

**CORPORATE GOVERNANCE OF THE SAUDI ARABIAN PUBLICLY TRADED
COMPANIES: AN APPRAISAL AND PROPOSALS FOR IMPROVEMENT**

by

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Changes in economic and business practices around the globe and the rapid reform movement in developing countries require a sound corporate governance structure to be implemented in Saudi Arabia. A winning reform agenda has to take national factors into consideration. Agency problem types (controlling shareholder *v.* minority shareholders) and a weak external enforcement mechanism (especially judiciary) in the Saudi system suggest that immediate reform of corporate governance should focus on internal corporate governance, namely shareholder position including minority shareholders protection and the board of directors. Such a strategy of reform does not intend to undermine the importance of administrative and judicial reforms to corporate governance efficiency in the country, but rather offers fast-track reform proposals that may boost the corporate governance system until a full development of strong external structure in the country is established. Well-structured internal corporate governance is expected to comply with a number of comparative benchmarks that may reduce agency cost problem and observe the Saudi moral systems, particularly ones related to Islam. Linking corporate governance to the country's moral system will more likely facilitate legal transplant of corporate governance standards into the Saudi system. Overall, the adoption of the proposals recommended in this dissertation is imperative to achieving the goals of improving corporate governance in Saudi Arabia and attracting greater investment in the country's capital market.

TABLE OF CONTENTS

1.0	INTRODUCTION.....	1
1.1	GENERAL REMARKS	1
1.2	THE DISSERTATION HYPOTHESES.....	4
1.3	THE METHODOLOGY.....	6
1.4	THE SOURCES.....	7
1.5	VALUE AND AIMS OF THE DISSERTATION.....	8
1.6	STRUCTURE OF THE DISSERTATION	9
2.0	SAUDI ARABIA: HISTORY, ECONOMY, AND LEGAL SYSTEM.....	12
2.1	INTRODUCTION	12
2.2	THE KINGDOM OF SAUDI ARABIA.....	13
	2.2.1 Introduction	13
	2.2.2 The History of the State	17
	2.2.2.1 The First Saudi State (1745-1818)	18
	2.2.2.2 The Second Saudi State (1840-1891)	19
	2.2.2.3 The Modern Saudi State (1932)	20
	2.2.3 The Saudi Economy.....	21
	2.2.3.1 Overview	21
	2.2.3.2 Rentierism Ramifications.....	28

2.2.3.3	Reform Agenda	31
2.3	STRUCTURE OF POWER IN THE KINGDOM.....	36
2.3.1	Constitutionalism in Islam.....	36
2.3.2	Constitutionalism in Modern Saudi State	37
2.3.2.1	The Basic Law of Governance	38
2.3.2.2	The <i>Shura</i> Council	40
2.3.2.3	The Council of Ministers	42
2.3.2.4	The Judiciary.....	44
2.4	SOURCES OF LEGAL AUTHORITY	47
2.4.1	Legislations.....	47
2.4.1.1	Statutes (<i>anzima</i>)	48
2.4.1.2	Regulations	51
2.4.2	Islamic Law Sources.....	53
2.4.3	Primary Sources	53
2.4.3.1	Koran.....	53
2.4.3.2	<i>Sunna</i>	55
2.4.4	Supplementary Sources	55
2.4.4.1	<i>Ijma</i>	56
2.4.4.2	<i>Qias</i>	56
2.4.5	Legal Rules in Islam.....	57
2.4.5.1	Introduction.....	57
2.4.5.2	The Rule Making Process in Islamic Legal System	58
2.4.6	Juridical Schools in Islam.....	59

2.5	BUSINESS ORGANIZATIONS IN SAUDI ARABIA.....	62
2.5.1	The Evolution of Business Organizations’ Regulations in Saudi Arabia..	62
2.5.2	Law Sources for Business Organizations	65
2.5.3	Business Organization Forms.....	66
2.5.3.1	General Partnership Company.....	68
2.5.3.2	Limited Partnership Company	69
2.5.3.3	Limited Liability Company.....	70
2.5.3.4	Joint Stock Company.....	72
2.6	CONCLUSION	79
3.0	CORPORATE GOVERNANCE I: CONCEPT AND VALUE	81
3.1	INTRODUCTION	81
3.2	CORPORATE GOVERNANCE ORIGIN.....	81
3.3	CONTEMPORARY MEANING OF CORPORATE GOVERNANCE	83
3.4	CORPORATE GOVERNANCE SOURCES	86
3.4.1	Hard sources	86
3.4.2	Soft Sources.....	88
3.4.3	Corporate Law Role in Corporate Governance	90
3.5	CORPORATE GOVERNANCE PLAYERS	94
3.5.1	Stakeholders.....	94
3.5.2	Gatekeepers.....	96
3.6	GOOD CORPORATE GOVERNANCE AGENDA	99
3.7	DRIVING FORCES OF IMPLEMENTING GOOD CORPORATE GOVERNANCE	102

3.7.1	Introduction	102
3.7.2	External Finance.....	102
3.7.3	Globalization.....	109
3.7.4	Capital Market Crisis and Corporate Scandals	112
3.7.4.1	Capital Market Crisis	112
3.7.4.2	Publicly traded corporation s’ Scandals	116
3.7.5	Privatization.....	119
3.8	CONCLUSION	124
4.0	CORPORATE GOVERNANCE II: THEORY OF THE FIRM AND OWNERSHIP AND CONTROL.....	126
4.1	INTRODUCTION	126
4.2	THE NATURE OF THE PUBLICLY TRADED CORPORATION	126
4.2.1	Traditional theory	126
4.2.2	The Nexus of the Contracts Approach	130
4.2.3	Entity Theory.....	134
4.2.4	Team Production Theory.....	137
4.3	THE OBJECTIVE OF THE PUBLICLY TRADED CORPORATION....	140
4.3.1	Shareholders Wealth Maximization	140
4.3.2	Stakeholders welfare maximization.....	144
4.4	THE CONTROL OF THE PUBLICLY TRADED CORPORATION	148
4.4.1	Separation of Ownership and Control	148
4.4.1.1	Introduction.....	148
4.4.1.2	Patterns of Control.....	150

	4.4.1.3 Agency Problem	151
4.5	CONCLUSION	153
5.0	ISLAM AND CORPORATE GOVERNANCE	155
5.1	INTRODUCTION	155
5.2	PRINCIPLES OF CORPORATE GOVERNANCE IN ISLAM.....	156
5.2.1	Social Responsibility.....	156
5.2.1.1	Islamic Perspective on Social Responsibility	156
5.2.1.2	The Socially Responsible Company.....	160
5.2.2	<i>Adel</i>	161
5.2.3	Trustworthiness and Honesty.....	163
5.2.3.1	Introduction.....	163
5.2.3.2	Trustworthiness.....	164
5.2.3.3	Honesty.....	166
5.2.4	<i>Shura</i> (Consultation)	170
5.2.4.1	<i>Shuratic</i> Decision-making Process in Islam	170
5.2.4.2	<i>Shura</i> and Corporate Governance.....	173
5.2.5	Accountability	175
5.2.5.1	Fear of Allah	175
5.2.5.2	“Encouraging Good and Discouraging Evil”	177
5.2.5.3	Accountability and Corporate Governance.....	179
5.3	A BIRD’S EYE VIEW OF ISLAMIC CORPORATE GOVERNANCE SYSTEM182	
5.3.1	The Protection of Minority Shareholders	183

5.3.2	The Duty of Company’s Management.....	183
5.3.3	Transparency and the Disclosure Framework	184
5.3.4	Accountability	185
5.4	CONCLUSION	187
6.0	CORPORATE GOVERNANCE IN SAUDI ARABIA: GENERAL FRAMEWORK.....	189
6.1	INTRODUCTION	189
6.2	SAUDI CAPITAL MARKET.....	190
6.2.1	Historical Remarks.....	190
6.2.2	Modern Capital Market Structure	193
6.2.2.1	Regulatory Framework	193
6.2.2.2	The Economics of the Saudi Stock Market.....	200
6.3	SOURCES OF SAUDI CORPORATE GOVERNANCE	206
6.3.1	Hard sources	206
6.3.1.1	The Companies Law of 1965	206
6.3.1.2	Capital Market Law and Regulations.....	208
6.3.1.3	Corporate Governance Regulations	209
6.3.1.4	Listing Rules	210
6.3.2	Accounting Standards.....	213
6.3.3	Other Sources of Corporate Governance.....	217
6.4	DISCLOSURE IN THE SAUDI LEGAL SYSTEM	219
6.4.1	Introduction	219
6.4.2	Saudi Disclosure System	221

6.4.2.1	Disclosure by the Company.....	223
6.4.2.2	Disclosure Concerning Members of the Board of Director, Senior Executives, and Shareholders.....	228
6.5	OWNERSHIP AND CONTROL IN SAUDI PUBLICLY TRADED COMPANIES.....	231
6.5.1	Ownership Structure.....	231
6.5.1.1	Government Ownership	233
6.5.1.2	Semi Government Ownership.....	234
6.5.2	Public Pension Agency (PPA).....	235
6.5.3	General Organization of Social Insurance (GOSI)	236
6.5.3.1	Family Ownership.....	238
6.5.3.2	Individual Investors' Holdings	240
6.5.3.3	Foreign Ownership	241
6.5.3.4	Ownership and Control Pattern	244
6.6	SAUDI JUDICIAL SYSTEM AND CORPORATE GOVERNANCE	248
6.6.1	Introduction	248
6.6.2	The Efficiency of the Saudi Judicial System	249
6.6.2.1	The Judicial Process and Enforcement.....	249
6.6.2.2	Judges' Qualifications.....	251
6.6.2.3	Judicial System Segmentation.....	252
6.6.2.4	Transparency.....	254
6.6.2.5	Law Profession	255

6.6.3	Does the Saudi Judicial system support Corporate Governance effectively?	256
6.7	CONCLUSION	260
7.0	INTERNAL CORPORATE GOVERNANCE IN SAUDI PUBLICLY TRADED COMPANIES: BOARD OF DIRECTORS	262
7.1	INTRODUCTION	262
7.2	BOARD STRUCTURE	263
7.3	DECISION MAKING FRAMEWORK	267
7.4	THE ISLAMIC PERSPECTIVE ON BOARD DECISION MAKING	270
7.5	BOARD SIZE AND COMPOSITION.....	272
7.5.1	The Size of the Board	272
7.5.2	Ownership and Nationality.....	273
7.5.3	Membership Ceilings	275
7.5.3.1	Number of Board Memberships	275
7.5.3.2	Age of Directors.....	276
7.5.4	Women’s Representation.....	278
7.6	INDEPENDENCE OF THE BOARD.....	280
7.6.1	Separation of Leadership Posts.....	280
7.6.2	Independent Directors	281
7.6.3	Independence and Board Committees.....	284
7.7	THE BOARD MEMBERS’ DUTIES AND LIABILITY.....	286
7.7.1	The Duty of Care	286
7.7.2	Duty of Loyalty	288

7.7.3	Liability of Directors	291
7.8	THE DIRECTORS AND EXECUTIVES REMUNERATION.....	294
7.8.1	The “Pay Without Performance” Issue.....	294
7.8.1.1	Introduction.....	294
7.8.1.2	Remuneration in Saudi Companies.....	295
7.8.2	“Say on Pay”	299
7.9	CONCLUSION	300
8.0	INTERNAL CORPORATE GOVERNANCE IN SAUDI ARABIAN PUBLICLY TRADED COMPANIES: SHAREHOLDERS RIGHTS, DUTIES AND PROTECTION OF MINORITY	301
8.1	INTRODUCTION	301
8.2	WHO IS THE SHAREHOLDER?.....	302
8.3	THE SHAREHOLDERS’ RIGHTS.....	305
8.3.1	Shareholder Political Rights.....	305
8.3.1.1	Right to attend the Shareholders’ General Meeting (GM)	305
8.3.1.2	Right to Vote.....	308
8.3.1.3	Right to Have Access to Company Information.....	310
8.3.1.4	Right to Sue.....	311
8.3.2	Economic Rights	315
8.4	THE SHAREHOLDERS' DUTIES.....	318
8.5	SHAREHOLDERS’ POWER: THE ORDINARY SHAREHOLDERS’ GM VS. THE EXTRAORDINARY SHAREHOLDERS’ GM	319
8.5.1	Scope of Shareholders’ Power.....	320

8.5.2	B. Procedural Guarantees	323
8.5.2.1	1. Convocation of Shareholders' GMs	323
8.5.2.2	2. Resolutions of Shareholders' GMs	324
8.6	MINORITY SHAREHOLDERS' PROTECTION	326
8.6.1	Introduction	326
8.6.2	Protection through Specific Statutory Provisions	328
8.6.2.1	Right to Call and Attend the Shareholders' GM	328
8.6.2.2	Right to Add Items to the GM Agenda	330
8.6.2.3	Right to Request Dividends.....	331
8.6.2.4	Cumulative Voting in Board Elections.....	332
8.6.3	Equal and Fair Treatment of Shareholders and its Implications for Minority Shareholders.....	334
8.6.3.1	Preemptive Rights.....	334
8.6.3.2	Compulsory Purchase (Tagalong) Rights.....	335
8.7	CONCLUSION	337
9.0	CONCLUSION.....	340
	APPENDIX A	344
	BIBLIOGRAPHY.....	362

LIST OF TABLES

Table 1. Population of the Eight Most Populous Arab States in 2011	15
Table 2. Comparison of GDP of the Five Largest Middle Eastern Economies	23
Table 3. Arab Countries' Capital Markets Indicators	201
Table 4. Saudi Stock Market Capitalization 2002–2011	203
Table 5. Number of Saudi Publicly Traded Joint Stock Companies from 1990 to 2012	232
Table 6. Major Shareholding in Listed Companies Owned by Saudi Government Institutions, According to the Saudi Securities Exchange (Tadawul) Fifteen Market Sectors.....	234
Table 7. Major Shareholding of the Public Pension Agency (PPA) in Saudi Listed Companies by Sector	236
Table 8. Major Shareholding of the General Organization of Social Insurance (GOSI) in Saudi Listed Companies by Sector	237
Table 9. Major Shareholdings of Semi Government Institutions in Saudi Listed Companies by Sectors.....	238
Table 10. Family Ownership in Saudi Arabia in the Saudi Capital Market (at the end of September 2012)	240
Table 11. Top Four Major Individual Shareholders' Ownership in the Saudi Arabian Capital Market (at the end of September 2012)	241

Table 12. Foreign Ownerships in Saudi Listed Banks.....	244
Table 13. Concentration Level of Major Stock Holding (5% or more) in the 20 Largest Saudi Listed Companies	245
Table 14. Number of Major Shareholders in Saudi Listed Companies	246
Table 15. Institutional Major Holding Distribution in the Saudi Capital Market.....	247
Table 16. Number of Judges in Selected Countries	250
Table 17. Two Enforcement Indicators for Selected Countries (2014)	251
Table 18. Executive Remuneration in the Ten Largest Saudi Publicly Held Companies in 2012	297

LIST OF FIGURES

Figure 1. Foreign Membership in the Boards of Directors of Saudi Listed Companies (2011).	274
Figure 2. The Composition of the Saudi-Listed Companies' Boards of Directors in 2011.....	283
Figure 3. The Composition of the Nomination and Remuneration Committee in Saudi Listed Companies (2011).....	285
Figure 4. The Composition of the Audit Committee in Saudi Listed Companies (2011)	286
Figure 5. The Conflict of Interests Approval Requests to the Shareholders GM of the Saudi Listed.....	321
Figure 6. The Number of Ordinary GM Convened According to First and the Second Times Invitations	324
Figure 7. Number of Shares Required for Shareholders GM Attendance in the Largest 20 Saudi Listed Companies (Based on Market Capitalization)	330
Figure 8. The Adoption of Cumulative Voting in Electing the Board Members (2010–2012)..	333

1.0 INTRODUCTION

1.1 GENERAL REMARKS

Saudi Arabia is currently witnessing an economic boom due to both high revenues from petroleum sales and legal reforms that King Abdullah is implementing.¹ In a 2013 World Bank Doing Business Report, Saudi Arabia ranked 26 at the ease of doing business worldwide.² Moreover, Saudi Arabia is one of the most attractive Middle Eastern countries for foreign direct investment: in 2010 the inward FDI reached over \$36 billion dollars.³ Additionally, Saudi Arabia recently became part of the G-20.⁴ However, Saudi Arabia is still a rentier state by which oil represents most of the country's income.⁵ To avoid possible ramifications of an economy based

¹ For example, the new Law of judiciary and King Abdullah Project for Improvement of Judiciary.

² See World Bank, Doing Business Report 2013, *available at* <http://www.doingbusiness.org/Rankings> (accessed on Jan. 20, 2014). Saudi Arabia was ranked 13 in 2010. *Id.*

³ See Table A: Distribution of FDI Flows among Economies by Range, 2012 and Annex Table 1. FDI by Region and Economy, 2007–2012, in World Investment Report (2013): Global Value Chains: Investment and Trade for Development, *available at* http://unctad.org/en/PublicationsLibrary/wir2013_en.pdf (accessed on Jan. 20, 2014).

⁴ For information about the G-20 group see Australian Department of Foreign Affairs and Trade, homepage, *available at* <http://www.dfat.gov.au/trade/g20/> (accessed on Jan. 20, 2014).

⁵ Government Spending represents more the third of the country GDP. See Heritage, 2014 Index for Economic Freedom, *available at* <http://www.heritage.org/index/country/saudi-arabia> (accessed on Jan. 20, 2014). According to the originator of this concept “Rentier States are defined ... as those countries that receive on a regular basis substantial amounts of external rent. External rents are in turn defined as rentals paid by foreign individuals, concerns or governments to individuals, concerns or governments of a given country.” See H. Mahdavy, *The Pattern and Problems of Economic Development in Rentier States: The Case of Iran*, in *STUDIES IN THE ECONOMIC HISTORY OF THE MIDDLE EAST: FROM THE RISE OF ISLAM TO THE PRESENT DAY* 428 (M.A. Cook ed., Oxford University

on only one revenue source, the Saudi government launched ambitious projects and announce further plans to diversify the economy.⁶

At the top of the reform agenda is economic reform. Accordingly, many laws and regulations have been enacted or amended – most notably in matters related to trade and investment – especially in corporate governance. One of the most notable steps was the creation of the Saudi Capital Market Authority (CMA) in 2003 and the enactment of the Capital Market Law to complement the Companies Law of 1965.⁷ The newly established Capital Market Authority enacted several regulations that were transplanted, mostly from Anglo-American tradition, to regulate the Saudi capital market.⁸

Despite that, a massive capital market crash occurred two years later (2006), with the result that savings of middle class investors vanished. Although the capital market crash was mainly related to the unreasonable increase in share prices, many voices at all levels of public and private sectors attributed such a crisis to the weak corporate governance structure in Saudi Arabia.⁹ Even the King himself was displeased with the middle class's collective losses in the

Press, 1970). Moreover, Mahdavy notes that “the oil revenues received by the governments of the oil exporting countries have very little to do with the production processes of their domestic economies.” *Id.* at 429.

⁶ For example, Saudi Arabia is building four huge economic cities which cost \$60 billion dollars. *See* <http://www.sagia.gov.sa/en/Why-Saudi-Arabia/Economic-cities/> (accessed on Oct. 27, 2010).

⁷ Until 2004 the Companies Law was the only statutory source of corporate governance in the country.

⁸ Professor James Cox of Duke Law School is the chief drafter of the Saudi Capital Market Law. *See* Joseph W. Beach, *The Saudi Arabian Capital Market Law: A Practical Study of the Creation of Law in Developing Markets*, 41 STAN. J. INT'L L. 307, 308 (2005).

⁹ *See* Institute of International Finance, Inc. & The Institute for Corporate Governance, *Corporate Governance in Saudi Arabia: An Investor Perspective* 1 (2006) which describes the situation of the Saudi capital market:

[T]he equity culture in Saudi Arabia Remains weak as investors lack sophistication. The bulk of investors manage their own portfolios, usually without access to investment research, and much of their activity is driven by incomplete information and rumor. During the bull market of 2004 and 2005, many non-professional investment management firms were set up, which charged lower fees

capital market. Appearing on national television, he (the King) promised to indemnify the affected small investors by allowing them to invest in a government-managed risk free fund.¹⁰ In the same year, a group of international experts concluded that “Saudi Arabia’s corporate governance framework complied with only one-half of guidelines recommended in the [Institute of International Finance’s (IIF)] *Policies for Corporate Governance in Emerging Markets*.”¹¹ In response to this obvious corporate governance issue, the Capital Market Authority CMA announced new corporate governance principles based on best corporate governance practices.¹² Nonetheless, Saudi corporate governance system still has not been compliant with best practices. In 2009, for instance, a World Bank assessment of the Saudi corporate governance, including the corporate governance principles, indicated that Saudi corporate governance falls behind international best practice standards, namely the OECD Principles.

