/2012.

[486] Daniel McCarthy and Shilea Puffer, 'Corporate Governance in Russia, towards a European, US, or Russian Model' (2002) *European Management Journal*, 631.

The mid-eighties was indeed the period of time when the wind of change started blowing at the USSR in a decade time. Russia, or to be more accurate, the USSR had some forms of 'security'. Those were the "“shares” [which] represented some financial tools that were placed mainly among the employees in order to involve additional funds for the enterprise development."[487]

More like what is commonly known as 'employee options' in our nowadays free market economy, such an application looked homogeneous with the life of the USSR at that time. Looking behind, the Soviet Union was the cradle of the communist economic, labour oriented theories, and looking ahead. The Union was trying to provide sources of funding for companies. However, the importance of such applications stems from the fact that it was the inception point from which many efforts followed to revive the corporate, or the joint-stock company method in doing business.[488] That ended with the "systematization of legal regulation of corporate forms of business [that] occurred only in the middle of 90-es of the last century with the acceptance of the first part of the Civil Code in 1994 and the Law on joint-stock companies in 1995."[489]

7.5.3.2 Russia after the Disintegration of the Soviet Union: The Dilemma of Privatization

Moving to describe the situation in Russia after the disintegration of the Soviet Union, it was not a surprise that the effort of that time tried to eliminate the dominance of government ownership in corporate, being the major call for reform. However, it was also expected that "seven decades of communism and central planning had provided little or no experience in dealing with issues of ownership and shareholder rights."[490]

[487] Molotnikov (n 487) 1, citing "Zenkin S. Joint-stock companies – new again//Socialist labour 1990. № 6".
[488] In the same meaning, Molotnikov (n 487).
[489] Ibid 22.
[490] McCarthy and Puffer (n 486) 631.

Indeed, "mass privatization was imposed on a country without any underlying free market infrastructure".[491]

In indicating what should have been the expectations of the mass privatization, it was said that, "Mass privatisation was designed to destroy governmental control, in favour of private investors… However, just as the Utopian socialists' prediction that law would disappear in the Soviet Union proved to be ill-founded."[492]

The scene at that time seemed to call for privatization. It was characterized by "centralized government control and the political framework and state control resulted in sluggish improvement and growth of the organization … three fifth of the Russian joint stock companies in operation today appeared as a result of mass privatization. Mass sale of shares in privatized enterprises was done through freely transferable vouchers". [493]

Such trend in selling shares as vouchers that can be transferred with minimal restrictions, taken with the above illustrated historical trend in issuing 'options' to companies' personnel, resulted in the concentration of the interests over enterprises in the hands of insiders. By this, one of the major norms on which good corporate governance should be based was negated, i.e. the separation of ownership and control, the very normal consequence was that "managers were working with short term perspectives for their personal gains and minority shareholders rights were violated."[494]

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[491] Jennifer G. Hill, 'Comparative Corporate Governance and Russia - Coming Full Circle' In Guenther Doeker-Mach, Günther Doeker-Mach and Klaus A. Zieger (eds) *Law, Legal Culture and Politics in the Twenty First Century - Essays in Honour Of Alice Erh-Soon Tay* (Franz Steiner Verlag, 2004), 153.
[492] Ibid 12.
[493] Molotnikov (n 487).
[494] Rajesh Pathak, 'Corporate Governance in Russia: A Report (March 10, 2011), 1 <http://ssrn.com/abstract=1782684> accessed on 02/01/2012

A report on corporate governance in Russia[495] reported a number of factors that led to such situation. Unsurprisingly, political factors were at the top of such factors. For example, relationships that insiders had with politicians, the prevailing culture against disclosure and transparency, let alone the weakness of the legal system and its enforcement, and the carelessness of minority shareholders in invoking their rights; submitting to a feeling of uselessness.[496]

7.5.3.3 The Need for Corporate Governance

After years of repeated, grave malfeasances against minority shareholders and fierce battles for assets, controlling owners of Russian firms have begun to understand that the only way to sustain the development of their companies is by attracting external funds. Alternatively, some of the large owners simply want to exit their businesses by selling their assets at a good price.[497]

The need for reform was considered to be imminent, and at that point in time, many of the 'modern' norms of corporate governance were introduced in the legislative framework of Russia, at least in the law in the books. However, the same above mentioned report indicates that the improvement in that regard was slow, being an expected consequence of a long-term history of ignorance of the good corporate governance norms.

How did all this transformation take place? The relevant period of time was marked with a debate between two schools, a school calling for a gradual transition into more good governance norms while the other was calling on a shock change, fearing that a

[495] Ibid.
[496] In the same meaning, ibid.
[497] Olga Lazareva, Andrei Rachinsky and Sergey Stepanov, 'A Survey of Corporate Governance in Russia'(2007) CEFIR/ NES Working Paper No. 103, 3 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=997965> accessed on 10/01/2012

"reversion to Communism might occur."[498] Unsurprisingly, this approach "was strongly supported by a number of major US governmental institutions, such as Treasury and the IMF."[499]

As a result of such 'shocking' corporate reform as well as the 'mass' privatization efforts, it was a clear fact that the initiative towards bringing Russia into conformity with the commonly accepted norms of corporate governance failed. It also resulted into disastrous consequences on the economy that "In the decade following its transition from a socialist State to a market economy, Russia's economy deteriorated significantly, with GDP less than two-thirds its pre-privatization level. It has been reported that corporate governance problems associated with the privatisation resulted in a loss of around US$ 50 billion in market capitalisation for the Russian stock market."[500]