Changes in economic and business practices around the globe and the rapid reform movement in developing countries, however, require that a sound corporate governance structure to be implemented in Saudi Arabia. In other words, Saudi Arabia has to compete effectively in the “race to the top” for corporate governance reform, in part to attract national and international portfolio investors.¹³ A well-structured corporate governance model is necessary to attract more

compared to established and reputable financial institutions. Poor monitoring by the authorities of these companies allegedly allowed them to make profit by front-running.

¹⁰ Nothing has yet been set in this regard.

¹¹ Institute of International Finance, Inc. & the Institute for Corporate Governance, *Corporate Governance in Saudi Arabia: An Investor Perspective* 11 (2006).

¹² Its official name is “Corporate Governance Regulation in the Kingdom of Saudi Arabia” issued by the Board of Capital Market Authority resolution No. 1/212/2006 dated 21/10/1427 (corresponding to 12/11/ 2006), available at <http://www.cma.org.sa/En/Documents/CORPORATE%20GOV.pdf> (accessed on Oct. 28, 2010) [hereinafter SCGR].

¹³ This phrase is borrowed from “the race to the top” phrase in American corporate law literature referring to the competition among U.S. states for increasing the corporate law standards to attract more incorporation in their states. This view is adopted as a counter argument against an older view that argued states are racing to the bottom

investors to the capital market as well as to open a new venue of low cost financing for national companies.

1.2 THE DISSERTATION HYPOTHESES

More reforms have to be implemented to improve the Saudi corporate governance. However, a reform plan should not merely be about blind compliance with international best practices. Corporate governance reform is more than a cut and paste process. A winning reform agenda has to take national factors into consideration, as Professor Bernard Black and Reinier Kraalman had noted that “emerging economies cannot simply copy the corporate laws of developed economies. These laws depend upon highly evolved market, legal and governmental institutions and cultural norms that often do not exist in emerging economies.”¹⁴

The Saudi economy represents a concentrated ownership system with a controlling majority shareholder(s) v. minority shareholders agency problem.¹⁵ Moreover, Saudi Arabia lacks the prerequisite institutions that are able to support efficient corporate governance.¹⁶ For

by lowering their governance standards instead. For more information about the race to the bottom and the race to the top *See generally* William L. Cary, *Federalism and Corporate Law: Reflection upon Delaware*, 88 YALE L.J. 663 (1974) FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 5–6 (1991).

¹⁴ Bernard Black & Reinier Kraalman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1913 (1995–1996).

¹⁵ *See* John Armour et al., *Agency Problems and Legal Strategies*, in *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 35, 36 (Reinier Kraakman et al. eds., 2d ed. 2009). Also, *see* the World Bank, *Corporate Governance: A Framework for Implementation* 29 (2002) (“[t]he ownership structure in corporate sector and its financing sources have a defining impact on the design of corporate governance systems.”). *Id.*

¹⁶ *See generally* Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781 (2000–2001).

example, the judiciary is underdeveloped and extremely slow: if someone has a judgment to enforce, he will wait a long time to see enforcement enacted. Also, the administrative authority, required by law to oversee companies, is not able to do so efficiently because of the lack of qualified people to enforce relevant laws and the shortage of staff. As the General Director of the Companies Directorate at the Saudi Ministry of Commerce and Industry has said, “We cannot keep up. I work day and night just to finish the necessary work.”¹⁷ Having well functioning institutions represents a backbone for external corporate governance.¹⁸ However, achievement of such a thing by developing countries needs a very long and complex process of reform which may not always succeed.

Agency problem type and a weak external enforcement mechanism in the Saudi system suggest that immediate reform of corporate governance should focus on internal corporate governance, namely shareholder position including minority shareholders protection and the board of directors.¹⁹ Internal governance is based mostly on the quality of the mentioned organs of company governance, as Professor Arthur Pinto put it, “[i]nternal corporate governance looks at the allocation of power and internal mechanism designed to protect shareholders without undermining those who need to manage the corporation.”²⁰ Such a strategy of reform does not

¹⁷ Personal interview in Saudi Arabia (Sept. 2010).

¹⁸ External corporate governance refers to “[f]orces from outside the corporation exercise a disciplining influence on management as well, in particular various markets such as takeover.” (Footnote omitted.) Klaus J. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation*, 59 AM. J. COMP. L. 1, 8 (2001).

¹⁹ Internal governance is connected to the power within the corporation and the interaction between the board of directors and shareholders. See Hopt, *supra* note 18. The drafters of the new Russian joint stock companies statute had considered the issue of weak external governance in Russia. The Russian statute is based mainly on enfacement of corporate governance through checks and balance between internal governance mechanisms and less discretionary legal provisions (Bright-Line Rules). See Black & Kraalman, *supra* note 14, at 1911.

²⁰ Arthur R. Pinto, *An Overview of the United States Corporate Governance in Publicly Traded Corporations*, 58 AM. J. COMP. L. 257, 264 (2010).

intend to undermine the importance of administrative and judicial reforms to corporate governance efficiency in the country, but rather offers fast track reform proposals that may increase the corporate governance system until a full development of strong institutional structure in the country is hopefully established. Well-structured internal corporate governance is expected to comply with a number of comparative benchmarks that may reduce agency cost problem and observe the Saudi moral systems, particularly ones related to Islam. Linking corporate governance to the country's moral system will more likely facilitate legal transplant of corporate governance standards into the Saudi system.²¹

1.3 THE METHODOLOGY

This study uses analytical and comparative law methodologies. Comparative law methods will serve this dissertation from several different sides. One example is to understand the nature of corporate governance problems under the Saudi system.²² The second example is to determine if the solutions that are found in other legal systems – whether legislative, non-binding principles, and other comparative corporate governance literature – offer insight for improving the Saudi corporate governance.²³ In this context, Professors Zweigert and Kotz have remarked that

²¹ See Denial Berkowitz et al., *The Transplant Effect*, 51 AM. J. COMP. L. 257, 163 (2003) (“for the law to be effective, it must be meaningful in the context in which it is applied so citizens have an incentive to use the law and to demand institutions that work to enforce and develop the law”). *Id.* at 167.

²² See generally Hiram E. Chodosh, *Comparing Comparisons: In Search of Methodology*, 84 IOWA L. REV. 1025, 1073–74 (1999).

²³ See generally Chodosh, *supra* note 22, at 1025, 1074–77.

“[I]n legislators all over the world have found that on many matters good laws cannot be produced without the assistance of comparative law.”²⁴

1.4 THE SOURCES

Generally speaking, the Saudi library lacks a wealthy secondary source on corporate law and governance. Moreover, secondary sources in other Arab countries with regard to corporate governance theory and reform debate are rare, thin and descriptive in nature.²⁵ Consultation of such sources does not normally provide insight into reforms but rather furnish a better understanding of legal issues at hand in a similar way hornbooks work in the U.S. legal system. Therefore, comparative corporate governance literature represents an indispensable source for accomplish the goal of this dissertation.

Saudi Arabian case law relating to company law and governance has still not been published. An insistent investigation (with special approval) has revealed that few cases were filed with regard to corporate governance matters, especially derivative lawsuits in which no single case has been located.²⁶ Thus, Saudi court decisions will contribute little to this research.

²⁴ K. ZWEIGERT & H. KOTZ, AN INTRODUCTION TO COMPARATIVE LAW 16 (3d ed. 1998).

²⁵ An exception to this statement is the work of Dr. Almajid, providing a general overview of Saudi corporate governance. *See* Fahad Mohammad Almajid, A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective (Ph.D.) (2008) (unpublished dissertation University of Manchester). Almajid’s work mainly provides an extensive evaluation of the external and internal Saudi corporate governance structures against the U.S. and U.K. structures. Conversely, this dissertation argues for reforming Saudi corporate governance through internal corporate mechanisms. Most of the discussions related to external governance mechanisms were to support that hypothesis.

²⁶ I could not locate a single case. In fact, I do not know if this is related to poor record keeping or, in fact, is true.

The study will consult a number of unpublished or not widely circulated administrative decisions, circulars and legal memos. Such documents (especially the ones issued by the Ministry of Commerce and Industry) play a crucial role in understanding the nature of Saudi corporate governance and to define a number of issues that affect the efficiency of that system.

1.5 VALUE AND AIMS OF THE DISSERTATION

Generally, there are few studies about the Saudi legal system and fewer still about Saudi company law or governance in English and Arabic. Accordingly, the dissertation hopefully will fill in some gaps relating to Saudi company law and corporate governance that English-speaking and future Saudi scholars interested in corporate governance, in general, or internal corporate governance in Saudi Arabia, including minority shareholders' protection, in particular, will find helpful.

The dissertation will contribute to a better understanding of Saudi company law and Saudi corporate governance. Comparing our structure of corporate governance with the governance structure of other countries carries a great deal of importance for better understanding of our law.²⁷ Last and most importantly, the dissertation is intended to present to Saudi policy makers and future drafters of new company law and governance guidelines with a clear insight and wisdom needed to implement legal reform.

²⁷ See Chodosh, *supra* note 22.

1.6 STRUCTURE OF THE DISSERTATION

To achieve its objectives, apart from this introduction **chapter**, the dissertation is divided into eight chapters. **Chapter Two** provides the necessary background of Saudi Arabian history, economy and legal system with illustration of the constitutional structure. The chapter illustrates sources of the legal rules, both positive and religious. As well the chapter will then shed light on the important forms of business organizations under Saudi law: general partnership, limited partnership, Limited Liability Company, and Joint Stock Company.

Chapter Three will discuss the concept of corporate governance by summarizing different points of view attempting to define this illusive concept. One of the chapter goals is to show that corporate governance can be defined in different ways depending on perspective. Then, the chapter will address factors that made corporate governance a globally important topic, such as market crashes, globalization, foreign direct investment, sovereign creation of wealth funds and privatization.

Chapter Four will review two important philosophical questions whose answers will weigh heavily on the entire structure of the country involved. The first question is: what is the nature of the public company? The second question is: for whose interest should the public company be run? Finally, the chapter will be shed light on ownership and control theory as originally formed Berle and Means' seminal book, "*The Modern Corporation and Private Property*."²⁸ Then the chapter will provide a brief survey of agency cost problem in dispersed and concentrated models of ownership and what different problems each model may have.

²⁸ ADOLF A. BERLE JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1933). Although Berle and Means were not the first to recognize the separation of ownership and control in

Chapter Five will examine Islamic views on corporate governance. It will first illustrate Islamic views on governance, then illustrating the interactions and implications of the Islamic system with respect to modern corporate governance ideology.

Chapter Six will be dedicated to examining the general framework of corporate governance in Saudi Arabia. The chapter will shed light on the Saudi capital market including the ownership pattern of publicly held companies. Moreover, the sources of corporate governance will be listed. The legal framework governing disclosure systems will be explored. Finally, this chapter will assess the ability of the Saudi judicial system to support corporate governance.

Chapters Seven and Eight will be devoted to evaluating internal corporate governance in Saudi Arabia. **Chapter Seven** will be devoted to the examination of the board of directors. In this chapter, the board structure, formation, directors' duties and remuneration will be discussed. **Chapter Eight** will focus on shareholders' position – particularly their rights, collective decision making (general meeting), and minority shareholders protection. Specific comparative points will be raised in these chapters. Moreover, through all parts of the chapter alternative arrangements will be proposed.

publicly held corporations; however, they did shed light on this matter. Historically, Adam Smith noted this problem in his seminal work:

The directors of such companies, however, being the manager rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. It is upon this account that joint stock companies ... have seldom been able to maintain the competition against private adventurers.

ADAM SMITH, THE WEALTH OF NATIONS 941 (Bantam Classic ed. 2003).

Chapter Nine will provide the reader with the conclusion of this dissertation, listing the main recommendations for reform of the Saudi internal corporate governance.

2.0 SAUDI ARABIA: HISTORY, ECONOMY, AND LEGAL SYSTEM

2.1 INTRODUCTION

This chapter provides the necessary background of Saudi Arabia beginning with the contemporary history and economy. Then brief view of Saudi legal system will be delineated of the State and the relationship between religion and politics from inception until present day. The chapter then explores the constitutional arrangement and structure of power in the country. The chapter will explain the sources of legal rules in Saudi Arabia namely, first the positive sources which are legislations and regulations. Second, the chapter will provide a brief background of Islamic law sources such as the Koran and the *Sunna* (Prophet Mohammad's traditions). The end of the chapter will provide a brief background of business organizations under Saudi legal system.

2.2 THE KINGDOM OF SAUDI ARABIA

2.2.1 Introduction

Saudi Arabia is situated in *Jazirat Al-Arab* (Arab Peninsula or Island)¹ with a size of 2,149,690 SQ KM,² around 20% of the United States of America in size³ and nearly the same size as Western Europe.⁴ In the early seventh century, in the Hejaz region, the western part of Saudi Arabia, the Islamic faith was introduced in Mecca by the Prophet Mohammad.⁵ Soon after, the Prophet had established the first Islamic state in another Hejazi city, Medina.⁶ Muslims around the world are obligated to pray, *Assalah*, toward Mecca (*Qibla*)⁷ five times per day and to visit Mecca twice in their life time: one time for the *Hajj* (pilgrimage)⁸ and the other for the *Umrah* (a

¹ *Jazirat Al-Arab* size is 2,590,000 square kilometers. *Jazirat Al-Arab* literally means “Arab Island” while its true meaning refers to the Arab Peninsula because it is surrounded by only three seas: the Red Sea from the west, Arabian Gulf from East, and Arabian Sea from the south. The northern side of Arab Peninsula is bordered by the Fertile Crescent including Mesopotamia. The Arab peninsula is on the western end of the Asian continent at the heart of the so called “Middle East” region. The Arab Peninsula contains several Arab countries: Saudi Arabia, Yemen, Oman, Bahrain, Kuwait, Qatar, UAE and parts of Jordan and Iraq. For general information on the geography of the Arab peninsula, see, e.g., Fathi Mohammad Abu Ainah, *Drasat fi jugrafiat shibh jazeera al arab* (1994). (Studies on the Geography of Arabian peninsula).

² U.S. Department of State website, available at <http://www.state.gov/r/pa/ei/bgn/3584.htm> (accessed on Apr. 18, 2012).

³ *Id.*

⁴ ALAN RICHARDS & JOHN WATERBURY, *A POLITICAL ECONOMY OF THE MIDDLE EAST* 37–__ (3d ed. 2008).

⁵ See, e.g., FOUAD AL-FARSI, *MODERNITY AND TRADITION: THE SAUDI EQUATION* 36 (1994); ALBERT HOURANI, *A HISTORY OF THE ARAB PEOPLES* 14–15 (1991).

⁶ See AL-FARSI, *supra* note 5.

⁷ Qibla is an Arab word that “... refers to the proper direction for prayer.” The direction has to be toward the Kaaba, which is located in Mecca. RAJ BHALA, *UNDERSTANDING ISLAMIC LAW (SHARI’A)* 362 (2011).

⁸ Allah orders every eligible muslim to perform the Hajj, as Allah said in the Koran: “And pilgrimage to the House is a duty unto Allah for mankind, for him who can find a way thither. As for him who disbelieveth, (let him know that) lo! Allah is Independent of (all) creatures.” (Koran: Surat Al-Emran, Verse number 97). The Hajj and prayer are part of Islam’s five pillars of faith: Asshahada (to testify that “there is no god but Allah and Muhammad is His prophet); Assalah (prayer); Assiyam (fasting during the month of Ramadan); Azzakat (religious tax spent in

mandatory visit to Mecca in the life time).⁹ Such a position has privileged Saudi Arabia with a special importance in the Islamic world and with significant value in the hearts of Muslims around the globe.

The majority of the country's land consists of rough and rugged topography. Infertile deserts form nearly all of Saudi Arabia's vast territory where neither rivers nor lakes exist. The annual rainfall average in most Saudi lands is less than (50.8 cm) making non-irrigated agriculture a challenging activity in most parts of the country.¹⁰ 27,136,977 people inhabit Saudi Arabia,¹¹ the sixth most populous Arab state.¹² Only eighteen million are Saudi citizens: the rest of the population mostly are expatriate laborers and their dependents.¹³ All Saudi citizens are

prescribed charitable purposes); and the Hajj. For a brief overview of the pillars see generally AL-FARSI, *supra* note 5, at 32–35.

⁹ The Koran provides that the faithful should “Perform the pilgrimage and the visit (to Mecca) for Allah” (Koran: Surat Al-Baqara, Verse number 196).

¹⁰ RICHARDS & WATERBURY, *supra* note 4, at 44. However, agriculture is widespread in al-Hasa oasis in the eastern part and in the rainy southwestern region of Asir. See TIM NIBLOCK & MONICA MALIK, *THE POLITICAL ECONOMY OF SAUDI ARABIA* 35 (2007).

¹¹ The Saudi Central Department of Statistics and Information, Key indicators, <http://www.cdsi.gov.sa/> (accessed on Apr. 18, 2012).

¹² Egypt is the most populous Arab country with about 83 million people. The CIA World Factbook, available at <https://www.cia.gov/library/publications/the-world-factbook/geos/eg.html> (accessed on Apr. 25, 2012). Algeria is the second populous Arab state with around 35 million inhabitants. The CIA World Factbook, available at <https://www.cia.gov/library/publications/the-world-factbook/geos/ag.html> (accessed on Apr. 25, 2012). The third most inhabited Arab state is Sudan with a population of around 34 million. The CIA World Factbook, available at <https://www.cia.gov/library/publications/the-world-factbook/geos/su.html> (accessed on Apr. 25, 2012).

¹³ The Saudi Central Department of Statistics and Information, Key indicators, <http://www.cdsi.gov.sa/> (accessed on Apr. 18, 2012). The country's early development plans necessitate hosting foreign workers and highly skilled professionals to live and work in the country for all endeavors. However, this shortage of workforce is not a problem anymore due to the massive increase in the Saudi population in the last few decades. Available statistics did not indicate how many workers' dependents are in-country and there is no estimate of the illegal immigrants who usually come to visit (for Hajj or Umrah) the Islamic Holy Cities (Mecca and Madina) and decide not to return to their home countries or formerly legally hosted workers who remain in the country after the expiration of their work permit. For the illegal workforce in Saudi Arabia see RODNEY WILSON ET AL., *ECONOMIC DEVELOPMENT IN SAUDI ARABIA* 98 (2004).

Muslims; 90% of them are of Arab origin.¹⁴ Sunni Muslims form the majority of Saudi citizens with the remainder chiefly Shiite Muslims.¹⁵ Saudi Arabia is a young country with only 3% of the country's population above the age of 65.¹⁶

Table 1. Population of the Eight Most Populous Arab States in 2011

No.	Country	Population (Million)
1	Egypt	82,536
2	Algeria	35,980
3	Sudan	34,318
4	Iraq	32,961
5	Morocco	32,272
6	Saudi Arabia	28,082
7	Yemen	24,799
8	Syria	20,820

Source: World Bank, World Development Indicators.

Since its beginning, Saudi Arabia has been an active member of the international community. For instance, in the wake of World War II, Saudi Arabia was one of the subscribers to the United Nations' (U.N.) Declaration and hence joined allies at The San Francisco conference to sign the U.N. Charter.¹⁷ Also, Saudi Arabia has membership in many international organizations and agencies, most importantly the International Monetary Fund (IMF), World Bank, World Trade Organization (WTO), and most recently the G-20 group. Additionally, Saudi

¹⁴ CIA, World Factbook, available at <https://www.cia.gov/library/publications/the-world-factbook/geos/sa.html> (accessed on Mar. 15, 2012).

¹⁵ There is no available Saudi official record indicating the percentage of Shiite Muslims in Saudi Arabia. However, studies suggest that they are between 10 to 15 percent of the Saudi population. See Crisis Group Middle East Report N. 45, The Shiite Question In Saudi Arabia, 19 September (2005), p. 1, available at <http://www.crisisgroup.org/~media/Files/Middle%20East%20North%20Africa/Iran%20Gulf/Saudi%20Arabia/The%20Shiite%20Question%20in%20Saudi%20Arabia.pdf> (accessed on Apr. 20, 2012).