7.5.3.4 The Experience of Russia: A Closing Note

As shown above, the market and the whole economic environment in Russia were very different from that in the United States. The grave differences were characterized "with the absence of all the basements of a free market economy characters. It was still the trend that the government set production quotas to companies, decisions of banks were dominated by the authority, and as indicated above, the method applied for privatization, being the freely negotiated vouchers representing securities in auctions resulted in the concentration of the interests in companies in the hands of insiders."[501]

In looking for the reasons behind the failure of reform in Russia up to the above illustrated point in time, it was said that such shocking and dramatic change, which was forced in a very short period of time, should have been expected. In their substance,

[498] Hill (n 491) 7.
[499] Ibid 7.
[500] Ibid 8.
[501] Ibid.

such efforts were indeed trying to force the adaptation of the U.S corporate model, while "Russia's underlying institutions and economic conditions differed radically from the US system, on which its economic transformation was based."[502] This brings us back to the argument of Troy A. Parades on whether the transplantation of a corporate law is the answer for distortions in corporate governance practices; no effective law reform may take place before setting the basis for a well-functioning market, including finding the appropriate approach for privatization, let alone the problem of enforcement.

7.5.4 Malaysia, Mature Norms for an Emerging Market Economy

Malaysia is a good example for a corporate governance system in an emerging market. The most distinctive thing about the Malaysian experience is that it had good 'laws in the books' at the time the Asian financial crisis hit that area of the world, which called for strengthening the laws and the applicable norms in light of the weakness revealed in the enforcement and application of such norms. For the presentation of this experience, the research will give a narration that highlights the situation before the crisis, the shortcoming discovered, the measures taken to cure the shortcomings, and the advancement that such measures realized.

In addition, a feature of the corporate management system that is applied by some companies to put in place an 'Islamic corporate governance system' will also be highlighted.

7.5.4.1 Malaysia and the Financial Crisis

The financial crisis of the year 1997 was very detrimental for some of the emerging markets in the Far East. The area faced one of the worst financial crises in history on the reaction to the currency crisis of Thailand, turning the economies of the area from

[502] Ibid 10.

being among the most booming economies to economies that needed major rescue. This raised doubts and worries amongst the investors as regard the safe investment in the area. Malaysia was one of the countries of the area that suffered badly from this situation.[503]

"The Malaysian Ringgit experienced waves of speculative pressure. It depreciated 40% against the US Dollar by the end of August 1998 from its level in June 1997. The Kuala Lumpur Stock Exchange (KLSE) Composite Index fell by 79% from a high of 1,271 points in February 1997 to 262 points in September 1998."[504]

It is remarkable, though, that, at that time, Malaysia had in place good applications for corporate governance. A system in place at that time was based on the Common Law practices, but it was localized to the local needs. To give an example on the developed system at that time, it is noteworthy to mention that "the Kuala Lumpur Stock Exchange listing rules evolved a number of provisions that provided for checks and balances to enhance transparency and accountability. It introduced the requirement for independent directors on boards of publicly listed companies in 1987 and the establishment of audit committees in 1993."[505] Not to forget of course the well-developed Corporate Law that was in place since the year 1965, the law of the securities industry as per the law of the year 1973, the law establishing the securities commission in the year 1993, and the

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[503] In the same meaning, Boo Yeang Khoo, 'Review of Corporate Governance in Asia: Corporate Governance in Malaysia' (November 2003) <http://adbi.adb.org/files/2003.11.10.corporate.governance.malaysia.pdf> accessed on 02/01/2013

[504] Ibid 2, citing The Central Bank and the financial system in Malaysia", 1999, Bank Negara Malaysia, Kuala Lumpur, 560.

[505] Philip Koh Tong Ngee, 'Corporate Governance in Malaysia: Regulatory Reform and Its Outcomes', In Eduardo T. Gonzalez (ed) *Best Practices in Asian Corporate Governance* (The Asian Productivity Organization, Tokyo, 2007), 93<http://www.apo-tokyo.org/00e-books/IS-20_BP_AsianCorpGov/IS-20_BP_AsianCorpGov.pdf> accessed on 10/01/2013

good regulation for banks, etc., which all indicate a well-developed corporate environment.[506]

As is the story in many of the systems of corporate governance, reform usually starts in the aftermath of serious financial crisis. Malaysia, of course, was not away from such a phenomenon. The financial crisis of 1997 "…highlighted weaknesses in corporate governance in Malaysia, which led to efforts to rectify and overhaul the entire corporate sector in Malaysia"[507] and generated a substantial amount of analysis and debate largely focused on macro-economic issues, systemic stability as well as issues pertaining to the regulation of international investors, the role and function of regulators and the need to improve disclosure and the governance system."[508]

7.5.4.2 Malaysia after the Financial Crisis

The financial crisis revealed many areas of weakness in the corporate governance system in Malaysia. Major examples of such areas of weaknesses were "the weak financial structure of many companies; over-leveraging by companies; lack of transparency, disclosure and accountability; existence of a complex system of family control companies; little or no effective laws to ensure that controlling shareholders and management treat small investors fairly and equitably; assets shifting; conglomerate structures that were perceived to be given preferential treatment; allegations of cronyism."[509] Among the weaknesses that the crisis revealed in Malaysia were also "the ineffective board of directors, weak internal controls, poor audits, lack of inadequate

[506] iIid for more details.
[507] Kamini Singam, 'Corporate Governance in Malaysia' (2003) *Bond Law Review*, 316;B. Chia 'Corporate Governance: Malaysia' (2001) 31*Asia Business Law Review*, 42.
[508] Ibid 316, Citing 'Report on Corporate Governance' (February 1999) High Level Finance Committee on Corporate Governance of Malaysia, ii.
[509] Khoo (n 503) 2.

disclosure and lax legal enforcement characterized in corporate governance in many Southeast Asian countries."[510]

Malaysia reacted on 25 March 1999 by issuing a code of corporate governance. The Code was introduced by the Malaysian Institute of Corporate Governance (MICG) and aims to set out principles and best practices on structures and processes that companies may use in their operations towards achieving optimal governance framework.

The code contained two types of rules, the prescriptive and the non-prescriptive rules. The prescriptive model sets standards of desirable practices for disclosure of compliance. The Non-prescriptive model requires actual disclosure of corporate governance practices.

The code took a flexible approach and contained a set of principles and best practices equivalent to those internationally accepted and adopted. It also contained principles and best practices for other corporate participants, along with the necessary explanatory notes. It "essentially aims to encourage disclosure by providing adequate, timely and relevant information to the investing public so as to facilitate informed investment decisions being made and to evaluate the performance of the companies."[511]

What is noteworthy to mention about the Malaysian Code of Corporate governance is that it took a hybrid approach; as regard to Part One which sets out broad principles for corporate governance. It requires PLCs to annually disclose a narrative account on how

[510]Singam (n 507) 317.
[511] Khoo (n 503) 3.

they applied the principles to their structures and processes. However, in part 2, it lists best practices that PLCs follow, on a comply-or- explain basis.

By examining the first part of the code, certain examples can be given for the treatment of some particular corporate governance issues and the method by which the same were treated under the code. It can be said that it mainly concerns the board of directors. It provides that a PLC should be supervised by a board of directors, which should be formed by a balanced number of executives and non-executives. Such executives should be appointed following a transparent manner, and there should be in place a clear mechanism for the supply of information to the board to enable it to do its duties. In addition, there should be a re- election for directors, every three years at maximum. The remuneration of the directors should be fair, specified in a transparent manner, and disclosed and reported.[512]
The code also encourages the dialogue between shareholders (institutional in particular) and the companies, and it sets that general meeting should be an appropriate chance for such communication.

Beside the issuance of the codes, there were also tremendous efforts towards better disclosure, transparency, training and qualification for directors, etc.[513]

7.5.5 Malaysia and Islamic Corporate Governance

At first, it should be noted that the matter of adhering to the norms of Islamic corporate governance is a matter of choice for Malaysian companies, but it is with no wonder that a considerable number of Malaysian companies are taking such a choice.

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[512] In similar meaning, Dato' Megat Najmuddin Khas, a presentation published on the web: <http://www.adb.org/Projects/APEC/Corp_Gov/Malaysian_Code_Corporate_Governance.pdf>
[513] For greater details on the mentioned efforts, see table 1.2, Khoo (n 503).

As further detailed elsewhere in this research, Islamic corporate governance is somewhat a modern term that brings together the norms of corporate governance and the principles of *Sharia'a* that encourages faithful practices and denies certain acts for being forbidden by the sources of *Sharia'a*.

The intention to abide by the norms of Islamic Corporate Governance is clearer in the case of Islamic financial institutions. Malaysia has in place "Guidelines on the Governance of *Shariah* Committee for the Islamic Financial Institutions."[514] Also, there exists a *Sharia'a* Advisory Council which is the sole reference as regard to the compliance with *Sharia* by Islamic financial institutions.

The Guidelines provide that every Islamic financial institution should establish a *Sharia'a* Committee, the members of which, three at minimum, are appointed by the board of directors. However, the appointment is subject to the approval of Bank Negara Malaysia (The Central Bank of Malaysia). The Committee plays an advisory role, but it is required to endorse certain decisions and documentations of the company.

This kind of a distinctive initiate in Malaysia is surely positive. However, the Guidelines were criticized on a number of grounds, the major among which concern the advisory role of the Committee, and urges that the Committee should have greater interference with the daily business of the company to ensure compliance with *Sharia'a*.[515]

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[514]Islamic Banking and Takaful Department, 'Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions' (1 April 2005) <http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/23_gps.pdf> accessed on 20/01/2013

[515] For more details in this regard, Aishath Muneeza and Rusni Hassan, 'The Legal Conflicts in Shari'ah Corporate Governance of Islamic Financial Institutions in Malaysia' (2011) JKAU: Islamic Econ.

7.5.6 The Experience of Malaysia: A Closing Note

An impression about corporate governance in Malaysia will sure be positive with good and modern norms being in place since an early time, albeit some drawbacks in application. This might be expected with regard to the fact that the Malaysian economy at that time was still developing and hence had the character of a developing economy in terms of concentrated ownership and dominance of family businesses, not to forget the weaker implementation and enforcement.

The financial crisis hit Malaysia at the time the economy was prospering, but it seemed that Malaysia had, to some extent, a fast recovery. An observer would believe that it enjoyed certain degree of immunity, thanks to the norms previously in force, as well as to the serious efforts of reform that followed the crisis.

7.6 Lesson from cross-country models of corporate governance

It is clear that Saudi legislation seeks to adopt rules and standards that regulate the management of joint stock companies listed on the stock market to ensure their compliance with the best governance practices. This is in order to guarantee the protection of shareholders' rights as well as the rights of stakeholders.[516]

However, there are characteristics which assimilate the Saudi system to both the common and the civil law. On the other hand, the Saudi legal system, including its corporate governance regime, is based on civil law as is the case in Germany and France. The system also contains many rules that protect and regulate rights and interests of stakeholders' groups and minority shareholders as well as providing some limitations to CEO power. For example, Saudi law prevents the position of the chairman

[516] See e.g. Article 2 (a) of the New Corporate Governance Regulations.

of the board of directors from being simultaneously held with any other executive position in the company. [517]

Moreover, unlike the Anglo-Saxon model, the government in Saudi Arabia dominates most labour, financial, services and business sectors, and recently it has tended to privatise some of them under its supervision

Additionally, the ownership structure of many large Saudi joint stock companies has been occupied by state-concentrated ownership. This environment to some extent boosts the state's role and control over the corporate sector.