¹⁶ CIA, World Factbook, available at <https://www.cia.gov/library/publications/the-world-factbook/geos/sa.html> (accessed on Nov. 20, 2011).

¹⁷ The History of The United Nation Charter of the United Nations, on the U.N. website, available at <http://www.un.org/en/aboutun/charter/history/declaration.shtml> (accessed on Apr. 20, 2012).

Arabia is a member and has a very influential role in other international and regional organizations and institutions such as the Organization of Islamic Cooperation (OIC),¹⁸ the League of Arab States (LAS),¹⁹ and the Cooperation Council for the Arab States of the Gulf (GCC).²⁰ In 1960s, Saudi Arabia and other oil-producing countries founded the Organization of Petroleum Exporting Countries (OPEC),²¹ an intergovernmental organization whose chief responsibility is to coordinate oil production policies of its member oil-producing countries and to represent their interests in front of oil consumers.²²

¹⁸ The organization was founded in 1969 and consisted of 57 states (those states were a mixture of Islamic states and states having Islam as an influential presence on Muslim citizens. For member states see the OIC website *available at* http://www.oic-oci.org/member_states.asp (accessed on Apr. 22, 2012). The main objectives of OIC, *inter alia*, is “[t]o enhance and consolidate the bonds of fraternity and solidarity among the Member States; [and] [t]o safeguard and protect the common interests and support the legitimate causes of the Member States and coordinate and unify the efforts of the Member States in view of the challenges faced by the Islamic world in particular and the international community in general.” The OIC Charter Article 1 paragraphs 1 and 2, *available at* <http://www.oic-oci.org/english/charter/OIC%20Charter-new-en.pdf> (accessed on Apr. 22, 2012).

¹⁹ The League of Arab States [hereinafter LAS] is an intergovernmental organization whose concerns are the 22 Arab states’ affairs. The LAS was established in 1945. For more information about LAS website, *available at* http://www.arableagueonline.org/wps/portal/las_en/home_page!/ut/p/c5/04_SB8K8xLLM9MSSzPy8xBz9CP0os3gXy8CgMJMgYwOLYFdLA08jF09_X28jIwN_E6B8JG55C3MCuoNT8_TDQXbiNwMkb4ADOBro-3nk56bqF-RGVHjqOioCAKQoUKM!/dl3/d3/L2dBISEvZ0FBIS9nQSEh/ (accessed on Apr. 22, 2012).

²⁰ The Gulf Cooperation Council [hereinafter GCC] The GCC was founded in 1981 in accordance to its Charter. The GCC consists of the six Arab states, including Saudi Arabia, which are adjacent to the Arabian Gulf: Bahrain, Kuwait, Qatar, United Arab Emirates, and Oman. The GCC is advancing toward creating a free trade union among its members. See the GCC Charter, *available at* <http://www.gcc-sg.org/eng/indexfc7a.html?action=Sec-Show&ID=1> (accessed on Apr. 22, 2012).

²¹ See Organization of Petroleum Exporting Countries [hereinafter OPEC] Statute, *available at* OPEC website http://www.opec.org/opec_web/static_files_project/media/downloads/publications/OS.pdf (accessed on Apr. 22, 2012). For an overview of OPEC foundation and the reason for its creation, see AL-FARSY, *supra* note 5, at 118–19.

²² OPEC statute provides that “[t]he principal aim of the Organization shall be the coordination and unification of the petroleum policies of Member Countries and the determination of the best means for safeguarding their interests, individually and collectively.” OPEC Statute Article (2) paragraph (A).

2.2.2 The History of the State

The Arab Peninsula became part of an Islamic state in the early history of Islam as the majority of the inhabitants of that region converted to Islam. However, throughout the history of Islamic rule in the middle of the Arab Peninsula, an area known as the Najd, that part did not play a vital role in the emerging Islamic state in any political, economic, cultural fashion, or in any manner regarding Islamic jurisprudence.²³ The status of the Najd continued to be a “non-entity” even at the peak of the Ottoman (Islamic) Empire which rendered the middle of the Arab Peninsula a political vacuum: the region was governed by a primitive form of governance whereby every village or town was ruled by one of its inhabitants.²⁴ In other words, there was no central government in existence.²⁵ Accordingly, poverty and illiteracy covered the heart of Arab Peninsula (the Najd). The state of ignorance in the Najd facilitated the spread of paganistic behaviors among some Muslims including the worshiping of trees and the supplicating of tombs.²⁶ In contrast, the opposite side of the Peninsula, an area known as the Hejaz which included two of the three holy Mosques of Islam, had a centralized management due to the area’s religious importance.²⁷ Consequently, cultural and economic conditions in the Hejaz were much

²³ See UWAIHAH M. AL JUHANY, *NAJD BEFORE THE SALAFI REFORM MOVEMENT: SOCIAL, POLITICAL, AND RELIGIOUS CONDITIONS DURING THE THREE CENTURIES PRECEDING THE RISE OF THE SAUDI STATE 2* (Ithaca Press 2002).

²⁴ The method of assuming leadership in those settlements varies from one place to another and from time to time was decided through force or choice. See ABDULAH SALAH ALAUTHIMEEN, *TAREEK ALMAMLAKAH ALARABIAH ALSAUDIAH* vol. 1, 46 (1999). For more information about the economic, social, and political situation in Najed before the establishment of the first Saudi state. See *id.* at 35–38.

²⁵ See MADAWI ALRASHEED, *A HISTORY OF SAUDI ARABIA* 13 (2010).

²⁶ See generally UTHMAN IBN BISHR, *UNWAN AL-MAJD FI TARIKH NAJD* 81. vol. 1 (Dar al-Habeib 2008).

²⁷ ALAUTHIMEEN, *supra* note 24 at 23–24.

better than its counterpart conditions in the Najd.²⁸ However, the Islamic faith in Hejaz too was mixed with some Hippocratic rituals which deviated from pure Islamic faith.²⁹

2.2.2.1 The First Saudi State (1745-1818)

In the 18th century, Mohammad bin Abdulwahhab,³⁰ a son of an Islamic judge and scholar,³¹ openly rejected the deterioration of the Islamic faith in the Arab Peninsula.³² To purify the Islamic religion from the *biddah* (heterodoxies), Sheik Mohammad bin Abdulwahhab requested military support from the regional rulers in the Najd.³³ All of those rulers denied his request for assistance³⁴ except for Mohammad bin Saud, the ruler of the tiny Najdi village of Aldiriyah, who agreed to support the sheik by launching a *jihad* (holy war or mission).³⁵ This alliance is later called The Aldiriyah Pact.³⁶

²⁸ From all of the Islamic territories, Islamic jurists (*Ulima*) came to stay around Islam's two holy mosques in the Hejaz where they taught and wrote Islamic shariah. See ALAUTHIMEEN, *supra* note 24, at 23–24.

²⁹ *See id.* at 24–25.

³⁰ He was born in (1703) in the town of Aluyanah in the Najd, near Riyadh.

³¹ His name is Abdulwahhab bin Sulaiman bin Ali al-Tamimi. For his complete name, see IBN BISHR, *supra* note 26, at 198.

³² *See id.* at 86.

³³ *See id.*

³⁴ In fact, ibn Muamar was enthusiastic in supporting Sheik Mohammad's cause to reform all the aspects that contradicted pure Islamic beliefs. Sheik Mohammad instituted capital punishment by stoning an adulterous woman. This action elicited much opposition from the leader of Bani-Khalid tribe who had ultimate control of all the Najd region, including Aloyana. To appease the Bani-Khalid leader, ibn Muamar asked Sheik Mohammad to flee the area to safeguard him and his people.

³⁵ *See* IBN BISHR, *supra* note 26, at 89.

³⁶ In this agreement, Mohammad Bin Saud stipulates that the rule of the intended state stays in his hand and those of his descendants as long as they respect and uphold the principles of the Sheik Mohammad bin Abdulwahhab in protecting Islam from biddaa and govern in accordance with Islamic law (Shariah).

This allegiance surprisingly created a very strong state that spread and ruled most of the Arab Peninsula³⁷ while its military operations reached north to the Islamic Shiite Holy City in Iraq (Alnajaf).³⁸ This expansion precipitated fear throughout the Ottoman Empire as such growth jeopardized the Empire's control of the region.³⁹ Consequently, the Empire dispatched its army to the capital of the state, Aldiriyah, to subvert the movement and regain control over that region.⁴⁰ The Ottoman army accomplished its mission by destroying Aldiriyah⁴¹ and killed or exiled many members of both the al-Saud and Sheik Mohammad bin Abdulwahhab families.⁴²

2.2.2.2 The Second Saudi State (1840-1891)

Several years after the destruction of first Saudi state, Imam Faisal bin Turki, the grandson of Mohammad bin Saud, the founder of the first state, reestablished the Saudi state in Riyadh.⁴³ However, shortly after the death of Imam Faisal,⁴⁴ an internal struggle over the rule occurred

³⁷ The first Saudi state was bigger than its current predecessor, "The Kingdom of Saudi Arabia," wherein at its peak the state ruled Qatar, the United Arab Emirates, most of Oman, and some parts of modern Yemen. See ALAUTHIMEEN, *supra* note 24, at 149–50.

³⁸ Also, the Saudi army raided Basrah and Zubair; however, no part of Iraq was annexed by the Saudi state. See ALAUTHIMEEN, *supra* note 24, at 162–63.

³⁹ See ALRASHEED, *supra* note 25.

⁴⁰ See IBN BISHR, *supra* note 26, at 350.

⁴¹ See *id.* at 89.

⁴² In 1818, see *id.* at 381.

⁴³ AMEEN AL-RIHANI, TAREEK NAJD AL-HADEETH 94 (the Arab Institute of research and publication: 1980). Some historians attribute the reestablishment of the second Saudi state to Imam Faisal's father, Turki, who assumed the power of the state for a short period before he was assassinated by his nephew, Mashari, a member of the Al-Saud family, see, for example, ALAUTHIMEEN, *supra* note 24, at 219–34. However, other historians have more compelling points of view for not regarding Imam Turki as the first founder of the Saudi second state. As Professor Abu Aliyah argues, all attempts by Al-Saud family members at that period were merely part of a revolutionary movement against the Ottoman influence. The goal of such movements was achieved only during the period of Imam Faisal Bin Turki's rule after the withdrawal of the Othman army in 1840 from the Arab peninsula. See ABDULFATAH ABU ALIYAH, ALDAWLAH ALSAUDIYAH ALTHANIYAH 33 (1980).

⁴⁴ Imam Faisal died in 1865; however, his rule of the Najd was not constant were the Ottoman Empire exiled him twice into Egypt. See AL-RIHANI, *supra* note 43, at 94-95.

between the Al-Saud family members, namely the sons of Imam Faisal bin Turki.⁴⁵ Consequently, Prince Mohammad bin Rasheed, the governor of Hail and the head of the Al-Saud's rival family, the Rasheed's, decided to overthrow the Saud family and sent his army to conquer the region.⁴⁶ His military brought the leaders of the Al-Saud family to Hail to live under the rule and watchful eye of Prince Mohammad bin Rasheed.⁴⁷

2.2.2.3 The Modern Saudi State (1932)

At the beginning of the twentieth century,⁴⁸ Abdulaziz Bin Abdurrahman Al-Saud, a grandson of the founders of the first and second Saudi states, attempted to reestablish the Saudi state for the third time. His mission started from when he left his father's exile in Kuwait⁴⁹ with a few companions to recapture Riyadh from the rule of the Rasheed family.⁵⁰ In 1902 he invaded Riyadh and started building his new state upon the same pure Islamic principles upon which his grandfather and Sheik Mohammad bin Abdulwahhab built the first Saudi state.⁵¹ However, the creation of the Saudi state under the guise of Abdulaziz required more than thirty years of war,⁵²

⁴⁵ See AL-RIHANI, *supra* note 43, at 97.

⁴⁶ Alrasheed Family is from Shammar tribe. For more information about the history of Al-Rasheed family see ABDULLAH SALAH ALAUTHIMEEN, NISHAAT AMART ALRASHEED (Riyadh: H 1411 [1990]).

⁴⁷ See AL-RIHANI, *supra* note 43, at 103.

⁴⁸ In 1901 Abdulaziz launched his first attempt to invade Riyadh and was not successful.

⁴⁹ He was living with his father, Abdurrahman, who was one of the fighting brothers whose efforts contributed to the end of the second Saudi state.

⁵⁰ They were about forty persons see AL-RIHANI, *supra* note 43, at 7.

⁵¹ See ALAUTHIMEEN, *supra* note 24, at 49–55.

⁵² For more details about Imam Abdulaziz's efforts to unify the Kingdom, see generally AL-RIHANI, *supra* note 43, at 103.

most of which was with the Rasheed family.⁵³ After a long struggle of strife on both sides of the Arab peninsula, Imam Abdulaziz acquired full control of what is known today as Saudi Arabia.⁵⁴ Upon the unification of all Abdulaziz's intended territories, he named the newly unified state The Kingdom of Saudi Arabia and declared himself its king.⁵⁵ To the present day, the Kingdom still exists in the same shape established by King Abdulaziz. After his death,⁵⁶ his sons succeeded him in ruling the Kingdom.⁵⁷

2.2.3 The Saudi Economy

2.2.3.1 Overview

In 1932, modern Saudi Arabia emerged into a rough economic and socio-political environment. Each societal community had its own nearly self-contained closed economy and independent political order.⁵⁸ Saudi Arabia was one of the poorest countries in the world with a primeval economy that was based mainly on agriculture and trade (largely through barter).⁵⁹ The country

⁵³ Alrasheed family ruled the Arab peninsula for about one hundred years. At the zenith of their power, the state ranged from the southern part of current Syria southward to the northern part of current Yemen. *See generally* ALAUTHIMEEN, *supra* note 24.

⁵⁴ This occurred in 1930 upon the annexation of Jazan province in the southern region of modern Saudi Arabia and the northern part of modern Yemen. *See* ALAUTHIMEEN, *supra* note 24, at 207.

⁵⁵ In 1932.

⁵⁶ On November 9, 1953. Today, Saudi Arabia includes the historically important regions in the Arab peninsula which are the Najd (middle), the Hejaz (west), the Aseir (south), the Ahsa (east), and the Juff (North).

⁵⁷ Kings of Saudi Arabia: King Saud from 1953 to 1964, King Faisal from 1964 to 1975, King Khalid from 1975 to 1982, King Fahad from 1982 to 2005, and King Abdullah from 2005 to present.

⁵⁸ *See* HELEN LACKNER, A HOUSE BUILT ON SAND: A POLITICAL ECONOMY OF SAUDI ARABIA 2–3 (1978).

⁵⁹ NIBLOCK & MALIK, *supra* note 10, at 35 (2007) (they described the economic situation of pre-modern Saudi state by saying: “inhabitants of the interior of the country were mainly pastoralists, raising goats, sheep, and camels. Settled agriculture was present in Asir and in the oasis areas of al-Hasa. Inhabitants of the small towns were mainly engaged in commercial and artisanal activities. There was virtually no industry. The traditional economy was generally based on a complex of small, self-sufficient units, the largest boundaries of which were those of oasis,

neither had a basic infrastructure of roads, hospitals, and formal schools nor modern government structures, including a professional judicial system and organized bureaucracy.⁶⁰ Quite simply, people were living a primitive life that was comparable to their ancestors' life in antiquity.⁶¹

Most of the government's income came from foreign aid and taxes levied upon visitors to the two holy cities, Mecca and Medina.⁶² The discovery of oil in the late 1930s provided the newly-founded state with extra income to finance its treasury.⁶³ However, in the 1970s, the price of a barrel of oil leaped enormously from around \$2.50 to \$9.50. The massive increase in oil prices turned the whole economic situation in the Kingdom upside down.⁶⁴ Currently, Saudi Arabia possesses around 25% of the Earth's proven oil reserves and is the world's highest oil producer.⁶⁵ Most of the oil revenue since then has been channeled toward building the country's infrastructure,⁶⁶ and expanding public institutions and social welfare programs.⁶⁷ Saudi Arabia is

village or tribe. The social characteristics which accompanied this form of economic life were those of relative poverty, a high level of illiteracy, and substantial isolation from developments outside of the local area." *Id.*

⁶⁰ See NIBLOCK & MALIK, *supra* note 10, at 32.

⁶¹ See *id.* at 35.

⁶² See *id.* at 37.

⁶³ See *id.*

⁶⁴ The first oil well was drilled in 1938 by an American company. This happened after King Abdul Aziz granted a British company concession to search for oil in the eastern part of country in 1924. However, the British company failed to fulfill its part of the agreement with the Saudi king. Accordingly, the King repudiated the British company concession and then decided to move in another direction by which he granted the new concession to an American company, "The Standard Oil Company of California" in 1933, which was renamed several years later to the Arab-American Oil Company (ARAMCO). See the Saudi Arabia Development March: Excerpts, Saudi Arabian Ministry of Economic and Planning, 15–16 (2009). In fact, the British company was not interested in exploring oil in the Saudi territory but rather acquiring the concession to prevent others from doing so to keep the supply of oil to the market as low as they could, thus maintaining oil prices. See LACKNER, *supra* note 58, at 33.

⁶⁵ Also, Saudi Arabia is considered a reliable source of oil to the industrialized world.

⁶⁶ Giacomo Luciani, *From Private Sector to National Bourgeoisie: Saudi Arabian Business*, in SAUDI ARABIA IN THE BALANCE: POLITICAL ECONOMY, SOCIETY, FOREIGN AFFAIRS 158–59 (Paul Arts & Gerd Nonneman eds., 2005).

⁶⁷ LACKNER, *supra* note 58, at 137–39.

the world's largest oil producer (10,520,000 BBL/Day)⁶⁸ and the second largest proven oil reserves holder.⁶⁹ The Saudi economy is one of the largest economies in the Middle East⁷⁰ and the largest in Arab countries, with a GDP of \$711 billion and a GNI per capita \$21,210 in 2012.⁷¹ The size of the country's economy qualified it to join the G-20 economic group.⁷²

Table 2. Comparison of GDP of the Five Largest Middle Eastern Economies

No.	Country	GDP in 2012 (Billion US\$)
1	Turkey	789
2	Saudi Arabia	711
3	Iran	514
4	UAE	348
5	Egypt	262

Source: World Bank, World Development Indicators.

* The GDP of Iran and UAE are according to (2011) data.

Since its foundation, “Saudi [Arabia] ... economic policy [has been] based on the principles of comprehensive social welfare and a free-market economy open to all goods, services, products, and capital.”⁷³ In 2011, Saudi Arabia ranked 54th worldwide in economic

⁶⁸ CIA, World Factbook, available at <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2173rank.html> (accessed on Apr. 20, 2012).

⁶⁹ In 2011, Venezuela replaced Saudi Arabia as the World's long known highest proven oil reserve holder. See OPEC, Annual Statistical Bulletin 2010/2011, table 3.1.page 22, available at http://www.opec.org/opec_web/static_files_project/media/downloads/publications/ASB2010_2011.pdf (accessed on Apr. 25, 2012).

⁷⁰ It is the second largest economy in the Middle East after Turkey (Turkey's GDP is about \$789 billion), <http://data.worldbank.org/country/turkey> (accessed on Apr. 1, 2014).

⁷¹ The World Bank Data, available at <http://data.worldbank.org/country/saudi-arabia> (accessed on Feb. 10, 2014).

⁷² For brief historical background on G-20, see the G-20 website, available at <http://www.g20.org/en/g20/the-origins-and-evolution-of-the-g20> (accessed on Apr. 22, 2012).