In relation to the common law tradition, the corporate governance theory and the adopted model in Saudi Arabia seems to be much closer to the Anglo-Saxon model and more in harmony with its general theory which aims to generate a fair return for shareholders. Saudi legislation and the corporate governance regulations adopt the unitary board of directors and do not provide an option to approve a two-tier model

Furthermore, the Saudi system does not support the trend of a bank-oriented or any other long-term dominant ownership. Furthermore, Saudi corporations are not subject to any legal enforcement or compliance that gives employees a right to participate in strategic management decisions or to have any representative form.

[517] See Article 81 (1) of the new Companies Law 2015, stating 'A member may not combine the position of a chairman and any other executive position.'

8. Chapter Eight: Conclusions and Recommendations

This thesis investigated the subject of reform of the legal framework of corporate governance in Saudi Arabia, and the challenges of building such a framework in the country focusing on the following problem areas:

First: the research attempted an analysis and assessment of the prevalent corporate governance structures in the Kingdom of Saudi Arabia in order to establishing the shortcomings and the required reforms.

Second: given that the Saudi legal system is fundamentally based on Islamic legal principles, the thesis also explored the question of compatibility or otherwise between modern principles of corporate governance (i.e. OECD) and Islamic principles of corporate governance.

Third: the thesis adopted a modelling approach drawing on international standards of good corporate governance and cross-country models and experiences for insights to reform and enhance efficiency of the institutional and legislative framework of corporate governance in Saudi Arabia.

The conclusions and recommendation of this thesis can be summarised in the following two sections.

8.1 The importance of corporate governance reform in Saudi Arabia

The thesis argued that Saudi Arabia should leverage the positive correlation, proven in empirical studies, between good corporate governance and economic growth, transparency and stability in financial markets to realize sustainable development objectives and to transform the Saudi national economy from oil-dependent into a diversified resource economy envisaged in *Vision 2030*. Thus, the drive for corporate governance reform in Saudi Arabia is qualitatively distinct from crises or scandal imbued reforms such as experienced in recent decades in e.g. the USA and Malaysia.

8.2 The proposed normative model of corporate governance is a suitable analytic framework

One of the main conclusions and contributions of this thesis is that the global standards of corporate governance could be modelled into a universal -or universalizable- normative model. Thus, the thesis proposed in chapter 2 a generic three-layer taxonomic model of normative corporate governance standards consisting of: a) core layer of corporate governance values, including transparency, accountability, responsibility and fairness; b) a medium layer of supra-national standards (i.e. Islamic and OECD Principles), and c) a final layer of national frameworks of corporate governance standards in individual countries.

This model may be regarded to play a threefold role in the analysis of corporate governance globally. First the model discerns not only the layers but also the relations between the normative levels of corporate governance standards. Second, from a legal point of view, the model discerns the desirable legal compatibility between the various sets of standards starting from the outermost towards the core layer. Consequently, national standards of corporate governance exemplified in legal rules in various countries are desired to be compatible with the supra-national principles of corporate governance and the later, in turn, are required to be compatible with the core value of corporate governance.

Thirdly, the model provides a perspective to analyse and evaluate the efficiency of reform of the Saudi (or any other) national framework of corporate governance. In this respect, the efficiency of the national legal system is measured progressively according to the proximity of the national standards to international principles of corporate governance.

8.3 The Saudi institutional framework of corporate governance

The analysis and critical assessment in this thesis focused on two level of the Saudi institutional framework of corporate governance: law-making and institutionalisation of state authorities and the level of law application.

Institutionalization and law-making: while the Saudi Basic Law of Governance (i.e. constitution) includes three (executive, judicial and regulatory) state authorities, the institutionalization of state power is contrary to the principle of separation of powers. This is due the fact that the institution ultimately vested with the regulative (legislative) is ambiguous. Additionally, ultimate authority over all executive, judicial and regulative power (legislative) in concentrated in the hands of the monarch.

Law application: The absence of separation of powers ramifies on the level of application and weaken the principle of the rule of law. Consequently, the Saudi institutional framework is defined by the following characteristics:

8.3.1 Weak legislative process

lack of clear demarcation of institutional competence of the state agencies

The lack of technical personnel in the legislative system of the Kingdom, compared to legislative systems of other countries and the many tasks commissioned to such a system.

The legislative system in the Kingdom lacks institutional view to build the capacities of its personnel.

The legislative system is currently no more than a range of executive cycles with limited competences, lacking an institutional methodology to form a coherent legislative view.

8.3.2 The Slow Wheels of Reform

One of the major requirements of enhancing commercial investment is the continuous review for the legislations that support investment and provide stability for financial markets. This is due to the lack of comprehensive reform plan but also due to the institutional lack of clarity and vision.

8.3.3 Weak Methodology

The making of Saudi legislation is carried out without any procedural guide, which determines the necessary procedural steps to be taken towards making of the legislation.

8.3.4 Uncontrolled Legislative Delegation

The lack of clear separation of powers results in uncontrolled legislative delegation and delegation of legislative power. The Council of Ministers, in absence of any real legislative power with Ashura Council (the Saudi Parliament), exercises both legislative and executive powers.

8.3.5 Lack of Legitimacy Due to the Absence of Legislative Delegation Instrument

8.3.6 Exceeding the Scope of Legislative Delegation and Contradiction of the Implementation Regulation to the Main Law

8.3.7 Heavy Transplantation

8.3.8 Duplication

8.3.9 Unregulated judicial review

8.3.10 Disparity in judicial decisions

8.3.11 No uniform judicial structure

8.4 Reform of the Saudi framework: First phase: 1965 – 2012

The characteristics of this phase can be summarized in the following points:

8.4.1 Voting rights must be strengthened

Provisions of the Companies Law 1965 on voting rights are inconsistent with good corporate governance practices. According to the Companies Law 1965, shareholders are entitled to all the rights attached to the share and this includes also the right to attend, participate in deliberations, and vote at GSMs. The same rights shall also be entrenched in the company articles of association specifying which categories of shareholders are entitled to attend the GSM. However, the CL allows each shareholder holding at least twenty shares to attend the meetings, even if the statutes or articles of association mandate otherwise. Perceived from the point of view of good corporate governance practices, this provision may constitute a procedural obstacle that impedes entitled shareholders from participating and voting in an AGM. Accordingly, the CMA may be recommended to consider lowering the threshold to include all the holders of shares, irrespective of the number of shares held.

8.4.2 There is need to enhance minority protection from controlling shareholder abuse

Shareholders have pre-emptive rights to purchase new shares, to protect against share dilution and expropriation through capital increases. The Council of Ministers can cancel or restrict pre-emptive rights in six instances including: case of concession, public utility company, in companies where the state guarantees a certain rate of profits and or is subsidized and or participated by the government, in case of banking institutions.

8.4.3 Approval of board and key executive remuneration

The board report (distributed at the AGM) must include the remuneration packages of its members and its five highest paid executives on an individual basis, but it does not appear that the shareholder meeting approves the actual remuneration. Companies are not required to disclose their remuneration policies, which good practices would call for to explain the link between executive remuneration and company’s performance.

8.4.4 Inefficiently broad provisions relating to sales of major corporate assets

According to the CL provisions, the board cannot decide to conclude loans of terms exceeding three years, sell or mortgage company real estate, sell or mortgage company premise, unless provided for in the company’s articles of association.

8.4.5 Capital market transparency and regulatory consultation must be strengthened

1) There is insufficient disclosure of non-financial information (especially on beneficial ownership) which requires intervention by the regulatory agencies to approximate the standards and practices to the level required by the OECD principles.

2) an absence of foreign competition (foreign companies are not allowed to access the Tadawul).

3) Prevalence of improper conduct and abuse of position by brokers and industry insiders.

4) CMA should engage more actively with stakeholders in a comparable level and approach to that adopted by SAMA’s formal consultative process.

8.4.6 The non-financial disclosure framework for listed companies should be revised and harmonized

Listed companies have already been under significant disclosure obligations under the Listing Rules (LRs), and recommendations of the CGR. However, some of the nonfinancial disclosure recommendations of the OECD Principles are not implemented. The CMA and its stakeholders are recommended to consider revising the nonfinancial disclosure requirements contained in the regulation and LRs.

8.4.7 The position of company secretary could be introduced into the corporate governance framework by the CGR

The CGR could introduce a requirement to establish the institution of company secretary in listed companies. Company secretaries are employees of the company, but serve to assist boards in their governance activities. The majority of companies in KSA provide timely and relevant information to their boards and a professional company secretary charged to manage the proper and effective functioning of the board could be considered.

8.4.8 Minority shareholder rights should be strengthened by mandating that acquirers of 50% of a company's capital have to extend a tender offer to the remaining shareholders

8.4.9 The review and approval framework of related party transactions should be upgraded

8.4.10 Greater use should be made of skilled independent directors

8.4.11 Experience with cumulative voting should be reviewed

8.4.12 Stakeholders should work in partnership to build awareness of the value of corporate governance.

8.4.13 The CMA and SAMA should roll out a corporate governance awareness raising campaign

8.4.14 All stakeholders should be encouraged to develop high-quality training programs for directors

8.4.15 Media Capacity Building Workshop

8.5 Reform of the Saudi framework: Second Phase: 2015 - 2017

Since 2015, the legal framework of corporate governance in Saudi Arabia witnessed a significant impetus towards greater efficiency through the enactment of the new Companies Law (2015) and the new Corporate Governance Regulations (2017). Since these two instruments have only recently come into force, it is too early now to assess the practical impact they would have on the legal framework of corporate governance in Saudi Arabia's accession to the World Trade Organization in 2004, and the precipitous growth of foreign direct investment.

Growth of the Saudi Arabian stock market, including the recent opening of the stock market to foreign investment and the development of a vibrant sukuk market.

Diversification of the Saudi Arabian economy into new industries beyond the traditional hydrocarbon based economy.

The larger role small and medium enterprises play in the economy, which requires a more efficient regulatory environment for their success.

The need for the private sector to play a larger role in the Kingdom's economic development.

8.6 Impact of the new Companies Law 2015

8.6.1 Audit committees

The new law has introduced an audit committee to monitor the business of JSC. Moreover, a whole Chapter (4) has been dedicated to dealing with this essential issue as an important tool of corporate governance.

8.6.2 Cumulative voting

The new law also introduced cumulative voting in the election of the Board of Directors. Accordingly, Article 95 states that cumulative voting must be used in the election of the board of directors, so that individuals may not use the right to vote more than once per share.

8.6.3 Prohibition on combing the post of Board Chairman with an Executive position

The third point is that the Companies Law 2015 prohibits combining the post of Chairman of the Board of directors and any other executive position in the company in Article 81 paragraph 1.

8.6.4 Types of Companies

The old Companies Law involved three rarely used forms of corporate entity under which are no longer permitted by the new Law. These are – namely - Cooperative Companies, partnerships limited by shares and Variable Capital Companies (Article 3). Accordingly, the main forms of corporate entity used will continue to be the Limited Liability Company (LLC) or Joint Stock Company (JSC).