⁷³ The supreme economic council article (1), <http://www.sec.gov.sa/Council-Regulations.aspx?lang=en-US&Page=2> (accessed on Oct. 14, 2011). In fact, Saudi Arabia was always committed to free economy principles since its inception. The first five year development plan affirmed this position at a time when the wave of socialism overreached many countries in the world including many Arab countries such as Egypt, Yemen, Syria (etc.) by stating that:

The commitment of Saudi Arabia to a free economy derives from the teachings of the nation's religious code and its long-standing social traditions. It is supported by growing evidence that

freedom according to the Heritage Foundation's Economic Freedom Index.⁷⁴ The Saudi economy attracted \$35.5 billion of foreign direct investment in 2009 (FDI).⁷⁵

Although Saudi economy has been growing steadily since 2001,⁷⁶ a high unemployment rate among citizens still persists (10.5%).⁷⁷ The Saudi government, in the wake of recent revolutions in some Arab countries (e.g. Tunisia, Egypt, and Libya) and the significant political pressure from unemployed Saudis, granted every unemployed citizen a monthly unemployment allowance.⁷⁸ The government attempted to implement measures to increase citizens'

economic and social change cannot be imposed on the country by the actions of the Government alone; but must come about through increasing participation of all elements of society in both the process of development and its benefits. Only by continuously encouraging private enterprise—large and small companies, family businesses, and individuals—to pursue those activities that they can undertake more effectively than government agencies, will the economy be able to benefit to the full from the ability and initiative of all its people.

Saudi Arabia's Central Planning Organization, the First Development Plan (1970–1975), p. 21 (1970).

⁷⁴ 2011 Index of Economic Freedoms, p. 355, *available at* http://www.heritage.org/Index/pdf/2011/Index2011_Full.pdf (accessed on Oct. 23, 2011). Economic freedom is described as follow:

Economic freedom is the fundamental right of every human to control his or her own labor and property. In an economically free society, individuals are free to work, produce, consume, and invest in any way they please, with that freedom both protected by the state and unconstrained by the state. In economically free societies, governments allow labor, capital and goods to move freely, and refrain from coercion or constraint of liberty beyond the extent necessary to protect and maintain liberty itself.

2011 Index of Economic Freedom, <http://www.heritage.org/Index/> (accessed on Oct. 23, 2011).

⁷⁵ Saudi Arabian General Investment Authority (SAGIA), Annual FDI Report on Saudi Arabia 2 (2010), *available at* <http://www.saudincc.org.sa/CMSPages/GetFile.aspx?guid=877012e0-c352-483b-b6de-3ef276cc68a3> (accessed on Oct. 23, 2011).

⁷⁶ For example, the growth rate in the Saudi economy reached 6.77% in 2011. The Saudi Central Department of Statistics and Information, Key Indicators, <http://www.cdsi.gov.sa/english/> (accessed on Apr. 25, 2012).

⁷⁷ The Saudi Central Department of Statistics and Information: Key indicators, <http://www.cdsi.gov.sa/> (accessed on Apr. 25, 2012). In fact, there are no reliable sources that could provide for an accurate percentage of unemployment. *See* DARYL CHAMPION, THE PARADOXICAL KINGDOM: SAUDI ARABIA AND THE MOMENTUM OF REFORM 193 (2003) (he noted that: “[t]he uncertainty surrounding unemployment statistics is indicative of a systematic lack of reliable socioeconomic data and general lack of sociopolitical-economic transparency”). *Id.*

⁷⁸ See Royal order number (a/30) in (20/3/1432) correspondent to (4-23-2011). The program named “Hafiz” which means in English “motivation” The scheme is designed to help unemployed citizens find jobs through training and pressure on private sector to employ Saudi citizens instead of foreign workers. To this point the

employment percentage in the private sector through a process called ‘*Saudization*.’⁷⁹ To the present, *Saudization* policies have never reached their intended targets.⁸⁰ The Saudi private sector normally prefers a foreign workforce which commonly comes from low income countries (e.g. India, Bangladesh, and Egypt) over its own national work force, mainly because of the immense difference between the two groups’ salaries. Saudi workers would normally cost businesses over four times the salary of their foreign counterparts.⁸¹ Because businesses greatly depend on such low cost foreign labors, Saudi private actors have always attempted to avoid the implementation of the *Saudization* policies.⁸²

The Saudi nascent private sector greatly “depends,” directly or indirectly, on the government’s support through subsidies or “contacts.”⁸³ The private sector’s weak role in the economy may increase in the future if the implementation of the ambitious national strategy of privatization is accomplished.⁸⁴ The Supreme Economic Council is responsible for supervising the implementation of this strategy. The Council has declared the intention to privatize nineteen

program will pay every unemployed Saudi about \$500 per month. For more information about this program, see Hafiz website, <https://www.hafiz.gov.sa/HRDFWeb/> (accessed on Mar. 19, 2012).

⁷⁹ For critical overview on Saudization and Unemployment among Saudi citizens, see RAMADY, *THE SAUDI ARABIAN ECONOMY* 361–93 (2010).

⁸⁰ For a general overview of impediments of the Saudization program’s success in Saudi private sector, see RAMADY, *supra* note 79, at 368–69.

⁸¹ See RAMADY, *supra* note 79, at 368–69.

⁸² WILSON ET AL., *supra* note 13.

⁸³ See *id.* at 127.

⁸⁴ Some economic sectors have been privatized, but at a very slow pace since the beginning of the implementation of the strategy. Also, for the last decade the government has started working (although at a slow pace) to increase the private sector role in the economy and to improve the public sector’s efficiency. For privatization in Saudi Arabia, see generally RAMADY, *supra* note 79, at 323–37.

economic sectors such as telecommunications, rail and air transportation, hotels, sport clubs, and state ownership in publicly-held corporations.⁸⁵

Economic policy and planning are shaped through various governmental agencies. Most important is the Supreme Economic Council, the highest ranking⁸⁶ economic advisory body.⁸⁷ The chief goal of the Council is the provision of better economic coordination among government agencies. The preamble of the Council Regulation highlights the purpose behind establishing the Council:

⁸⁵ See the Supreme Economic Council: Public Utilities and Activities targeted by privatization, http://www.sec.gov.sa/getdoc/47215a65-b78d-4598-8d7a-2e597e5c1815/List_of_Uilities.aspx (accessed on Apr. 25, 2012).

⁸⁶ The Supreme Economic Council is chaired by the King. The Supreme Economic Council Regulation article § (4) issued by the Royal Order No. A/ 111 in 17 Jumada al-Akirah 1420 H corresponding to 28 August 1999.

⁸⁷ Under its regulation the Council does not have executive power. The Supreme Economic Council Regulation article § (1). This article sets precise objectives to achieve its policy:

- 1- Ensuring the security, welfare, and prosperity of the society while preserving Islamic values, the environment, and the country's natural resources, taking into consideration both present and future needs.
- 2- Steady economic growth at an appropriate level to achieve a real increase in per capita income.
- 3- Price stability.
- 4- Providing opportunities for productive work and optimal employment of the work force.
- 5- Controlling the public debt and keeping it within acceptable limits.
- 6- Ensuring a fair distribution of income and opportunities for employment and investment.
- 7- Expanding the economic base and increasing the sources of government revenues.
- 8- Increasing savings and developing additional savings and sound investment opportunities.
- 9- Increasing government revenues and linking them to the country's economic growth; thus allowing the government to carry out its responsibilities with respect to national development and comprehensive social welfare.
- 10- Increasing capital investment and domestic savings in the national economy in an effective manner, supporting the government's privatization program, and developing The Offset Program.
- 11- Increasing the participation of the private sector in developing the national economy through the government's privatization program.
- 12- Strengthen the economy's ability to react effectively and flexibly to changes in the international economic environment.

In view of the large number of government agencies and institutions concerned with economic affairs and the wide range of their responsibilities, it is essential to develop an organizational structure and management system that encompasses all of these entities, based on sound research and analysis, to ensure coordination among the various agencies and integration of their activities, and to facilitate effective decision-making with respect to economic issues.⁸⁸

The Ministry of Economy and Planning is another economic policy maker which has been entrusted with preparing the Five Year Development Plans since 1970.⁸⁹ Currently, “the 9th Five Year Development Plan” is under implementation.⁹⁰ On the other hand, the Ministry of Finance is in charge of implementing financial policies, formulating the government’s budget and supervising its implementation.⁹¹ Monetary policies are formulated and implemented by the Ministry of Finance and the Saudi Arabian Monetary Agency (SAMA), which also serves as the country’s central bank.⁹²

Beside commercial banks, there are several government development banks (funds) in charge of providing interest-free long term and medium term financing, such as the Agricultural Bank,⁹³ the Industrial Development Fund,⁹⁴ the Credit and Saving Bank,⁹⁵ the Public Investment Fund,⁹⁶ and the Real Estate Development Fund.⁹⁷

⁸⁸ See the preamble of Supreme Economic Council Regulation, *available at* <http://www.sec.gov.sa/Council-Regulations.aspx?lang=en-US> (accessed on Oct. 14, 2011), <http://www.sec.gov.sa/Council-Regulations.aspx?lang=en-US&Page=2> (accessed on Oct. 14, 2011).

⁸⁹ The Ministry of Economic and Planning webpage, <http://www.mep.gov.sa/index.jsp;jsessionid=CFCFADB81A6EFAB579A3507A1D4FF40D.beta?event=ArticleView&Article.ObjectID=1> (accessed on May 2, 2012).

⁹⁰ See Ministry of Economic and Planning, About Us, *available at* <http://www.mep.gov.sa> (accessed on May 2, 2012).

⁹¹ See the Ministry of Finance webpage, <http://www.mof.gov.sa/English/MinistryProfile/Pages/OurGoals.aspx> (accessed on June 6, 2012).

⁹² See the Saudi Arabian Monetary Agency (SAMA) webpage, <http://www.sama.gov.sa/sites/samaen/AboutSAMA/Pages/SAMAFunction.aspx> (accessed on June 6, 2012).

⁹³ Established in 1963 by the Royal Decree number (58).

⁹⁴ Established in 1974 by the Royal Decree number (M/3).

Saudi Arabia has robust economic relations with various developed and developing economies. The U.S. is one of the most important economic partners to Saudi Arabia.⁹⁸ Moreover, the U.S. is the top exporting country to Saudi Arabia⁹⁹ and the second largest country receiving Saudi exports.¹⁰⁰ Accordingly, Saudi Arabia has pegged its currency (Riyal) to the U.S. dollar.¹⁰¹ Moreover, Saudi Arabia has solid economic relations with various other developed and developing nations, including both Asian¹⁰² and EU countries.¹⁰³

2.2.3.2 Rentierism Ramifications

Rentierism is an old concept that regained currency with the discovery of oil in the Middle East.¹⁰⁴ Rentier states, according to Mahdavy's, refer to "those countries that receive on a regular basis substantial amounts of external rent."¹⁰⁵ However, receiving a huge amount of exterior rent

⁹⁵ Established in 1971 by the Royal Decree number (M/44). In 2006, a new law enacted by the Royal decree number (M/34) which abrogated the 1971 decree.

⁹⁶ Established in 1971 by the Royal decree number (M/24).

⁹⁷ Established in 1974 by the Royal Decree number (M/23).

⁹⁸ Economic relations followed the political alliance between both countries, initiated in a February 14, 1945 summit held between King Abdul Aziz, the founder of the new Saudi state, and the American President Roosevelt on board the USS Quincy. See David E. Long, *US-Saudi Relations: Evolution, Current Conditions, and Future Prospects*, 15 MEDITERRANEAN Q. 24, 27 (2004).

⁹⁹ In 2010, the U.S. exported 13.2% of Saudi imports. The Ministry of Economic and Planning, Statistical Yearbook, Table 14-10: Top (15) Trading Countries to Saudi Arabia by Value of imports in 2010.

¹⁰⁰ 13% of Saudi exports are imported U.S. Ministry of Economy and Planning, Export Statistics of 2010, 12 (2010).

¹⁰¹ A U.S. Dollar is worth 3.75 Saudi Riyals.

¹⁰² 55% of Saudi exports are sent to various Asian countries (excluding Arab and Islamic states) such as Japan, South Korea and China. Ministry of Economy and Planning, Export Statistics of 2010, 12 (2010).

¹⁰³ 10% of Saudi exports are sent to various EU countries. Ministry of Economy and Planning, Export Statistics of 2010, 12 (2010).

¹⁰⁴ Hazem Beblawi, *The Rentier State in the Arab World*, in THE ARAB STATE 85, 85 (Giacomo Luciani ed., 1990).

¹⁰⁵ H. Mahdavy, *The Pattern and Problems of Economic Development in Rentier States: The Case of Iran*, in STUDIES IN THE ECONOMIC HISTORY OF THE MIDDLE EAST: FROM THE RISE OF ISLAM TO THE PRESENT DAY 428

is not *per se* enough to categorize a country as a rentier state. Other factors have to be present to consider a country as rentier state. First, only a small percentage of the population in a rentier economy can participate in originating the “wealth” of the nation, while at the same time “the rest of the society is only engaged in the distribution and utili[z]ation of this wealth.”¹⁰⁶ Secondly, the state is the main receiver of the exteriorly generated wealth.¹⁰⁷ Thirdly, the external revenue represents a high percentage of the country’s wealth.¹⁰⁸

Under this economic paradigm, the role of the conventional government shifted from being a redistributor of the wealth, generated by national productive capitals by “taxation” and economic interaction among national factors (a production state),¹⁰⁹ to merely a distributor of the externally acquired rent to various economic sectors (an allocation state).¹¹⁰ Externally-attained wealth tends to equip ruling authority with strong political influence over its subjects, as Hazem Beblawi noted: “the ‘economic power’ ... bestowed upon the few would allow them to seize

(M.A. Cook ed., Oxford University Press 1970). Moreover, Mahdavy defines external rent by stating that: “External rents are in turn defined as rentals paid by foreign individuals, concerns or governments to individuals, concerns or governments of a given country.” *Id.* at 428. In the same juncture, Mahdavy notes that “the oil revenues received by the governments of the oil exporting countries have very little to do with the production processes of their domestic economies.” *Id.* at 429.

¹⁰⁶ Beblawi, *supra*, note 104, at at 85, 87.

¹⁰⁷ *Id.* at 85, 88.

¹⁰⁸ See Giacomo Luciani, *Allocation Vs. Production States: A Theoretical Framework*, in *THE ARAD STATE* 65, 72 (Giacomo Luciani ed., 1990).

¹⁰⁹ See *id.* at 65, 71.

¹¹⁰ See *id.* (he noted that: “[a] rentier ... state will inevitably end up performing the role of allocating the income that it receives from the rest of the world. It is free to do so in a variety of ways; among the various purposes for which money is spent, the strengthening of domestic economic base may be included, but not necessarily so. Even if this happens to be one of the goals of the state, as long as the domestic taxation is not tapped to raise further income through domestic taxation, the strengthening of the domestic economy is not reflected in the income of the state, and is therefore not a precondition for the existence and expansion of the state.”). *Id.* at 71.

‘political power’ as well, or else induce the political elite to take over the external rent from them without major political disruption.”¹¹¹

Rentierism forms a “rentier mentality” among the citizens.¹¹² A society with such a mentality does not always believe that the wealth is generated through hard work and “risktaking” but through “chance and situations.”¹¹³ Such mentality motivates laziness (or high wage expectation)¹¹⁴ and shopping for effortless income opportunities.¹¹⁵ Public employment is perceived to be a privilege to every citizen, as a part of dividing external rent pie.¹¹⁶ Accordingly, “[c]ivil servant productivity is, understandably, not very high and they usually see their principal duty as being available in their offices during working hours (Al Dawam).”¹¹⁷

Unluckily, rentierism’s characteristics and syndromes are easily traceable in Saudi Arabia. For instance, 90% of the government’s budget is financed by oil exports,¹¹⁸ and oil rent

¹¹¹ Beblawi, *supra*, note 104, at at 85, 88.

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ For example over a million are unemployed, while around five million foreign workers find jobs in Saudi Arabia.

¹¹⁵ For instance, many Saudis allow foreign persons to illegally open enterprises under their names for monthly or annual fixed incomes. In such a scenario the citizen does not do anything and does not know about the business. This practice is not only confined to small business but sometimes reaches other respectful businesses and professions such as law firms. Many internationally recognized firms conducting business in Saudi Arabia under the name of a Saudi licensed lawyer may be asked for a royalty for the usage of the Saudi in some cases. This amount requested covers most of his firm’s expenses and provides him with a good amount of profit which lets him relax his legal practice with other customers to the minimum.

¹¹⁶ *See, e.g.,* Beblawi, *supra* note 104, at 85, 91 (he noted that: “[e]very citizen – if not self – employed in business and/or not working for a private venture – has a legitimate aspiration to be a government employee; in most cases this aspiration is fulfilled.”). *Id.*

¹¹⁷ Beblawi, *supra* note 104, at 85, 91.

¹¹⁸ Ministry of Economic and Planning, Statistical Yearbook of 2010, Table 11-1: Actual Revenues and Expenditures for Saudi Arabia General Budget for years 2006–2010.

composes around 57% of the country's GDP.¹¹⁹ In addition, no personal income taxation is imposed on citizen or foreigners,¹²⁰ while Saudi enterprises only pay *Zakat* (a form of religious tax that is only allowed to be spent mostly on particular charitable matters), and foreign companies pay taxes.¹²¹ If “no taxation without representation” has become a long accepted pillar of modern democracies,¹²² then in Saudi Arabia this concept implies a different meaning: “no representation if no need for taxation.”¹²³ This implied perception is confirmed by the constitutional arrangement of the Saudi government whereby the approval and supervision of state income and spending, including the government budget, are excluded from the *Shura* Council's (legislative Council) command.¹²⁴

2.2.3.3 Reform Agenda

Oil is an exhaustible natural resource: its contribution to the Saudi economy is limited to a specific period of time.¹²⁵ In addition, oil might be replaced by alternative energy sources (cheaper or cleaner) at any point in the near future, at which time the market demand will vanish

¹¹⁹ Ministry of Economy and Planning, the Central Department of Statistics and Information, Economic Indicators of the Saudi Arabian Economy in 2011, Table (6).

¹²⁰ See Article (2) of Income Tax Law which issued the Royal Decree No. (M/1) in Muharram 15, 1425 H, Corresponding to March 6, 2004.

¹²¹ There is no personal income tax system in Saudi Arabia legal's system. Foreign corporations pay taxation, while Saudi private associations pay *Zakat*. For *Zakat* in Saudi Arabia, see generally Abdullah Wahib AlLami, *Zakat as Islamic Taxation and Its Application in the Contemporary Saudi Legal System*, 5 J. ISLAMIC ST. PRAC. INT'L L. 83 (2009). For tax imposed on non Saudis see the Income Tax Law issued by Royal Decree No. 1 in 15 Muharram 1425 H corresponding to March 6, 2004.

¹²² See Luciani, *supra* note 108, at 65, 75.

¹²³ For political implications of rentierism including political legitimacy and tax imposition, see Luciani, *supra* note 108, at 65, 75–78.

¹²⁴ See CL. § (15).

¹²⁵ Saudi oil reserves are expected to be depleted in the next five to six decades. RAMADY, *supra* note 79, at 15.

or decrease.¹²⁶ Undoubtedly, if one of the expected scenarios materialized, the Saudi economy would be in a great danger of losing oil rent as it is the main driving force of the country's development. Eventually, the standard of living in the country would dwindle to an unthinkable level. At this juncture, the Saudi economist and former deputy Minister of Finance, Abdulaziz al-Dukheil, depicted national sentiments toward this upcoming catastrophe by saying:

My mind and comprehension have difficulty to live with this leniency toward oil depletion in Saudi Arabia, while economic and geological facts screech in my head all day and night, especially when I look at sulking or pregnant women with an expected arriver to this life.¹²⁷

Escaping this eminent calamity requires Saudi Arabia to diversify its economy. Theoretically, diversification of the economy has been on the top of the Saudi government's economic agenda since the first Five Year Economic Development Plan in the 1970's.¹²⁸ However, to this moment, very little advancement on this direction has been achieved; oil is still the main source of national income.¹²⁹ Saudi needs to direct oil rent towards "productive capital formation" sectors which would ensure sustainable development for the young and coming generations,¹³⁰ such as petrochemical and pharmaceutical industries and services (e.g. tourism, health care, and education). In this context, Professor Geoffrey Heal suggested that oil rent should be channeled "[t]hrough trade and capital markets ... or through use as an input into

¹²⁶ *See id.* at 16. *See also* YOUSEF KHALIFA AL-YOUSEF, MAJLIS AL-TAAWIN AL-KALIJ FI MUTHALATH AL-WIRATHAH WA AL-NAFIT WA AL-GUA AL-ODMA 176 (2011).

¹²⁷ *See* ABDULAZIZ M. AL-DUKHEIL, AL-TANMIA AL-QTISADIAH FI ALMAMLAHAH ALARABIYA ALSAUDIAH: QIRAHAH NAQDIYAH 875 (2012) (translated by the author).