8.6.5 Absence of a general duty of loyalty

The new Companies Law does not, however, change the substance of the situation which prevailed under the old law. While, on the one hand, a general duty of loyalty appears to be founded in the more concrete duties bestowed on directors by the Companies Law such as Articles 71 and 72 of the Companies Law, Article 75 (1), on the other hand provides for the principle regulation on the powers of directors only to the extent that directors must have the "widest authority" to manage the company and does not limit such powers to the objective of the company.

8.6.6 Liability under Companies Law

The issue of management liability is regulated for both JSCs and LLCs in individual sections of the new Companies Law. LLC managers responsibilities are governed by Article 165 (2), while JSC directors' liability is regulated by Article 78 (1) of the Companies Law. However, both provisions stipulate that persons engaged in the management of a company will be individually and jointly liable towards the company, its shareholders and third parties for the following acts: violations of their duties under the Companies Law; breaches of the company's articles; and errors of management.

8.6.7 Infringement of Director duties

The duties of a manager of an LLC are not explicitly regulated by the Companies Law. However, based on the generally accepted conventional wisdom that the duties of JSC directors in the old Saudi Arabian Companies Law (Royal Decree M/6 of 1385 Hijri) applied analogously to LLC managers it could be argued that the same understanding will be applied to the new Companies Law, and the articles of the Companies Law governing the liability of JSC directors will be applied to LLC management particularly because the management liability regime was not changed within the new Companies Law

8.6.8 Infringement of company's articles

The Companies Law does not explicitly state that the duties of a director may be expended in the company's articles. However, this follows indirectly from the fact that the articles of association of a company may deviate from the Companies Law, insofar as the articles do not conflict with any binding provisions of the Companies Law.

8.6.9 Error of management

Neither Article 78(1) nor Article 165(2) of the Companies Law define what constitutes an 'error of management' that would prompt liability of management under these provisions. Thus, even minor mistakes could produce management liability according to Articles 78(1) and 165(2) of the Companies Law. Since this would significantly hinder the operation of a company, economic considerations suggest that an error of management within the meaning of Articles 78(1) and 165(2) should be interpreted more restrictively. Nonetheless, since no relevant jurisprudence is available from the Saudi Arabian courts, it is unclear whether the courts would follow this interpretation.

8.6.10 Prohibition of competition

Pursuant to Article 72 of the new Companies Law, a director may not engage in any commercial activity that is in competition with a business activity carried out by the company or conduct business in any branch of the activities carried out by the company, unless with the permission of the company.

8.6.11 Prohibition of self-dealing

Article 71 of the Companies Law prohibits directors from having a direct or indirect interest in any transaction or contract concluded for the account of the company.

8.6.12 Lack of statutory definition of *fraudulent act* and *abuse of authority*

The liability of JSC directors and LLC managers for damages or loss caused by their fraudulent actions is provided for by Articles 78(1), 78(3), 165(2) and 164(4) of the Companies Law. However, what constitutes a fraudulent act is not defined by the law. Under Islamic law, 'fraud' is generally understood either as the suggestion – as a fact –

of something untrue by someone who does not believe his or her statement to be true; or the suppression of that which is true by someone with knowledge of that fact.

8.6.13 Penalties and punitive measures

Chapter 11 of the new Companies law deals with penalties. Accordingly, directors may be subject to legal penalties pursuant to Article 212 and following of the Companies Law.

8.6.14 The mandatory nature of the new Regulations 2017

The new Corporate Governance Regulations (2017) depart significantly from the voluntary mode of application which characterised the old Regulations. Rather than being merely ‘guiding principles’ Article 2 (b) states that the new Regulations ‘are mandatory to companies except the provisions that contain a reference of being guiding’

8.6.15 A new regime of greater transparency

Furthermore, the Regulations reiterate the importance for companies to adopt clear, efficient and sound decision-making processes. First and foremost, these processes help protect shareholders and stakeholders.

8.6.16 Shareholder Rights

Key rights are set out in Articles 4 to 15 of the Regulations and include: fair and equal treatment among shareholders, non-discrimination among shareholders of the same class, fair distributions, equal rights related to access of corporate information and communications, rights to attend and vote in general assemblies and board and audit member selections. In particular, fair treatment of shareholders requires the following:

a) The Board is obliged to seek shareholders' rights protection to ensure fairness and equality among them.

b) The Board and the Executive Management of the Company is obliged not to discriminate among shareholders who own the same class of shares nor prevent them from accessing any of their rights.

c) The Company shall specify in its internal policies the procedures that are necessary to guarantee that all shareholders exercise their rights.

8.6.17 Board of Directors

Detailed rules and principles governing board of directors (which also include that of the chairman, independent directors and the secretary of the board) (together, the Board) are set out Articles 16 to 41 of the Regulations and cover matters including: board formation, composition, appointment, conditions of membership, termination, responsibilities, main functions, independence, distribution of competencies and duties (including vis-à-vis those in executive management positions), agenda setting, meeting procedures, auditing, and training. Furthermore, the Regulations enshrine the fiduciary duties to adhere to the principles of truthfulness, honesty and loyalty.

8.6.18 Conflicts of Interest

The Regulations also cover the Board’s avoidance, assessment and disclosure of (and dealings with) conflict of interest situations. There is a need to establish policies and procedures in relation to related party transactions, conflicts scenarios (with or for the company or its competitors), conflicted persons, accepting gifts, and complying with the authorization, renewal and termination of the board and its members, as per the Companies Law.

8.6.19 Committees

Provisions dealing with the formation, composition, membership, powers, procedures, responsibilities, policies, meetings and announcements of committees for remuneration, risk management, audit, corporate governance and nomination are set out in Articles 83 to 88 of the Regulations.

8.6.20 Audit and Internal Control

Also outlined are the requirements as to the composition, appointment, roles and responsibilities of internal and external auditors. Listed companies should have internal control systems in place, along with audit plans and regular published reports. Listed companies must also maintain policies on effective corporate governance, and have an internal corporate governance committee regularly review compliance.

8.6.21 Stakeholder rights

Boards of listed companies are now required to produce policies on their dealings with various stakeholders, including employees and incentives given to them. These drafted policies should describe how to protect their respective rights, deal with complaints, confidentiality of information, professional conduct, social contributions, treatment of employees, and dealing with non-compliance with these policies and procedures. Employee incentive schemes and payouts must be documented. Separate policies governing professional and ethical corporate standards, social responsibilities and social initiatives are also to be made available.

8.6.22 General Disclosures and Transparency

There is a general requirement to disclose and make available up-to-date and accurate information to the company's various stakeholders. The board must maintain policies on information disclosure, and provide a regular board report along with that of the audit committee’s report and regularly maintain information on the company’s website. Remuneration of board members and the executive management must be disclosed pursuant to a standard template, as set out in the Regulations. All records of the company must be maintained for a period of ten years, or longer if, any potential claims are pending.

8.7 Islamic and international principles of corporate governance are compatible

Another major conclusion of this thesis is that the international standards of corporate governance are compatible with the principles Islamic Shari’a. This is particularly important to stress because the Saudi legal system is fundamentally based on Islamic legal and religious principles.

Moreover, an additional contribution of this thesis is the distinction proposed between formal and substantive compatibility between international/supranational standards of corporate governance and the principles of Islamic Shari’a. This distinction departs from the conventional exclusive focus by students in the field on the similarities and regulative import between Islamic and particularly OECD principles.

8.7.1 Formal Compatibility

One of the main conclusions of this thesis is that the normative model of corporate governance proposed in section 2.4.1 lends a distinct perspective through which another aspect of compatibility emerges, namely a formal compatibility between Islam and OCED principles.

The OECD principles and their underlying pillars of corporate governance are both regarded as meta-legal principles as discussed in sections 2.4.2 and 0. As such these principles designate the basic principles which underlie corporate legal frameworks, or upon which national corporate laws are to be formulated.

This same characteristic also applies to Islamic principles of corporate governance since the legal character of these principles should equally constitute the Islamic foundation on which national corporate governance frameworks may be established. Thus, the Islamic principles may be applied across a broad range of national jurisdictions. The ensuing national laws need not necessarily be uniform since the operationalization of the Islamic principles can be adapted to the conditions and requirements of individual national jurisdictions.

8.7.2 Substantive compatibility

As already noted above, substantive compatibility relates to similarity of the regulative import of Islamic and OECD principles. These similarities include both the core values of corporate governance including fairness, accountability, responsibility and transparency. Substantive compatibility also includes similarities between Islamic principles and the six OECD principles.

The main conclusion in this regard is that, owing to its fundamental basis in Islamic law, the Saudi corporate system can be ameliorated consistently with Islam corporate principles when the latter are clearly elucidated and articulated. In addition, owning to its reciprocal relationships internationally, the Saudi system can also utilize international standards to streamline its corporate governance system with those of its partners and also lead the way forward for further regional development particularly within the GCC countries

8.8 International Standards are desirable criteria to approximate efficiency of the Saudi framework of corporate governance

Having established the compatibility between OECD and Islamic principles of corporate governance, the thesis concludes that modern international standards of corporate governance, as embodied in the OECD Principles, constitute the desirable criteria to enhance and achieve greater efficiency of the Saudi legal framework of corporate governance. Notably, the OECD principles have greatly advanced the global corporate governance agenda and provided specific guidance for legislative and regulatory initiatives in both OECD and non-OECD countries worldwide. In the analysis of the Saudi framework of corporate governance in this thesis, the OECD principles are perceived to set the standard of legal efficiency as these play a number of related aims:

Informative aim: the comparative analysis of OECD principles both with Islamic principles and the prevalent legal framework of Saudi Arabia aim is to inform policy options designed to enhance the efficiency of the legal framework of corporate governance in Saudi Arabia not only of the existence but also of the relevance of a pool of instruments which can profitably be utilised. In particular, the OECD Principles are particularly relevant to Saudi Arabia on account of the country being a member of the G20 which is a partner to the latest version of OECD Principles published in 2015. More generally, however, there is a need to shed light on the international standards and efforts by inter-governmental organisations in relation to standardised corporate governance rules in the context of corporate governance and the GCC. These standards include many aspects, such as by providing benchmarks and recommendations to enhance the national legislative, institutional and regulatory framework of corporate governance.

8.9 Lesson learned from cross-country models

Notwithstanding the mixed nature of the Saudi legal system indicated in section (1.1.2.1), the adoption of some laws from one legal tradition into another with a different legal culture is not equivalent but rather leaves a particular tradition (usually the indigenous tradition) as the dominant one the country. It is therefore important to pose the question of the impact of legal origins debate on the Saudi legal system. In this respect, there are a number of factor which need to be taken into account, including:

In principle, there is agreement between the main presupposition of this thesis and a basic tenet of the legal origins thesis to the effect that there is a correlation between the quality of legal rules and positive economic impact. This thesis argues for an enhanced and a robust legal framework of corporate governance in Saudi Arabia to attract investment, increase growth and realize development goals. The correlation argued for by LSSV goes much deeper in claiming that the quality and economic efficiency of corporate governance rules is determined by their legal origin.