¹²⁸ *See* the goals of the first Five Year Development Plan (1970–1975) which states that one of the goals of the plan is to decrease dependency on oil as a main source of national income.

¹²⁹ AL-DUKHEIL, *supra* note 127, at 886.

¹³⁰ *See id.* at 28.

domestic production, it can be converted to a stock of wealth of another sort, which generates income and can in principle be preserved indefinitely.”

The Saudi government has launched ambitious projects and plans to fulfill the diversification strategy. For instance, in the 1970’s, the Saudi government built two successful industrial cities, Jubail and Yanbu, which have attracted a total of over \$65 billion in investments and employ 107,000.¹³¹ Recently, Saudi Arabia has been building four huge economic cities which, thus far, have cost a total of \$60 billion dollars.¹³² However, most of those ambitious projects may never see the light of the day.¹³³

Moreover, in the last decade, the Saudi government has worked diligently to attract foreign direct investments (FDI). In 2000, the Saudi Arabian General Investment Authority (SAGIA) was founded as a specialized government agency with the primary goal of promoting and supervising investment inflow and post entry affairs of investment in Saudi Arabia. A few years after its inception, SAGIA’s efforts, in conjunction with the economic boom that Saudi Arabia is witnessing due to both the massive increase of the price of oil in the international markets and legal reforms King Abdullah has implemented, yielded pivotal results for the Saudi economy.¹³⁴ For instance, Saudi Arabia is ranked 11th regarding the ease of doing business

¹³¹ The Royal Commission of Jubail and Yanbu website, *available at* <http://www.rcjy.gov.sa/en-US/AboutUs/Pages/default.aspx> (accessed on May 2, 2012).

¹³² For example, Saudi Arabia is building four huge economic cities which cost \$60 billion dollars. *See* <http://www.sagia.gov.sa/en/Why-Saudi-Arabia/Economic-cities/> (accessed on Oct. 27, 2010).

¹³³ None of those cities has been completed yet and their foundations have yet to be started, such as Hail Economic City. Hail’s Governor’s (Prince Saud bin Abdulmohsen) press release about Hail economic city noted “there are bureaucratic and financial impediments to Hail Economic City.” *Al-Riyadh Newspaper*, Issue (16038) in May 22, 2012.

¹³⁴ For example, the new Law of Judiciary.

worldwide in the 2011 World Bank Doing Business Report.¹³⁵ Moreover, Saudi Arabia has become one of the most attractive countries for foreign direct investment: in 2008/2009 the inward FDI reached almost \$35 billion dollars.¹³⁶

The fairly high wage of Saudi (citizen) workers makes it difficult for the Saudi economy to be globally “competitive” in labor intensive industries such as agriculture and textile.¹³⁷ Accordingly, Saudi Arabia’s long term plan is to redirect its economy to be a “knowledge-based economy.”¹³⁸ Thus, the Saudi government has spent a significant part of its oil income on Saudi citizens’ education and technical training. Recently, Saudi Arabia inaugurated the King Abdullah University of Science and Technology (KAUST) as one of the world’s state of the art research institutions.¹³⁹ KAUST’s main goal is to link the Saudi economy to the developed world’s innovation-driven economy.¹⁴⁰ In the same vein, the number of universities in Saudi Arabia has jumped tremendously from seven public universities at the end of the millennium to over thirty universities at the present time.¹⁴¹ The Saudi government has also made available a generous

¹³⁵ See World Bank, *Doing Business Report* (2010), available at <http://www.doingbusiness.org/data/exploreeconomies/saudi-arabia/> (accessed on June 7, 2012).

¹³⁶ See Figure 1.4. in *World Investment Report (2010): Investing in a Low-carbon Economy*, available at http://www.unctad.org/en/docs/wir2010_embargo22_en.pdf (accessed on Oct. 27, 2010).

¹³⁷ See WILSON ET AL., *supra* note 13.

¹³⁸ See the Ministry of Economy and Planning, the (9th) Five Year Development Plan, 87–105 (2010–2014).

¹³⁹ For more information about the King Abdullah University of Science and Technology (KAUST) at its webpage, <http://www.kaust.edu.sa/> (accessed on Apr. 18, 2012).

¹⁴⁰ See the missions of the King Abdullah University of Science and Technology (KAUST) at its webpage, <http://www.kaust.edu.sa/> (accessed on June 7, 2012).

¹⁴¹ See the Ministry of Higher Education webpage, <http://www.mohe.gov.sa/ar/default.aspx> (accessed on June 7, 2012). There are twenty four public universities which have nine hundred thousand students and forty-five thousand faculty members. *Id.*

(57) out of (183) measured countries regarding corruption in the public sector.¹⁴⁷ However, combating corruption in Saudi Arabia may not be an easy task due to the widely accepted and appraised “nepotism,” as a western observer noted: “what we in the west consider to be nepotism is understood in the Saudi Arabian context as the traditional fundamental duty of any individual to look after the members of his family and tribe before anyone else.”¹⁴⁸

Strong connection among large sized families and tribes may explain part of the picture, but the other part may be connected to the weak legal system and enforcement institutions in the country, which allow such practices to find a suitable environment in which to grow.

2.3 STRUCTURE OF POWER IN THE KINGDOM

2.3.1 Constitutionalism in Islam¹⁴⁹

After the death of the Prophet Mohammad,¹⁵⁰ the rule of the Islamic state was passed to the caliphs (rulers) following the Prophet. The caliph was responsible for enforcing Islamic law (*Shariah*) and managing the affairs of the Islamic state according to the provisions of the *Shariah*.¹⁵¹ Under this arrangement, the caliph or Imam was the supreme authority of the Islamic

¹⁴⁷ Transparency International, Corruption Perceptions Index 2011, available at <http://cpi.transparency.org/cpi2011/results/> (accessed on Apr. 17, 2012).

¹⁴⁸ LACKNER, *supra* note 58, 147.

¹⁴⁹ For comprehensive discussion of this topic, see Abdullah Abdul Aziz Al-Munifi, *The Islamic Constitutional Theory (S.J.D)* (1973) (unpublished dissertation University of Virginia Law School).

¹⁵⁰ In 632 AD.

¹⁵¹ See ABI YALA ALFRA, *ALAHKAM ALSULTANAIH* 27–28 (Dar Alkutb Alalimaih 2000).

state. Accordingly, the Imam could appoint governance of Islamic provinces, and ministers and Judges.¹⁵² However, the legislative function was for God (Allah) whereas an Imam was only entrusted to implement Allah's rules and supplement them in the area where no applicable rules existed. Therefore, the separation of power (legislative, executive and judicial) as it is known in modern western thinking was not known in the original Islamic political literature and practice.¹⁵³

2.3.2 Constitutionalism in Modern Saudi State

The aforementioned old Islamic practice of political governance was the foundation of ruling Saudi Arabia until the formation of present-day Saudi Arabia by King Abdulaziz Al-Saud in 1932. Accordingly, King Abdulaziz and his ancestors (rulers) from the Al-Saud family were called Imams.¹⁵⁴ The name Imam conveyed two functions: religious leader of Muslim citizens and political leader of the state.¹⁵⁵ However, Imam Abdulaziz – on the wake of the capture of the Hejaz region – changed his name and upon the unification of the other regions declared himself as King of the Kingdom of Saudi Arabia. The name of the country changed; however, its practices remained the same. The King is the supreme authority in the Saudi Islamic state which is evident in the Saudi Basic Law of Governance: all state authorities report to the King.¹⁵⁶

¹⁵² This called al-Wlayat see IBN TIMYAH, AL-SIYASAH AL-SHARIAH FI ISLAH AL-RAAI WA AL-RAAYAH 7–16 (Dar Alim Alfouad for publication and distribution).

¹⁵³ Much of modern literature not only accepts the principle of separation of power but also praises it as a compatible principle with Islamic *Shura* principles or a new application of it.

¹⁵⁴ Abdulaziz was the first ruler in the Al-Saud family who changed the title of Imam to other royal names, such as Sultan and, finally, King.

¹⁵⁵ See ALFRA, *supra* note 151.

¹⁵⁶ B.L.G. § (44).

One should bear in mind that the King is not the source of the state powers – as in old western monarchies where the King is sacrosanct – but instead the King is merely the original holder of these functions by Islamic law (*shariah*).¹⁵⁷ Thus, according to the Saudi model, the King delegates some of his functions to separate institutions to facilitate the accomplishment of his job in more efficient ways which superficially mimic to some degree the political models of other states in the West or those influenced by the western political thinking and practice.

Thus, *shariah* is the sanctum and *not* the king, as Abdulaziz Al-Fahd noted: “[t]he Basic Law [of Governance] acknowledges the sacrosanct nature of the *shariah*, and when it provides that the King may suspend the Basic Law, it specifically subordinates this power to the Islamic authority granted in Article 7 [of the Basic Law of Governance].¹⁵⁸ For a better understanding of Saudi Arabia’s legal structure, it is critical to understand the aforementioned non-separation of “Mosque and State”¹⁵⁹ because to citizens of Saudi Arabia, Islam includes not only their government and spiritual devotion but also an entire way of life.¹⁶⁰

2.3.2.1 The Basic Law of Governance

As noted earlier, the Basic Law of Governance (BLG)¹⁶¹ is not the supreme law in Saudi Arabia; however, in a much broader meaning it is the highest legal enacted document that supersedes all

¹⁵⁷ See ABI ALHASAN ALMAWARDI, ALAHKAM ALSULTANIYAH WA ALWILAIYAT ALDINIYAH 51–52 (Dar alkitab alarabi 1994).

¹⁵⁸ Abdulaziz H. Al-Fahad, *Ornamental Constitutionalism: The Saudi Basic Law of Governance*, 30 YALE J. INT’L L. 375, 386 (2005).

¹⁵⁹ Phrase borrowed from Al-Munifi, *supra* note 149, at 287.

¹⁶⁰ For a brief discussion of the relationship between politics and faith in Islam, see Al-Munifi, *supra* note 149, at 287–99.

¹⁶¹ Royal Order No. (A/91) 27 Sha’ban 1412H – 1 March 1992 Published in Umm al-Qura Gazette No. 3397 2 Ramadan 1412H – 5 Mar. 1992 [hereinafter B.L.G.].

other acts and regulations.¹⁶² Even though this law states clearly that the constitution of Saudi Arabia is the Koran and *Sunnah*,¹⁶³ The BLG resembles other countries' constitutions in form and to some degree substance.¹⁶⁴ Accordingly, the basic law divides the state authority into three divisions: executive,¹⁶⁵ judiciary,¹⁶⁶ and regulatory.¹⁶⁷ These authorities derive their legitimacy from the King who is the last resort of those authorities.¹⁶⁸

More importantly, the BLG provides that Saudi Arabia is a monarchy where the throne is assumed by the descendants of King Abdulaziz al-Saud, the founder of the Kingdom of Saudi Arabia.¹⁶⁹ The election of a new king is vested in the allegiance commission which consists of a representative from all the existing branches descended from the founder of the third Saudi state, King Abdulaziz Bin Abdurrahman al-Saud.¹⁷⁰

The justice, *shura*, and equality are the foundation of governance in the Kingdom.¹⁷¹ The Basic Law also guarantees several rights and liberties for all people in the Kingdom, such as the protection of private property,¹⁷² individual security,¹⁷³ privacy¹⁷⁴ and from arbitrary

¹⁶² See MOHAMMAD ABDULAH ALMARZUGI, ALSULTAH ALTANDIMIHA FI ALMAMLIKAH ALARABIA ALSUADIAH 85 (Maktabat Alubikan 1424).

¹⁶³ B.L.G. § (1).

¹⁶⁴ See KHALID ALRWAIS & RIZG ALRAYIS, ALMADKAL LEDRAST ALAULUM ALQANONIAH 101 (maktabit alshugri 2002).

¹⁶⁵ B.L.G. § (44).

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*

¹⁶⁹ *Id.* § (5).

¹⁷⁰ *Id.*

¹⁷¹ *Id.* § (8). Worth mentioning, the last part specified that those norms are implemented according to the Islamic law (*Shari'a*).

¹⁷² B.L.G. § (18).

¹⁷³ *Id.* § (36).

punishment.¹⁷⁵ In addition, the Basic Law embraces social welfare by providing, for instance, that “[t]he state shall guarantee the right of the citizen and his family in emergencies, sickness, disability, and old age, and shall support the social security system and encourage institution and individual to participate in charitable work.”¹⁷⁶ Moreover, according to The Basic Law, the state is responsible to provide health care to every citizen¹⁷⁷ and provide citizens with general education.¹⁷⁸

2.3.2.2 The *Shura* Council

In March 1992, the promise of the reestablishment of the *Shura* Council¹⁷⁹ was fulfilled by King Fahd.¹⁸⁰ The Council consists of 150 members¹⁸¹ who represent the different regions and fabric of Saudi society and who are appointed directly by the King¹⁸² for four year terms.¹⁸³ The newly-formed branch of states resembles in its façade a parliament in democratic countries. Upon closer

¹⁷⁴ *Id.* § (37) and § (40).

¹⁷⁵ *Id.* § (38).

¹⁷⁶ *Id.* § (27).

¹⁷⁷ *Id.* § (31).

¹⁷⁸ *Id.* § (30).

¹⁷⁹ Islamic literature is full of describing the *shura* concept, which basically means the Islamic duty imposed upon the ruler to seek his citizens’ advice in all (important) matters related to governing the society. However, there is a division among Islamic jurists whether the ruler is obligated to follow such advice or merely take it into consideration. For a full discussion about *Shura* theory in Islam, see Hani Ahmad Abdulfatah, *Nizam Alshura Alislami Muqaranan bi Aldimocratia Alniabiah Almuasira* (PhD) (1990) (unpublished dissertation Ain Shams University law department Egypt). In the English language, also see Al-Munifi, *supra* note 149, at 366–71.

¹⁸⁰ The *Shura* Council Law issued by the Royal Order No. A/91 27 Sha’aban 1421/1 March 1992 [hereinafter SCL.].

¹⁸¹ CL. § (3).

¹⁸² The King appoints the members of the *shura* Council and the only legal constraint on his authority is the general requirement stated in Article (4) of the council. However, the practice is that most members are chosen from graduate degree holders from all regions in Saudi Arabia.

¹⁸³ *See* CL. § (12).

inspection, the Council is a new creation in Islam and rooted in *shura* principle.¹⁸⁴ The Council model is based on the early Islamic political principle called *shura* which imposes a duty upon the Islamic ruler to always consult with his people (citizens) about all matters related to the governance of the state.¹⁸⁵ However, Islamic jurists are divided about whether the opinions of the jurists are obligatory or merely consultative. The *Shura* Council in Saudi Arabia is based on the opinion that the *shura* is not binding (consultative) on the King.¹⁸⁶ Although the decisions of the *Shura* Council are deemed merely advisory, they in fact carry a great political weight.

The role of the *Shura* Council includes participating in the formation of the country's general plans of economic and social development,¹⁸⁷ reviewing acts, regulations,¹⁸⁸ international treaties and agreements,¹⁸⁹ concessions,¹⁹⁰ interpreting of acts,¹⁹¹ and discussing annual reports submitted by ministries and other government agencies.¹⁹² Moreover, the Council can express its position on the general policies of the Kingdom.¹⁹³ Any member of the Council may propose draft new legislation to the *Shura* Council or for the amendment of existing law.¹⁹⁴

¹⁸⁴ The main sources of Islam (Koran, *Sunnah*, and *Ijma*) recognize the necessity of the *Shura* as main pillar of Islamic political theory and practice.

¹⁸⁵ There is disagreement between jurists regarding the meaning of “Ahl al-Hal wa al-Aqd”. Some jurists confine this concept to a specific group in Islamic society such as leaders, Islamic jurists, and all other well-known members of the society who are entrusted with the full faith of the people. Additionally, jurists take liberal views by interpreting this concept as including all persons who may be eligible to enter a contract.

¹⁸⁶ Thus, many people when they translate the Arabic word “*shura*” to consultation by which they translate the “*Shura* Council” to the consultative council.

¹⁸⁷ CL. § (15)(a).

¹⁸⁸ *Id.* § (15)(b).

¹⁸⁹ *Id.*

¹⁹⁰ *Id.*

¹⁹¹ *Id.* § (15)(c).

¹⁹² *Id.* § (15)(d).

¹⁹³ *Id.* § (15).

¹⁹⁴ *Id.* § (23).

However, the Council differs from the parliament by not having the authority to discuss or approve the government's annual budget and does not have the authority to question executive power or withdraw confidence from them. In fact, the supervisory role of the Council is modest in comparison to its legislative role where its position is equal to the position of the Council of Ministers.¹⁹⁵

2.3.2.3 The Council of Ministers

The Executive branch of the state is vested in the hands of the Council of Ministers¹⁹⁶ which is chaired by the King¹⁹⁷ and membership of approximately thirty members.¹⁹⁸ The Council is composed of its president¹⁹⁹ (the King), the deputies of the president,²⁰⁰ ministers with portfolios,²⁰¹ ministers of state,²⁰² and advisors of the King who are appointed as members of the Council.²⁰³ The Council has full power over all executive and administrative affairs,²⁰⁴ inter alia, the authority of monitoring the implementation of laws, regulations and resolutions,²⁰⁵ creating

¹⁹⁵ A recent amendment to the *Shura* Council Law affords the Council final decision making power when its opinion conflicts with that of the Council of Ministers. The practice exemplifies that Saudi kings – in many cases – adopt the proposals of the *Shura* Council even if such proposals contradict actions of the Council of Ministers, which is headed by the King.

¹⁹⁶ S.B.L.G. art. § (44).

¹⁹⁷ S.C.M.L. art. § (12)(a).

¹⁹⁸ There are no prescribed minimum or maximum numbers of the size of the membership of the Council of the Ministers.

¹⁹⁹ S.C.M.L. art. § (1).

²⁰⁰ *Id.* § (12)(b).

²⁰¹ *Id.* § (12)(c).

²⁰² *Id.* § (12)(d).

²⁰³ *Id.* § (12)(e).

²⁰⁴ *Id.* § (24).

²⁰⁵ *Id.* § (24)(1).

and reorganizing public institutions,²⁰⁶ observation of the implementation of a general development plan,²⁰⁷ forming committees to review the conduct of ministries and other government instrumentalities,²⁰⁸ preparing the state's budget,²⁰⁹ and studying and adopting drafts of laws and regulations.²¹⁰

The chairman of the Council is responsible for guiding public policy of the state and assuring cooperation and coordination among the different government authorities to guarantee harmony and unity in the council of ministers.²¹¹ On the other hand, each minister with portfolio is considered to be the ultimate authority in running the affairs of his respective ministry.²¹²

Regarding the Council meetings, ordinary meetings require two-thirds of the Council members be present for a quorum unless exceptional circumstances necessitate convening by half of the members.²¹³ For decisions to be rendered valid, the majority of the attending members must be in agreement in normal meeting circumstances and, in cases of extraordinary meetings, two-thirds of attending members must be in agreement.²¹⁴ However, the enactment of the Council's decisions is always conditioned upon the approval of the king.²¹⁵

²⁰⁶ *Id.* § (24)(2).

²⁰⁷ *Id.* § (24)(3).

²⁰⁸ *Id.* § (24)(4).

²⁰⁹ *Id.* § (26).

²¹⁰ *Id.* § (21).

²¹¹ *Id.* § (29).

²¹² *Id.* § (10).

²¹³ *Id.* § (14).

²¹⁴ *Id.*

²¹⁵ *Id.* § (7).

2.3.2.4 The Judiciary

The judicial system in Saudi Arabia is a dual judicial system similar to other civil law countries such as France and Egypt where dual court systems exist.²¹⁶ The first part of this system, which is called the ordinary (general jurisdiction) judiciary, is responsible for civil and criminal disputes while the second part of judicial system is the Board of the Grievances (*Diwan al-madalm*), a court which has exclusive competence over all disputes involving the administration. The Basic Law of Governance assures the independence of the judiciary by stating that “[t]he judiciary shall be an independent authority. There shall be no power over judges in their judicial function other than power of the Islamic Shari’a.”²¹⁷ Also, the newly enacted judiciary code provides that “no one shall interfere in the judicial affairs.”²¹⁸ To embrace this independence, the Supreme Judicial Council is equipped with all authority related to non-judicial matters of the judges such as appointments, promotions, removals, inspections, training, and disciplinary actions. The council, which is composed of eleven members including the President of the Supreme Council, does not have any other judicial functions and remains as it was before the enactment of the new judicial code. However, in Saudi Arabia there is no constitutional court. Instead, all courts are eligible to abstain from applying legislation as being non-compliant with Islamic law. However, no court has the authority to strike down any legislation upon the finding of un-constitutionality.