The Saudi system is based fundamentally on the Islamic legal system. Thus, Islamic principles constitute the foundations of Saudi legal culture which may not be surpassed or superseded by legal transplantation from the French civil law.

The Saudi legal system has a religious base. This is in contradistinction to the mainly secular base of both the common law and civil law, and several sub-traditions—French, German, socialist, and Scandinavian—within civil law.

Thus, the scope of influence of the legal origin and the French civil law in particular on the Saudi legal system can be expected to be confined to the commercial sphere. Moreover, even within this limitation, it should be remembered, that Islamic law constitutes the background against which particular rules and to be interpreted and applied.

It is clear that Saudi legislation seeks to adopt rules and standards that regulate the management of joint stock companies listed on the stock market to ensure their compliance with the best governance practices. This is in order to guarantee the protection of shareholders' rights as well as the rights of stakeholders.[518]

However, there are characteristics which assimilate the Saudi system to both the common and the civil law. On the other hand, the Saudi legal system, including its corporate governance regime, is based on civil law as is the case in Germany and France. The system also contains many rules that protect and regulate rights and interests of stakeholders' groups and minority shareholders as well as providing some limitations to CEO power. For example, Saudi law prevents the position of the chairman of the board of directors from being simultaneously held with any other executive position in the company. [519]

Moreover, unlike the Anglo-Saxon model, the government in Saudi Arabia dominates most labour, financial, services and business sectors, and recently it has tended to privatise some of them under its supervision

Additionally, the ownership structure of many large Saudi joint stock companies has been occupied by state-concentrated ownership. This environment to some extent boosts the state's role and control over the corporate sector.

In relation to the common law tradition, the corporate governance theory and the adopted model in Saudi Arabia seems to be much closer to the Anglo-Saxon model and more in harmony with its general theory which aims to generate a fair return for shareholders. Saudi legislation and the corporate governance regulations adopt the unitary board of directors and do not provide an option to approve a two-tier model

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[518] See e.g. Article 2 (a) of the New Corporate Governance Regulations.

[519] See Article 81 (1) of the new Companies Law 2015, stating 'A member may not combine the position of a chairman and any other executive position.'

Furthermore, the Saudi system does not support the trend of a bank-oriented or any other long-term dominant ownership. Furthermore, Saudi corporations are not subject to any legal enforcement or compliance that gives employees a right to participate in strategic management decisions or to have any representative form.

Similar to the Anglo-Saxon model and more in harmony with its general theory Saudi legislators adopted the unitary board of directors and have not supported the bank-oriented system which creates long-term dominant ownership. Furthermore, there are no regulations that support any form of employee representation or participation in decision-making.

8.10 The efficiency legal framework in Saudi Arabia needs to be strengthened

The Saudi legal framework of corporate governance, like that of any other country, must be regarded as subject to continuous development and change. Accordingly, to answer the two main research questions above, the Saudi legal framework of corporate governance was divided in this thesis into two historical phases: a) earlier phase from 1965 – 2012; and b) a latter phase since 2015.

8.11 Efficiency of the institutional framework must be further strengthened

Lack of consistency of application of corporate governance provisions has been a major drawback in the earlier phase from 1965-2012. This is due mainly to the fact that court rulings and interpretations related to legal provisions are not made public; it is therefore difficult to monitor the consistency of interpreting the law. There are some inconsistencies between the different acts, and efforts are underway to remove them.

Additionally, efficiency of contract enforcement is relatively weak. The standard measures developed by the World Bank indicate that contract enforcement in Saudi Arabia is relatively slow and expensive when compared to OECD countries. It also takes more procedures to enforce a contract in the county making the whole process **more costly when compared to the OECD average.**

8.12 The CMA and other relevant regulators should further strengthen their enforcement activities

The CMA should consider the development of a process to systematically assess whether company disclosure is in compliance with the CGR. The CMA could enforce disclosure of compliance and issue warning letters, and fines when needed. These results should also be disclosed on the CMA and the Tadawul website.

8.13 CMA should consider focusing its enforcement activities on compliance with disclosure requirements, particularly nonfinancial disclosure

The CMA should continue to focus its enforcement efforts on disclosure, working towards full compliance with the CGR's 'comply or explain' requirements, and requirements with other non-financial disclosure rules. Enforcement could be strengthened in the area of public disclosure of ownership and adherence to the CGR. In addition to focusing on the largest companies in terms of market capitalization, the regulators may wish to focus their efforts on some of the smaller issuers, where corporate governance shortcomings are likely to be greatest.

8.14 Policymakers should review policies related to accounting standards development, particularly convergence to IFRS

An Accounting and Auditing ROSC should be carried-out to evaluate the costs and benefits of convergence with IFRS. Additional resources are essential for SOCPA to continue the revision, update, and interpretation of the accounting standards. The regulators should also consider increasing coordination between the Supervision and Financial Disclosure Department of the CMA and SOCPA to ensure consistency. Additional resources could be made available to SOCPA.

8.15 A "Code of Islamic Principle of Corporate Governance' should be enacted

It is strongly recommended that a Code of Islamic Principles of Corporate Governance should be enacted in Saudi Arabia. Such a code will serve many purposes, including:

1. Strengthen the corporate governance framework and the extant regulations.
2. Provides a nexus between the residual legal-religious character of Islamic principle and voluntary adherence.
3. It is expected that the code will receive much acceptance and adherence due to the religious base of its content.
4. The Saudi statutory system is still lacking full realization of the fiduciary duties of directors. Sharia principles provide a basis for fiduciary duties.
5. It can be supportive to the role of the judiciary in implementing good corporate governance.

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