²¹⁶ Napoleon established the “Council of the State” in 1799 which made France the mother of the dual legal system in many civil law countries which follow the French experience of having separate administrative courts. For a general overview of the French judicial system, see JOHN BELL ET AL., PRINCIPLES OF FRENCH LAW 37–54 (1998).

²¹⁷ B.L.G. § (46).

²¹⁸ Judiciary Law § (1) [hereinafter J.L.].

i. The Ordinary Court System

As noted earlier, the first component of the Saudi judicial system is the general or ordinary judiciary where all disputes between civil (private) parties and criminal case and charges are referred.²¹⁹ This judicial system is a three-tiered system.²²⁰ At the apex of the pyramid resides the Supreme Court.²²¹ However, the court's function in those situations is mostly to review the proper application of *shariah* or the “*anzimah*” (enacted statutes).²²² In other words, it is a court of law and not facts. The Court of Appeals is the middle level court in the general judicial hierarchy.²²³ The Court of Appeals is composed of specialized circuits such as commercial circuits,²²⁴ labor circuits,²²⁵ personal status circuits²²⁶ and criminal circuits.²²⁷ Cases in the Court of Appeals are heard and decided by a panel consisting of three appellate judges.²²⁸ The Court of Appeals is a court of law and fact.²²⁹ At the lowest level of the Saudi judicial system are the

²¹⁹ The new law of judicial reform was recently enacted through a new judicial law issued by royal decree M/78 (19 Ramadan in 1428 H).

²²⁰ J.L. § (9).

²²¹ J.L. § (9)(1). The Supreme Court located in the capital city of Riyadh is a newly established court in the Saudi judicial system. Its competence was vested under the Supreme Judicial Council. The court is composed of several circuits created by the Supreme Judicial Council. The high court has a mandatory and optional jurisdiction and has to review specific criminal punishment inflicted on the body of the accused, such as the death penalty. All other case reviews are optional to the litigants.

²²² J.L. § (11). At least one Court of Appeals has to be established in each of the thirteen Saudi provinces.

²²³ J.L. § (9)(2).

²²⁴ *Id.* § (16)(4).

²²⁵ *Id.* § (16)(5).

²²⁶ *Id.* § (16)(3).

²²⁷ *Id.* § (16)(2).

²²⁸ *Id.* § (15)(1). However, in cases of capital punishment, five judges must decide the case.

²²⁹ Where the case will be heard and decided upon as if it had never been initially heard by the court of first instance.

courts of first instance.²³⁰ These courts have limited jurisdiction based on the nature of the subject matter, such as Commercial Court,²³¹ Labor Court,²³² Criminal Court,²³³ Personal Status Court,²³⁴ and the General Court.²³⁵ Cases in the Court of first instance are heard and decided generally by one judge.²³⁶

ii. The Board of Grievances (Diwan al-Madalim)

The other second wing of the Saudi judicial system is Board of Grievances (*Diwan al-Madalim*).²³⁷ The BLG provides that: “[t]he Law shall set forth the structure and jurisdiction of the Board of Grievances.”²³⁸ Accordingly, the statute of the Board states that “[t]he Board of Grievances is an independent administrative judicial commission responsible directly to the King.”²³⁹ The Board is composed of a three-tiered administrative court.²⁴⁰ At the top of this court system is the High Administrative Court which is a court of law only.²⁴¹ Below the High Court, resides the Administrative Court of Appeals, the second level of adjudication, and the Administrative Courts at the bottom of the administrative judiciary pyramid. As mentioned earlier, the jurisdiction of the Board is limited to administrative disputes where a governmental

²³⁰ J.L. § (9)(3).

²³¹ *Id.* § (9)(3)(d).

²³² *Id.* § (9)(3)(e).

²³³ *Id.* § (9)(3)(b).

²³⁴ *Id.* § (9)(3)(c).

²³⁵ *Id.* § (9)(3)(a).

²³⁶ However, criminal courts require more than one judge. *See* J.L. § (20).

²³⁷ The Board of Grievances Law issued by Royal Decree No. (M/79) [hereinafter B.G.L.].

²³⁸ B.L.G. § (53).

²³⁹ *Id.* § (1).

²⁴⁰ *Id.* § (8).

²⁴¹ Thus, this court does not review facts when deciding the matter of the pending case.

entity is part of the dispute, that is, disputes related to administrative contracts,²⁴² decisions,²⁴³ rights of public employees²⁴⁴ and government tortuous acts.²⁴⁵ However, the jurisdiction of the Board does not include the review the acts of states' decisions which renders by the government in its sovereign power not the administrative one.²⁴⁶

2.4 SOURCES OF LEGAL AUTHORITY

2.4.1 Legislations

Not until King Abdulaziz's conquest of the Hejaz²⁴⁷ had the country experienced kind of positive legislations whatsoever.²⁴⁸ The un-codified rules of Islamic law (*Shariah*) were the sole law of the land.²⁴⁹ Hejaz, as mentioned earlier in this thesis, had a form of modern governmental

²⁴² B.G.L. § (13)(d).

²⁴³ *Id.* § (13)(b).

²⁴⁴ *Id.* § (13)(a).

²⁴⁵ *Id.* § (13)(c).

²⁴⁶ *Id.* § (14) which provides: "It shall not be permissible for the Board of Grievances to look into applications relating to questions of sovereignty" However, there is no clear distinct line separating an act of state from other administrative acts. For further discussion about acts of state in Saudi Arabia, see Mohamed Abdullah Al-Jerba, *The Board of Grievances: A Study of the Institution of Diwan Al-madhalim of Saudi Arabia with Particular Emphasis on its Administrative Jurisdiction* 211–16 (PhD) (1992) (unpublished dissertation University of Essex (U.K.)). Moreover, see Ayoub M.A. Al-Jarbou, *Judicial Review of Administrative Actions: A Comparative Study between the United States and Saudi Arabia* 334–46, vol. II (S.J.D.) (2002) (unpublished dissertation University of Virginia Law School).

²⁴⁷ In 1924.

²⁴⁸ See MOHAMMAD ABDULJAWAD MOHAMMAD, *AL-TATWER AL-TASHRI'E FI AL-MAMLAKH AL-ARABIA AL-SAUDIAH* 40 (Dar al-Ma'rif publisher, Alexandria, Egypt 1997).

²⁴⁹ *See id.*

organization due to Ottoman control and influence of that region.²⁵⁰ Accordingly, King Abdulaziz issued an order to recognize all pre-capture laws in the Hejaz region only.²⁵¹ It could be asserted that the evolution of positive law in the kingdom emerged from that early recognition of positive law in one part of the newly established state. Currently, legislations in Saudi Arabia are of different forms, generally categorized into laws (statutes) and regulations. The distinction is based on the authority issuing them and their subject matter. It is worth noting that Arab countries use the Arabic word *qanun* for “law” but Saudi Arabia – for policy reasons – chose the word *nizam*. Technically, those two words convey the same meaning: law.²⁵² The reason behind this word usage was to bypass the opposing social and religious views of applying non-Islamic codified rules imported from a non-Muslim (western) country’s legal traditions.²⁵³

2.4.1.1 Statutes (*anzima*)

i. Types of *anzima*

Saudi legal system observes two kinds of *anzima*. First, the basic laws include the Basic Law of Governance, Council of Ministers Law, *Shura* Council Law, Law of Providences, and the Law of the Allegiance Commission. These laws generally regulate the constitutional foundation of the state powers and the fundamental rights and liberties of the citizens. Thus, they reside at the top of the codified legislations hierarchy by Royal Order of the King as the supreme last resort of all

²⁵⁰ *See id.* at 40. In fact, Hejaz declares its independence from Ottoman Empire in 1916, a few years before its capture by king Abdulaziz in 1925. For more information about this era of the Hijaz independent state, *see* JOSHUA TEILTELBAUM, THE RISE AND FALL OF THE HASHEMITE KINGDOM OF THE HIJAZ (2001).

²⁵¹ *See id.* at 44.

²⁵² *See id.* at 13.

²⁵³ *See id.*

state powers (the *Imam*).²⁵⁴ Accordingly, basic laws stem from the King's absolute authority: no institution has legal power to review the King's order before its issuance nor competence to rescind the order's content as long as the *anzima* (statutes) are compatible with *Sharia*.

The second *anzima* form is the ordinary laws issued by Royal Decree after the study and review of the bill in both Councils the *Shura*²⁵⁵ and the Ministers.²⁵⁶ The King has full discretion to enact the bill or not. In short, neither time constraints nor constitutional mechanisms (by which the parliament could pass the law without his approval by special voting quorum) has an effect on the King's power. Furthermore, ordinary laws must comply with *Sharia* and Basic Laws which both supersede all other laws and regulations in the Kingdom.²⁵⁷ Some scholars rank the BLG at the top of the basic laws thereby prevailing over the other basic laws.²⁵⁸ According to this point of view, the lower status basic laws must not contradict the BLG. However, this argument does not find a basis in the constitutional practices in Saudi Arabia where all Basic Laws are treated equally.

²⁵⁴ For the King's authority see article § (44) of B.L.G. However, the Law of Allegiance Commission is the only law the King cannot modify without the consent of the allegiance commission according to commission law. See Article § (25) in the law of allegiance Commission.

²⁵⁵ CL. art. § (18) which states that: "[l]aws ... shall be issued and amended by Royal Decrees after review by the *Shura* Council."

²⁵⁶ C.M.L. art. § (20) which states that: "laws ... shall be issued and amended by Royal Decrees after being reviewed by the Council of Ministers."

²⁵⁷ Neither basic law of governance nor the other basic laws state that. However, in the Royal Decree No. (M/23) dated 26/8/1412 H the word law (regular) does not apply to the Basic law of governance, Council of Ministers Law, *Shura* Council Law, and the Law of Providences. Accordingly, this exception of these laws indicates its higher status, most especially its constitutional nature.

²⁵⁸ See ALRWAIIS & ALRAYIS, *supra* note 164.

ii. Legislative process

The traditional way to enact a new ordinary law or to amend an existing one²⁵⁹ is proposing the bill to the Council of Ministers by the relevant administrative organ. Upon receiving the bill, the Council refers the bill to its legal wing, the Bureau of Experts.²⁶⁰ In the Bureau, all relevant governmental and nongovernmental institutions are invited to study the proposed draft in free and democratic deliberations.²⁶¹ The bill is put in its final shape by the legal advisors of the Bureau to assure its compatibility with the Saudi legal system.²⁶² The Bureau then returns the revised bill to the Council of Ministers for voting on the adoption of the bill. If the Council of Ministers adopts the proposed bill, the Council will refer the bill to the *Shura* Council to study and vote on the proposed bill. The *Shura* Council then submits the bill to the King who decides either to refer the bill again to the Council of Ministers or to enact the law as it comes from the *Shura* Council.²⁶³ If the King sends back the bill to the Council of Ministers to review the bill as it is amended by the *Shura* Council, two scenarios might emerge from this referral:²⁶⁴ in the first, the Council of Ministers issues a resolution containing the adoption of the *Shura* amended bill by

²⁵⁹ This part is concerned with the ordinary legislative process of laws which were enacted by royal decrees. But laws that were enacted by extraordinary ways, i.e., based on the will of the King exclusively and issued by royal order, are not discussed here due to the lack of codified legislative process.

²⁶⁰ Currently, the Bureau of Experts consists of about thirty legal advisors (most have at least an LL.M. from the U.S.). See the Bureau of Experts homepage [<http://www.boe.gov.sa/Manswbeen.aspx>] (accessed on Feb. 20, 2014).

²⁶¹ Decision is taken by voting; the minority may attach their opinion or reservation to the Council of Ministers to decide on the matter.

²⁶² The legal advisor of the Bureau does not review technicalities of the studied matter but instead puts the substance in a legally acceptable matter. Also, the Bureau has the right to amend or ring a bell about any decision that contains a violation of the law of the land or international obligation.

²⁶³ CL. art. § (17).

²⁶⁴ *Id.*

which the King issued a Royal Decree to enact the law based on the *Shura* Council version.²⁶⁵ In the other scenario, the Council of Ministers disagrees with all or some of the provisions in the *Shura* Council's proposed amendment of the bill which is then referred back to the *Shura* Council for a second review. The *Shura* Council submits its decision on the matter to the King to enact the law in the form he sees more proper.²⁶⁶

The other method of proposing law is that the proposed bill starts from the *Shura* Council directly.²⁶⁷ The newly amended law of the *Shura* Council grants the Council right of proposing a new bill or amendment of existing law.²⁶⁸ Accordingly, the *Shura* Council will submit the draft to the King under the same process stated for the first mentioned method. Clearly, the legislative process in Saudi legal system is a triangle in which the King resides in the apex.

2.4.1.2 Regulations

Regulations are the other kind of legislation which take different forms but are enacted by executive power. Regulations may be used for supplementing an existing statute (implementing regulations),²⁶⁹ or independent regulations directed to safeguard public order (police regulations),²⁷⁰ or organizing public institutions (organizing regulations).²⁷¹ First, Implementing regulations usually contain technical and procedural rules necessary for the proper

²⁶⁵ *Id.*

²⁶⁶ *Id.*

²⁶⁷ This usually happens rarely.

²⁶⁸ CL. art. § (23).

²⁶⁹ See ALMARZUGI, *supra* note 162, at 91–93.

²⁷⁰ See ALRWAIS & ALRAYIS, *supra* note 164, at 111.

²⁷¹ See ALMARZUGI, *supra* note 162, at 90–91.

implementation of the relevant statute it supplements.²⁷² Thus, the implementing regulations are limited to the scope of the relevant statute and cannot exceed proper limits of that statute or contradict or modify any of its provisions.²⁷³ In addition, implementing regulations are not authorized to regulate matters linked to individual's rights and liberty, such as crime and punishment²⁷⁴ or the imposition of taxation.²⁷⁵ Secondly, the independent regulations are a set of rules initiated directly without depending on or supplementing an existing statute. Thirdly, police regulation, is directed to safeguard the public health, morals, and peace (tranquility).²⁷⁶ Fourthly, organizational regulation, allows the administration to establish public institutions (ministries and instrumentalities) and reorganize them.²⁷⁷ All regulations occupy the bottom of the legislation hierarchy after the basic and regular laws.²⁷⁸

²⁷² See ALRWAIIS & ALRAYIS, *supra* note 164, at 110.

²⁷³ See *id.*

²⁷⁴ B.L.G. art. § (38) which provides that “punishment shall be carried out on a personal basis. There shall be no crime or punishment except on the basis of a Shari’ah or a statutory provision and there shall be no punishment except for deeds subsequent to the effectiveness of a statutory provision.”

²⁷⁵ B.L.G. art. § (20) which provides that “taxes and fees shall be imposed only if needed and on a just basis. They shall be imposed, revised, abolished, or exempted only in accordance with the statute.”

²⁷⁶ See ALRWAIIS & ALRAYIS, *supra* note 164, at 111.

²⁷⁷ See *id.* at 110 [the introduction to study legal sciences].

²⁷⁸ See *id.* at 111. However, some legal scholars argue that organizational regulations have the same legal rank as regular law in their constitutional rank with regard to their specified legal scope. Thus, these regulations may amend or abrogate any legal provisions provided by regular law that concern the establishment or organization of public institutions or bodies such as ministries or an independent authority, i.e. the Capital Market authority. See Esam Bin Sayd, *alrghabh alla amal alsulth altanfithiah fi almamlakah alarabiyah alsaudiyah* (PhD) (2010) (unpublished dissertation Cairo University Law school (2010)).

2.4.2 Islamic Law Sources

Islamic jurisprudence has divided sources of legal authority (law) into primary and supplementary sources. The primary sources consist of the textual authorities: the Koran and the Prophet Mohammad's *Sunna* (traditions or teachings). The supplementary sources encompass an array of authorities (e.g. custom,²⁷⁹ equity,²⁸⁰ and the revelation of pre-Islamic holy texts²⁸¹), with the foremost two being *ijma* (consensus) and *qias* (analogy).

2.4.3 Primary Sources

2.4.3.1 Koran

The Koran is the supreme source of Islamic authority and is believed (by Muslims) to be the true words of God (Allah) revealed in Arabic to his last Prophet to humanity, Mohammad.²⁸² The revelation came to the Prophet Mohammad when he was in his forties in a gradual manner over twenty years.²⁸³ This piecemeal revelation facilitates its understanding and memorization by the Prophet's companions.²⁸⁴

²⁷⁹ *Urf* (customs) are recognized as a source of legal authority which is defined as "recurring practices that are acceptable to people of sound nature." MOHAMMAD HASHIM KAMALI, PRINCIPLES OF ISLAMIC JURISPRUDENCE 368 (2003). For *urf* in Islam see *id.* 368–82. For detailed study on the legal framework of customs in Islam see AYMAN SHABANA, CUSTOM IN ISLAMIC LAW AND LEGAL THEORY: THE DEVELOPMENT OF THE CONCEPTS OF URF AND ADAH IN THE ISLAMIC LEGAL TRADITION (2010).

²⁸⁰ For Equity as Islamic sources of authority see KAMALI, *supra* note 279, at 323–48.

²⁸¹ The Koran provides that: "He hath ordained for you that religion which He commended unto Noah, and that which We inspire in thee (Muhammad), and that which We commended unto Abraham and Moses and Jesus, saying: Establish the religion, and be not divided therein." (Koran: Ash-Shura: verse 13).

²⁸² See MOHAMMAD ABU-ZAHRA, USUAL AL-FIGH 75 (Cairo: Dar Alfiker Alarabi 2006).

²⁸³ See KAMALI, *supra* note 279, at 19.

²⁸⁴ See *id.* at 323–48.

While the Koran contains more than 6,000 verses, only 500 are of a legal nature.²⁸⁵ An Islamic scholar described the Koran's content through a modern lens, noting:

It is the fundamental and paramount source of the creed, rituals, ethics, and laws of Islamic religion. It is the book that 'differentiates' between right and wrong, so that nowadays, when the Muslim world is dealing with such universal issues as globalization, the environment, combating terrorism and drugs, issues of medical ethics, and feminism, evidence to support the various arguments is sought in Koran [sic].²⁸⁶

Extracting a legal rule from the Koran is not an easy task for ordinary persons because the Koran was revealed in the classical form of the Arabic language.²⁸⁷ The rules stated in the Koran are intentionally divided into two kinds: rules with clear meaning of application (definitive) and others with probable meanings, as the Koran provides:

He it is Who hath revealed unto thee (Muhammad) the Scripture wherein are clear revelations – they are the substance of the Book – and others (which are) allegorical. But those in whose hearts is doubt pursue, forsooth, that which is allegorical seeking (to cause) dissension by seeking to explain it. None knoweth its explanation save Allah. And those who are of sound instruction say: We believe therein; the whole is from our Lord; but only men of understanding really heed.²⁸⁸

Probable rules provide flexible interpretation that may fit generational needs in different times and venues.²⁸⁹ Since the Koran was revealed gradually over an extended period of time,²⁹⁰ various verses were abrogated by a latter revelation.²⁹¹ Both the abrogating and abrogated verses

²⁸⁵ The Holy Quran consists of thirty chapters which include one hundred and fourteen *suras* (verses). Its transmission spanned twenty three years and was divided between the two Islamic holy cities of Mecca and Madina. The Meccan *suras* were mostly directed tenets and rituals, whereas the *Madinian Suras* contain legal rules related to many aspects of legal subjects. See Abu-Zahra, *supra* note 282, at 76.

²⁸⁶ M.A.S. ABDEL HALEEM, THE QURAN: A NEW TRANSLATION IX (N.Y. Oxford Univ. Press 2008).

²⁸⁷ See IMRAN AHSAN KHAN NYAZEE, ISLAMIC JURISPRUDENCE 157 (2003).

²⁸⁸ Holy Quran: Verse (7) in sura Al-Imran.

²⁸⁹ See KAMALI, *supra* note 279, at 27–46.

²⁹⁰ See *id.* at 20.

²⁹¹ See *id.* at 209.

compose the final version of the Koran. However, only the first (the abrogating) convey valid legal rules.²⁹² Knowing abrogated rules are integral prerequisites of Islamic jurists.²⁹³

2.4.3.2 *Sunna*

Allah orders all Muslims to follow the commands of the Prophet Mohammad by saying “[w]hoever obeys the Messenger obeys God.”²⁹⁴ Consequently, the Prophet Mohammad’s “words, acts, and (tacit) approvals” or, in other words, the *Sunna*, are the second source of Islamic law.²⁹⁵ In the Arabic language, “*Sunna*” means the “well-trodden path.”²⁹⁶ Although the *Sunna* sometimes contain rules not mentioned directly in the Koran, many of its rules “restrict, qualify, or elaborate” on general rules of the Koran.²⁹⁷ For example, the Koran commands all Muslims to pray to God but did not specify the way of conducting this prayer. Accordingly, this procedure was then defined by the *Sunna*.²⁹⁸

2.4.4 Supplementary Sources

Alongside the primary sources, there is a wide range of other supplementary sources of Islamic law. These sources are considered to be supplementary because they do not contain independent

²⁹² In regards to abrogation, Allah said: “Such of our revelation as We abrogate or cause to be forgotten, but we bring (in place) one better or the like thereof. Knowest thou not that Allah is Able to do all things? (106)” (Koran: Al-Baqara verse 106).

²⁹³ For a detailed treatment of the abrogation in Islamic jurisprudence see John Burton, *The Sources of Islamic Law: Islamic theories of Abrogation* (1995).

²⁹⁴ Holy Quran: Verse (80) in sura Al-Nisa.

²⁹⁵ NYAZEE, *supra* note 287, at 163.

²⁹⁶ *Id.* at 162.

²⁹⁷ *Id.* at 177.

²⁹⁸ See MUSTAFA AHMAD AL-ZARQA, *AL-MADKHAL AL-FIQHI AL-AAM*, vol. 1, 74 (1998).

legal authority; however, they do depend on the two primary sources. The chief supplementary sources, which are agreed upon by the four *sunni mathahib*, are *ijma* and *qias*.

2.4.4.1 *Ijma*

Ijma is the third source of Islamic law, meaning “consensus” in Arabic. The technical meaning of *ijma*, however, refers to “[t]he consensus of *mujtahids* (independent jurists) from the *ummah* [nation] of [prophet] Muhammad, after his death, in a determined period upon a rule of Islamic law.”²⁹⁹ The opinions of the *mujahidun* (knowledgeable or independent jurists) are only counted when in *ijma* formation, at which time the opinion of *muqalidun* (ordinary scholars) is excluded from this process.³⁰⁰ Due to the strict conditions regarding the formation of *ijma*, rules derived from this source are rare and limited to the early era of Islam that directly followed the death of Prophet Mohammad.³⁰¹ However, when an *Ijma* is reached in a specific matter, the rule stemming thereof may not be amended or abrogated by a later *ijma*.³⁰²

2.4.4.2 *Qias*

Qias is the fourth chief Islamic source of authority. *Qias* is defined as “the extension of *Shariah* value from an original case, or *asl*, to a new case.”³⁰³ In other words, Islamic jurists (*mujtahid*) apply a rule stated in the Koran or *Sunna* to a new case that is not directly mentioned in this

²⁹⁹ NYAZEE, *supra* note 287, at 183.

³⁰⁰ KAMALI, *supra* note 279, at 233.

³⁰¹ For the Islamic jurist opinions over the formation of *ijma* see generally MOHAMMAD RAZI, ENCYCLOPEDIA OF ISLAMIC JURISPRUDENCE, vol. 3, 63–64 (2007).

³⁰² ABDULWAHHAB KHALLAF, *ELM USUL AL-FIGH* 46–47 (8th ed.: n.d.).

³⁰³ KAMALI, *supra* note 279, at 263.

source, due to similarity of reason between the original situation and the new one.³⁰⁴ For instance, the prohibition of intoxicants consumption is stated clearly in the Koran: “[y]ou who believe, intoxicants and gambling, idolatrous practices and [divining with] arrows are repugnant acts – Satan’s doing – shun them so that you may prosper,”³⁰⁵ while the prohibition of smoking marijuana is not mentioned literally in the Koran nor *Sunna*. Islamic jurists’ prohibition of marijuana use is based on the prohibition of intoxicants consumption due to an analogy between the reason of the prohibition of intoxicants consumption – which is the impairment of a person’s cognition – and the effect of marijuana consumption on the brain.³⁰⁶ In contrast to *ijma*, *Qias* has played a major role in forming many Islamic rules through Islamic history and will contribute to the future rulemaking of the Islamic legal system.³⁰⁷

2.4.5 Legal Rules in Islam

2.4.5.1 Introduction

A legal rule in Islam conveys one of following legal instructions to the peoples’ actions: obligatory (e.g., fulfilling contracts), recommended (e.g., charitable contributions), reprehended (e.g., extravagance), and prohibited (e.g., usury), and permissible (e.g., commerce and sport).³⁰⁸

Since the death of the Prophet Mohammad and the end of revelations, Islamic jurists, called *fuqaha* (singular. *faqih*), especially the premier ones, *mujtahidun* (singular. *mujtahid*), play an

³⁰⁴ ABU-ZAHRA, *supra* note 282, at 200.

³⁰⁵ Koran: Verse (90) in sura Al-Ma’ida (The Feast).

³⁰⁶ For prohibition of narcotics in Islam see generally 179–80. See RAZI, *supra* note 301, at vol. 2, 179–80.

³⁰⁷ See AL-ZARQA, *supra* note 298, at 79.

³⁰⁸ See NYAZEE, *supra* note 287, at 51–52.

exclusive role in determining the rules applicable to all sorts of life occasions. This rulemaking function assumed by Islamic jurists through Islamic history led a prominent orientalist, Bernard Weiss, to label Islamic law a “jurist law” like the ancient Roman legal system.³⁰⁹ He said, “[b]oth in Rome and in Islam the authority to expound law belonged to lay specialists rather than to the courts, as is the case in the Common Law.”³¹⁰

2.4.5.2 The Rule Making Process in Islamic Legal System

Islamic law is extracted from the divine sources of Islam through a mechanism of *Ijtihad*. “Because [Islamic] Law is buried ... within the (legally) imprecise and sometimes ambiguous language of sacred texts, it is said to be extracted from the text; and it is for this reason that the texts are to be considered sources of Law rather than the Law itself.”³¹¹ *Ijtihad* refers to “the process of reasoning that jurists employed in order to arrive at the best guess of what he thought might be the law pertaining to particular case.”³¹² *Mujtahid* (a jurist conducting *ijtihad*) utilizes a complex methodology, “*usul al-fiqh*,” to extract the legal rules from various Islamic sources.³¹³ *Usul al-fiqh* refers to the “body of principles of interpretation by the help of which the *mujtahid* is able to derive the law from the detailed evidence in the Koran [sic], the *Sunna*, *ijma*, and *qias* [sic].”³¹⁴ A *mujtahid* has to observe the hierarchy in Islamic law sources under which he has to

³⁰⁹ Bernard Weiss, *Interpretation in Islamic Law: The Theory of Ijtihad*, in ISLAMIC LAW AND LEGAL THEORY 199, 201 (Ian Edge ed., 1996).

³¹⁰ *Id.* at 199, 201.

³¹¹ *Id.* at 199, 199.

³¹² WAEL B. HALLAQ, AN INTRODUCTION TO ISLAMIC LAW 27 (2009).

³¹³ Imam al-shafi considered to be the founder of this field of knowledge in his a seminal monograph, “*al-Risala*.” See MAJID KHADDURI, ISLAMIC JURISPRUDENCE: SHAFII’S RISALA (1961).

³¹⁴ NYAZEE, *supra* note 287, at 37.

search for the rule in the Koran first, and then search for it in the *Sunna*. If there is no direct rule in the primary sources, the jurist has to consult the two chief supplementary sources, the *ijma* first and the *qias* second. In other words, the four chief sources of Islamic law sources have to be utilized sequentially.³¹⁵

A *mujtahid* has three main functions: to locate applicable rules in the primary sources, to expand the application of rules enclosed in primary sources to new situations not mentioned directly in the primary sources, and to formulate new rules based on the general guidance of Islamic sources when a matter is not directly or indirectly ruled on by the primary sources, and not the two chief supplementary sources (*Ijma* and *Qias*).³¹⁶ Because *ijtihad* involves application of a complex methodology and demands strict prerequisites, most Islamic law jurists do not satisfy the conditions of *ijtihad*.³¹⁷ Non-*mujtahid* jurists, called *muqallidun* (singular. *muqallid*), have to follow the opinions of the *mujtahhidun*.³¹⁸

2.4.6 Juridical Schools in Islam

In *Sunni* jurisprudence, non-*mujtahid* jurists are normally adherent to one of the four *Sunni fiqh* (juridical) schools (*maddahib*):³¹⁹ *al-Madhab al-Hanafi*,³²⁰ *al-Madhab al-Maliki*,³²¹ *al-Madhab*

³¹⁵ *Id.* at 145.

³¹⁶ See NYAZEE, *supra* note 287, at 264.

³¹⁷ *Id.* at 25.

³¹⁸ This process called *Taqlid* which “in the legal sense following the opinion of another.” NYAZEE, *supra* note 287, at 25. For general background about *taglid* see RAZI, *supra* note 301, at vol. 3, 108–09.

³¹⁹ *Madahi* defined as “the doctrine legacy that binds members of a school together.” Bernard Weiss, *The Madhhab in Islamic Legal Theory*, in *THE ISLAMIC SCHOOL OF LAW: EVOLUTION, DEVOLUTION, AND PROGRESS* 1, 1 (Peri Bearman et al. eds., 2005). For historical background on the Islamic *madahhibs* see Wael B. Hallaq, *THE ORIGINS AND EVOLUTION OF ISLAMIC LAW* 150–177 (2005). For general overview of juridical principles of these *madahhibs* see RAZI, *supra* note 301, at vol. 1, 248–96.

al-Shafi,³²² and *al-Madhab al-Hanbali*.³²³ The heritage of those scholars was preserved by students of the original schools' founders.³²⁴ The schools were later named after their respective founders.³²⁵ These *maddahib* agree on the authority of Koran, *Sunna*, *Ijma*, and *qias*.³²⁶ However, the *maddahib* utilize a slightly different *ijtihad* process which is connected to the authority and hierarchy of the less authoritative supplementary sources, such as custom, equity, and public policy. Currently, each school has an enormous juridical literature, *fiqh*, documenting legal rules reached by the school's founder and students starting from the school's inception.

The existence of several juridical schools has enriched Islamic jurisprudence and encourages the utilization of a comparative study approach of these schools. The Islamic legal system is one of the earlier legal systems that recognized the importance of comparative studies. Since the ninth century AC, Islamic scholars have devoted a great deal of their time to comparative studies of *madahhib*. In the twelfth century AC, for instance, the eminent *Hanbali* jurist, Ibn Qudamah, authored one of the early comprehensive comparative monographs, *al-*

³²⁰ *al-Madhab al-Hanafi* was founded by Abu Hanifa who died in 767 AC. See generally DAVID WAINES, AN INTRODUCTION TO ISLAM 66 (2d ed. 2003).

³²¹ *Id.* at 66–67.

³²² Mohammad bin Idris al-Shafi (died in 820 AC.) was the founder of *al-Madhab al-Shafi*. See generally WAINES, *supra* note 320, at 67–70.

³²³ *Id.* at 70–71.

³²⁴ In fact, school founders did not know or intending to form their own school. See Majid Khadduri, *Nature and Sources of Islamic Law*, 22 GEO. WASH. L. REV. 3, 18 (1953).

³²⁵ See HALLAQ, *supra* note 312, at 31. On the other hand, due to lack of documentation, several important *madahhib* had faded away such as the *sufiyan al-Thory* and *al-Awzai madahhib*. See generally STEVEN C. JUDD, AL-AWZA'I & SUFYAN AL-THAWRI: THE Umayyad Madhhab, in THE ISLAMIC SCHOOL OF LAW: EVOLUTION, DEVOLUTION, AND PROGRESS 10, 10–25 (Peri Bearman et al. eds., 2005).

³²⁶ See, e.g., NYAZEE, *supra* note 287, at 144.

Mughni,³²⁷ which, to the present time, has upheld its value as a primary source of Islamic jurisprudence.³²⁸

The influence of the four *maddahib* is not equal in all Islamic countries. For instance, North African countries (i.e. Morocco, Algeria, Mauritania, and Tunisia) are dominated by the *al-Madhab Maliki*,³²⁹ while Egypt adheres to *al-Madhab al-Shafi*.³³⁰ *al-Madhab al-Hanafi* was the official *Madhab* of the Ottoman Empire³³¹ and has retained its heavy influence on Turkish people since then.³³² Saudi Arabia and Qatar are the only states which have adopted the *al-Madhab al-Hanbali*.³³³ In comparison to other *madahib*, the *al-Madhab Hanbali* pursues an orthodox approach with regard to faith and worship subjects, and a very “liberal” approach in “commercial” matters.³³⁴

³²⁷ For Ibn Qudamah al-Maqdisi, *see generally* MAKDISI, G. “IBN KUDAMA AL-MAKDISI.” ENCYCLOPEDIA OF ISLAM (2d ed.). Brill Online, 2013. Reverence, 28 Apr. 2013, http://www.encyquran.brill.nl/entries/encyclopaedia-of-islam-2/ibn-kudama-al-makdisi-SIM_3262?s.num=3.

³²⁸ Other important early comparative monographs carry similar value of the al-Mughni such as *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*; *al-Hidayah fi Sharh Bidayat al-MuMubtadi*.

³²⁹ *See* MANSOUR H. MANSOUR, *THE MALIKI SCHOOL OF LAW: SPREAD AND DOMINATION IN NORTH AND WEST AFRICA, 8TH-14TH CENTURIES* 6 (1995).

³³⁰ *See* HALLAQ, *supra* note 312, at 36.

³³¹ *See generally* Rudolph Peters, *What Does It Means To Be An Official Madhhab? Hanafism and the Ottoman Empire*, in *THE ISLAMIC SCHOOL OF LAW: EVOLUTION, DEVOLUTION, AND PROGRESS* 147, 147–58 (Peri Bearman et al. eds., 2005).

³³² *See* HALLAQ, *supra* note 312, at 36.

³³³ “Hanbali School of Law,” in *THE OXFORD DICTIONARY OF ISLAM* (John L. Esposito ed.), Oxford Islamic Studies Online, <http://www.oxfordislamicstudies.com/article/opr/t125/e799> (accessed on Feb. 12, 2013).

³³⁴ *Id.*

2.5 BUSINESS ORGANIZATIONS IN SAUDI ARABIA

The Companies Law of 1965 (CL) is one of the oldest acts in Saudi Arabia.³³⁵ The CL follows the Civil law tradition in form and substance where the law requires incorporation of all business organizations, other than joint venture companies. Accordingly, all these business forms enjoy legal personalities.³³⁶ The various incorporated business vehicles are all called companies and, in some cases, share common attributes.

2.5.1 The Evolution of Business Organizations' Regulations in Saudi Arabia

As mentioned earlier, life in the Najd region was simple. Economic activities between businesses also followed an uncomplicated style. Islamic jurists developed un-codified Islamic partnerships that governed business relationships.³³⁷ The Hejaz region, conversely, witnessed a relatively high rate of economic activity due to its proximity to the Red Sea and the resulting money influx from Muslim visitors to the two Holy Cities (Mecca and Medina). The Hejaz had a special connection to the central government of the Ottoman Empire which applied Ottoman Commercial Code to the region.³³⁸

As mentioned, King Abdulaziz captured the Hejaz region in 1925 but kept this region independent from the other parts of the country. Consequently, the King recognized most of the

³³⁵ The law was enacted more than forty-five years ago by royal decree No. M/6 dated 6th of Rabi' al-Awwal in (1385 H) corresponding to (1965).

³³⁶ With exception to the joint adventure company.

³³⁷ See MOHAMMAD, *supra* note 248, at 52 (Dar al-Ma'rif publisher, Alexandria, Egypt, 1997).

³³⁸ See *id.* In 1916, the Hejaz declared its independence from the Ottoman Empire and became the Kingdom of Hejaz (1916-1824).

existing (pre-capture) laws of the Hejaz region.³³⁹ Several years later, the government introduced new commercial law there shortly before integrating the region with other parts of the state.³⁴⁰ Commercial Law consisted of six hundred and thirty three articles; however, only seven were about business organizations (companies).³⁴¹

In 1933, a year after the unification of the Hejaz region with the rest of the country and the declaration of the Kingdom of Saudi Arabia,³⁴² the Saudi government granted California Arabian Standard Oil Company (CASOC, now ARAMCO) rights for prospecting oil in the country.³⁴³ However, it was not until 1938 that the American company discovered oil in the eastern part of the kingdom: such a discovery would transform the entire portrait of the country in every aspect of life, including those of social, economic, political and legal significance.³⁴⁴ Consequently, the oil revenue-generated economic boom attracted the formation of many companies intent on building the country's infrastructure.³⁴⁵ All of these changes outdated the

³³⁹ Before King Abdulaziz captured the Hejaz region, it was newly independent from the Ottoman Empire.

³⁴⁰ Enacted in (1350 H) correspondent to (1931). This law is, also, called "the Law of Commercial Court."

³⁴¹ See arts. §§ (11–17) of the Commercial Law.

³⁴² In 1932.

³⁴³ This oil company has a history closely linked to Saudi Arabia's history and development. This relationship began when the Saudi government granted prospecting concessions to the company in 1933. See www.saudiaramco.com (accessed on Oct. 9, 2010).

³⁴⁴ For detailed discussion of those aspects, see Saud A. Al-Mashari, *The Influx of Oil Wealth and the Resultant Socio-Economic Development in Saudi Arabia: The impact of the Petrodollar on the Legal System of the Kingdom of Saudi Arabia (J.S.D.)* (1996) (unpublished dissertation, Washington University in St. Louis School of Law) (on filed with author).

³⁴⁵ There was almost no modern infrastructure in the country. The National Joint Stock Company for auto operations in the Hejaz and the Najd Kingdom was the first joint stock company. See MOHAMMAD, *supra* note 248, at 51. Also see the Explanatory Memorandum of the Saudi Companies Law which states:

Modern renaissance [in] the kingdom has embarked ... since the reign of H M King Abdulaziz ... a great effect in stimulating trade and increasing large development projected, such as the opening of roads and the construction of airports, dams, and government and private establishments.... Consequently, the number of companies has risen by leaps and bounds in a few years from a few score to several hundred, and is still constantly increasing.

shorthanded regulation of companies in Commercial Law and necessitated, as the explanatory note justifies, drafting:

[C]omprehensive regulations for companies, to set forth provisions to be observed upon their incorporation, dissolution, and liquidation and ... to determine the extent of supervisory and control power of Ministry [of Commerce and Industry] over that companies to safeguard the public interest and protect individuals' investment.³⁴⁶

In 1965, accordingly, King Faisal responded to the call of modernization by enacting a new company law which is still in effect.³⁴⁷ Although the Companies Law is based on French civil law model, Saudi business culture is clearly American-oriented, due mainly to the pioneer oil prospecting concession granted to the American oil company and the unique political alliance and economic partnership between the United States and the Kingdom of Saudi Arabia. As a result, the Saudi government has sponsored and supported a large number of Saudi citizens to the U.S. for education, from the early days of the oil discovery to the present.³⁴⁸ American-educated Saudis in both public and private sectors are expected to consider their American experience when debating any calls for reform in the country.

³⁴⁶ The Explanatory Memorandum of the Saudi Companies Law.

³⁴⁷ This new companies law is at a final stage of enactment and will replace the former law. However, the general framework and foundation of both are similar.

³⁴⁸ See, e.g., Saudi Cultural Mission to the U.S., Directory of Dissertations of Saudi Graduates from U.S. Universities between 1964-2005 (2006), available at http://www.sacm.org/Publications/56090_phd_complete.pdf (accessed on Jan. 30, 2014).

2.5.2 Law Sources for Business Organizations

The Companies Law of 1965 (CL) is the primary source of company law in Saudi Arabia and regulates all business association forms.³⁴⁹ Accordingly, all business associations, other than joint venture companies, are incorporated forms and enjoy legal personality.³⁵⁰ The CL contains 233 articles divided into fifteen sections. Section One has general provisions applicable to all company forms,³⁵¹ which are covered in Sections Two through Nine. Other chapters are devoted to regulate mergers, liquidation, and criminal sanctions.

Most importantly, CL designates more than a third of Section five to regulate joint stock companies. Consequently, this section states all provisions related to a joint stock company incorporation, governance (board of directors and the general meetings), finance, financial matters (accounting and auditing), alteration of the company's capital and, finally, the dissolution of the company. However, CL authorizes the Minister of Commerce and Industry to issue supplementary regulations to implement company law provisions.³⁵² For example, the Minister issued a resolution requiring all joint stock companies to establish auditing committees.³⁵³ Joint stock companies are required to adopt the standardized form of joint stock company bylaws³⁵⁴ unless there is a compelling reason to derogate from the terms stated in the

³⁴⁹ Enacted for more than forty-five years by the Royal No. M/6 dated 6th of Rabi' al-Awwal in (1385 H) correspondent to (1965).

³⁵⁰ With exception to joint venture company. C.L. art. § (13).

³⁵¹ C.L. arts. §§ (1–15).

³⁵² CL. art. § (233).

³⁵³ Ministerial Resolution No. (903) dated in (1414 H) corresponding to (1993).

³⁵⁴ CL. art. § (51).

Ministry form.³⁵⁵ Thus, the standardized approach taken by Saudi authorities has led to a similar legal framework among most Saudi joint stock companies even when circumstances and business factors required otherwise.

In addition to those legal sources, the relatively new (2003) Capital Market Law (CML) regulates many legal aspects related to publicly traded joint stock companies such as disclosure, securities listing, offering and distribution, market integrity, and underwriters' businesses.³⁵⁶ More importantly, this law established a governmental body (Capital Market Authority "CMA") to supervise and regulate the Saudi capital market. Accordingly, the CMA implemented several regulations to assure market fairness and integrity for all participants, especially small investors. These regulations include listing rules, market conduct, corporate governance, merger and acquisition, and securities offering.

2.5.3 Business Organization Forms

There are several forms of business organizations under CL such as general partnership company, limited partnership company, joint stock company, and limited liability company.³⁵⁷ To conduct business through association, the choice of one of the legally prescribed forms is mandatory. No other form is possible; otherwise, the law deems the business void. Saudi CL provides that: "any company that does not assume one of the [companies]-mentioned forms shall

³⁵⁵ *Id.*

³⁵⁶ See The Capital Market Law (SCML) that the enacted by the royal decree number (M/30) in Jumada al-Ahkirah 2, 1424 correspondent to (July 31, 2003).

³⁵⁷ CL. art. § (2). In fact, only the first six forms are true forms as the last two types listed are not true forms but a structure of doing business. In addition, state-owned companies do not abide by company law provisions as long as a royal decree is issued to authorize its business.

be (considered) null and void, and the persons who have made contracts in its name shall be severally and jointly liable for the obligations arising from such contracts.”³⁵⁸ Civil law jurists categorize forms into three types according to main attributes. The first type, the personal companies (partnership, joint venture, and limited partnership), denotes when personal relations between partners matter the most. Thus, a legal response to such relations is prominent in the provisions related to formation, name, management, and dissolution. In the U.S., such forms are termed “partnerships” (general and limited).

The second type is a financial company, which is a joint stock company or, more accurately, a publicly traded joint stock company. In financial companies, the identity of the persons participating in the enterprise does not affect the business of the company because these persons, the shareholders, change instantly with the transfer of stockholdings without any effect on the corporation’s business, especially its creditors.³⁵⁹ The third type is a hybrid company – a limited-by-shares partnership and a limited liability company, which have characteristics of both personal companies and financial companies. For instance, the identities of shareholders in a limited-by-shares partnership do not matter as in the case of a shareholder in a joint stock company; however, a general partner identity is very important to another partner in the case of a general partnership.

This section will briefly discuss the main forms of business organization under Saudi Legal System.

³⁵⁸ CL. art. § (2). There an exception to this provision regarding companies known in Islamic jurisprudence.

³⁵⁹ In contrast, a close joint stock company has some features of a partnership where interrelationships between shareholders matter and in which some restrictions on share transferability exist. For instance, many family companies elect the form of the joint stock company but still restrict transferring shares to a third party before satisfying some requirements.

2.5.3.1 General Partnership Company³⁶⁰

Retaining its traditional form since the Roman Empire,³⁶¹ a general partnership is a company formed between two or more partners³⁶² who are severally and jointly liable for a company's debts and obligations.³⁶³ The name of the partnership must contain the name of one or more of the partners.³⁶⁴ As with any company under the CL, a general partnership must have capital that is divided into non-assignable interests.³⁶⁵

A general partnership is managed by one or more managers who must be appointed in the company contract or in a separate contract.³⁶⁶ The manager does not necessarily have to be a partner.³⁶⁷ However, if the partners do not appoint a manager by either of the aforementioned ways, the partners have the right to manage the partnership.³⁶⁸ The general partnership dissolves upon the death of any partner, adjudged legal incapacity or declaration of bankruptcy, insolvency

³⁶⁰ Called in France (*societes en nom collectif*). See French Commercial Code art. § (L221-1).

³⁶¹ See generally SCOTT ROWLEY, *THE MODERN LAW OF PARTNERSHIP*, vol. 1, 5–6 (1916).

³⁶² CL. art. § (16). The meaning of persons here is not clear regarding covering natural persons only or including juridical persons such as partnerships and companies. Article § (28) of Omani commercial company law specifies that inclusion of both the natural and juridical person.

³⁶³ CL. art. § (16). Creditors need to claim their money first from the partnership and, if the partnership does not respond after a given notice, the creditors can collect their debt from the partners. See Article (20) of Saudi company law which states that:

A partner may not be required to satisfy a debt of the partnership out of his own money unless the partnership's liability for the debt has been established, either by virtue of the acknowledgment of those responsible for its management or by decision of the Commission for the Settlement of Commercial Companies' Disputes, and after partnership has been duly called upon to effect payment.

³⁶⁴ CL. art. § (17). It appears that the goal of this requirement is related to the historical evolution of partnership from a sole proprietorship where the name of the partner is an indicator of trust and personal liability of the partnership debts.

³⁶⁵ CL. art. § (18).

³⁶⁶ *Id.* § (27).

³⁶⁷ *Id.*

³⁶⁸ *Id.* § (28).

of one of the partners, or withdrawal of a partner from the partnership unless the partnership is a not-at-will partnership.³⁶⁹

2.5.3.2 Limited Partnership Company³⁷⁰

A limited partnership is an incorporated form of business (company) that consists of two categories of partners: the first includes at least one general partner who is severally and jointly liable for the debt of the partnership; and the other includes at least one limited partner who is liable for the partnership's debt and obligations only to the extent of his contribution to the capital of the company.³⁷¹ The name of limited partnership must not contain a name of any limited partner.³⁷² If a name of a limited partner appears in the name of the partnership, the law regards this limited partner as a general partner *vis a vis* third parties.³⁷³

General partners manage the limited partnership. Hence, the law does not allow a limited partner to interfere in any managerial activity of the partnership.³⁷⁴ If the limited partner, to the contrary of this ban, does participate in management, he is personally responsible for the transaction.³⁷⁵ However, if his participation in management causes or creates an impression to third parties that he is a general partner, he will be regarded as a general partner and thus be severally and jointly liable for all of the company's debts and obligations.³⁷⁶ Other than the

³⁶⁹ *Id.* § (35).

³⁷⁰ Called in France (*societes en commandite simple*). See French Commercial Code art. § (L222-1).

³⁷¹ CL. art. § (36).

³⁷² *Id.* § (37).

³⁷³ *Id.*

³⁷⁴ *Id.* § (38).

³⁷⁵ *Id.*

³⁷⁶ *Id.*

aforementioned legal framework, the general partnership provisions govern the assignment of interests,³⁷⁷ governance,³⁷⁸ and dissolution³⁷⁹ of the limited partnership.

2.5.3.3 Limited Liability Company³⁸⁰

A limited liability company³⁸¹ is the most popular form of all Saudi companies. A limited liability company (L.L.C) is formed by two or more persons who are responsible only for the debts and obligations of the company to the extent of their contribution to the company capital.³⁸² The number of partners in this company is limited to fifty.³⁸³ The company may chose its name from the names of one or more of the partners, or it may chose a name derived from its purpose.³⁸⁴ Regardless of the manner of naming, a limited liability company must always print its limited liability legal form beside its name.³⁸⁵ A limited liability company may elect any lawful purpose of business to pursue other than the businesses of insurance, savings, or banking.³⁸⁶

³⁷⁷ *Id.*

³⁷⁸ *Id.*

³⁷⁹ *Id.*

³⁸⁰ Called in France (*societes a responsabilite limitee*). See French Commercial Code Article § (L223-1).

³⁸¹ Limited liability company is the most popular business form in Saudi Arabia ever since the enactment of company law more than four decades ago.

³⁸² CL. art. § (157).

³⁸³ *Id.* This number attempts to convince a large group of partners to choose or transfer to a joint stock company (either close or public). However, the law has given some exceptions to family owned limited liability companies to exceed the maximum number of partners (fifty partners) which circumvents the mentioned legal policy intended by the legislation. For instance, Saudi Binladin Group (L.L.C.) where the company granted a special exception to exceed the stator prescribed number.

³⁸⁴ CL. art. § (160).

³⁸⁵ *Id.* § (12). Nevertheless, the company could use the short form of a limited liability company: L.L.C.

³⁸⁶ *Id.* § (159).

The CL has eliminated the minimum capital requirement for this company form: company promoters now determine necessary capital based on actual financial needs.³⁸⁷ The company gathers its capital only through non-public offerings because the law prohibits a limited liability company to make public offerings, either to raise or increase its capital.³⁸⁸ The company then divides its capital into equally valued, non-negotiable interests.³⁸⁹ Any partner may assign his interests to another partner or third party according to the terms of the company contract.³⁹⁰ Nevertheless, those terms cannot prevent any partner from transferring his complete interest to a third party. The only remedy the other partners have, in this situation, is to use their preemptive right to retain that interest.³⁹¹

With regard to company governance, partners make decisions in general meetings; thus, no decision is valid unless partners who own at least fifty percent or more of the company's capital vote in favor of that decision.³⁹² One or more managers³⁹³ retains the company's managerial power; and that manager may be removed for legitimate (proper) cause.³⁹⁴ In addition, when partners in a limited liability company number more than twenty, the company must form a supervisory board and execute decisions reserved for the board by the company's

³⁸⁷ *Id.* § (158).

³⁸⁸ *Id.*

³⁸⁹ *Id.*

³⁹⁰ CL. art. § (165).

³⁹¹ *Id.*

³⁹² *Id.* § (172).

³⁹³ *Id.* § (167).

³⁹⁴ *Id.* § (168).

contract.³⁹⁵ Unlike partnerships, a limited liability company does not dissolve upon the withdrawal of any partner or upon legal incapacity, insolvency, or bankruptcy of any partner.³⁹⁶

2.5.3.4 Joint Stock Company³⁹⁷

The CL does not define a joint stock company directly but instead indirectly lists some of its main characteristics: “[t]he capital of a corporation shall be divided into negotiable shares of equal value. The members thereof shall be responsible only to the extent of the value of their shares, and their number shall not be less than five.”³⁹⁸ However, in practice there are two types of joint stock companies: closed and publicly traded. In the closed joint stock company the capital of the company is formed not by a public offering but rather through private placement. In addition, there is no trading of the company shares in a capital market. Conversely, a public offering raises, at least, part of a publicly traded joint stock company’s capital. In addition, the capital market lists the company’s shares. Accordingly, thousands, if not millions, of people hold its shares. The minimum capital of this corporation is 10,000,000 (SAR).³⁹⁹

Publicly traded joint stock companies share common characteristics:

1. Limited Liability:

³⁹⁵ *Id.* § (170) and § (153).

³⁹⁶ *Id.* § (178). The provisions of this article are default rule. It is important to note this Article does not mention the death of a partner. The Saudi Company Law drafter apparently forgot to include this cause of dissolution especially in regards to other Arab law company laws stating that the death of one of the partners in limited liability is a cause of dissolution. In addition, the reasoning behind not dissolving the company upon the death of a partner is analogous to other causes mentioned in the article. Anyway, under Saudi company law the death of any partner does not dissolve the limited liability company unless stated in the article of the association.

³⁹⁷ Called in France (*societes anonymes*). See French Commercial Code art. § (L225-1).

³⁹⁸ CL. art. § (48).

³⁹⁹ CL. art. § (48) which states, also, that two million Riyals is the minimum capital requirement for a closely-held joint stock company.

Limited liability is an integral attribute of a joint stock company. Limited liability shields shareholders in joint stock companies from any personal liability, as the only risk they face is losing the amount of money they advanced to the company. This attribute enhances equity finance because risk-averse investors are hesitant of exposing “all of their assets to the risks of the business enterprise.”⁴⁰⁰ The CL provides that the shareholders in a joint stock company “are liable only to the extent of the value of their shares.”⁴⁰¹ Similarly, American corporate law provides for the same limitation, as the Model Business Corporation Act states: “a shareholder of a corporation is not personally liable for the acts or debts of the corporation.”⁴⁰² Law, in fact, is not the only available option to have limited ability; for example, an agreement between shareholders and lenders may achieve the same result but at a high “cost.”⁴⁰³ Professor Frank Gevurtz notes:

If owners who want limited liability must go out and negotiate non-recourse loans with all of the business’ creditors, they may need to spend more money on attorneys, no mention of spending extra time dickering with each creditor. Making limited liability available through the corporate form allows owners to

⁴⁰⁰ ARTHUR R. PINTO & DOUGLAS BRANSON, UNDERSTANDING CORPORATE LAW 37 (Lexis Nexis 2004).

⁴⁰¹ CL. art. § (48). At the enactment time almost all Islamic jurists in Saudi Arabia and other countries believed that limited liability contradicts *Sharia*; however, recent developments in Islamic jurisprudence approve compatibility of limited liability with *Sharia*. Professor Chibli Mallat noted this state of contradiction:

Yet neither law nor the business world has fully digested the separation, and some courts are reluctant to stop at the company’s assets in case of unpaid debt. This phenomenon is difficult to document in the absence of systematic law reporting, particularly in the Gulf states, where the size and importance of the companies in the era of oil is evident. Legal practice, as far as can be ascertained from lawyers and businessmen, confirms the difficulty, in countries where the persona of the directors and major shareholders of the companies is paramount, in limiting liability to the capital and assets of the company, without touching upon the personal property of the decisive actors in such business ventures.

CHIBLI MALLAT, INTRODUCTION TO MIDDLE EASTERN LAW 329 (Oxford Univ. Press 2009).

⁴⁰² MBCA § 6.22(b).

⁴⁰³ See FRANK EASTERBROOK & DANIEL FISCHER, THE ECONOMIC STRUCTURE OF CORPORATE LAW 41 (1991).

save this time and money. Hence, providing limited liability though the corporate form seems socially useful, if it not earth shattering in its importance.⁴⁰⁴

Thus, the statutory creation of limited liability in a joint stock company enables a company to secure low cost finance because the company's financial performance and potential are what matter to creditors, not the personal "wealth" of the shareholder.⁴⁰⁵ Limited liability also encourages shareholders to diversify their investment without exposing themselves to a great liability, as in other non-limited liability business vehicles.⁴⁰⁶ Diversification also leads to more separation of ownership and control where an apathetic shareholder will shy away from interfering in managerial matters.⁴⁰⁷ Consequently, shareholders' apathy caused by limited liability "reduces the cost of operating the corporation."⁴⁰⁸ Without limited liability share liquidity would be a myth. If the personal wealth of shareholder matters, then no transferring of shares would occur unless presumably a creditor grants his approval to the transaction in which the liquidity of shares is different from what it is currently.⁴⁰⁹ Thus, "limited liability saves all parties these investigation costs."⁴¹⁰

On the other hand, some scholars undermine the importance of limited liability by stating that "[l]imitations on liability turn out to be pervasive"⁴¹¹ because "creditors" usually avoid the "risk" by asking the shareholder for either a "personal guarantee" or "higher interest on

⁴⁰⁴ FRANKLIN A. GEVURTZ, CORPORATION LAW 29 (West Group 2000).

⁴⁰⁵ *See id.* at 32.

⁴⁰⁶ *See id.*

⁴⁰⁷ *See* EASTERBROOK & FISCHER, *supra* note 403, at 42.

⁴⁰⁸ *Id.*

⁴⁰⁹ *See* GEVURTZ, *supra* note 404, at 31.

⁴¹⁰ *Id.*

⁴¹¹ EASTERBROOK & FISCHER, *supra* note 403.

loans.”⁴¹² In addition, “[l]imited liability induces managers of incorporated entities to take risks or to tolerate an overall level of risk he otherwise would avoid.”⁴¹³ Regardless of those assumed drawbacks of limited liability, modern practice shows that “legislatures view the benefits of limited liability as outweighing the costs.”⁴¹⁴

2. Ease of Share Transfer:

Joint stock company Common shares are the most liquid of equity interests existent, as the shareholder of a public joint stock company could sell his shares directly to the buyer without consent of the company or other shareholders. Professors Henry Hansman and Reinier Kraakman note that this distinctive feature “enhances the liquidity of shareholders’ interests [,] mak[ing] it easier for shareholder to construct and maintain diversified investment portfolios.”⁴¹⁵ It also facilitates financing the company through public or private placements.⁴¹⁶

However, legal and contractual measures sometime hinder the full transferability of public joint stock company shares. The statutory restrictions on share transfer are usually for protecting third parties from fraudulent money collection by unsophisticated investors. Saudi CL, for example, provides:

Cash shares subscribed for by the founders and shares for contributions in kind, as well as founders’ shares shall not be negotiable before the publication of the balance sheet and the profits and losses statement for two complete financial

⁴¹² GEVURTZ, *supra* note 404.

⁴¹³ PINTO & BRANSON, *supra* note 400.

⁴¹⁴ *Id.* at 41.

⁴¹⁵ Henry Hansmann & Reinier Kraakman, *What is Corporate Law?*, in HENRY HANSMANN & REINIER KRAAKMAN, *THE ANATOMY OF CORPORATE LAW, A COMPARATIVE AND FUNCTIONAL APPROACH* 10 (Reinier Kraakman & Henry Hansmann et al. eds., 2004).

⁴¹⁶ *See id.*

years, each consisting of at least twelve months as from the date incorporation of the company.⁴¹⁷

This legal restriction applies only to transferring shares to a third party during the suspension period; however, founding subscribers can transfer their shares among themselves.⁴¹⁸ On the other hand, shareholders – at any time – may include in the company’s bylaws some restrictions of share transferability, a practice called “contractual restrictions.” This contractual restriction varies from one company to another. However, in any event the statutory and contractual restrictions on share transferability have not reached the point of depriving the shareholder from transferring his shares: the law considers that action a fundamental right of the shareholder.⁴¹⁹

3. Independent Management:

Public joint stock companies usually conduct business on a large scale and collect money from many people who may lack the technical capacity to run the business efficiently. Thus, those people like to place their money in the hands of professional management. Professors William Klein and John Coffee note that “[i]ndividual shareholders may rationally conclude that they would not want important decisions affecting their investment to be made by people like themselves.”⁴²⁰ Accordingly, law delegates the task of managing public companies to specialized professionals that is a board of directors. Saudi company law states that “[a] joint stock company shall be managed by the board of directors”⁴²¹ as does the Model Business Corporate Act

⁴¹⁷ CL. art. § (100).

⁴¹⁸ *Id.*

⁴¹⁹ *See id.* § (101).

⁴²⁰ WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 110 (2007).

⁴²¹ CL. art. § (66).

(MBCA).⁴²² This structure of power in some ways resembles the constitutional structure of government.⁴²³ In fact, concentration of decision-making power in the hands of management is a very important attribute in publicly held companies where some scholars believe it is “[t]he single most important fact of corporate law”⁴²⁴ which enhances “specialization” of functions⁴²⁵ and eases the interaction and supervision in the company.⁴²⁶

4. Perpetual Life:

The CL is silent about the duration of the joint stock company, which implies that a joint stock company may specify its lifespan in its contract. However, the mandatory bylaws form of the joint stock company has set a limit for the life this company for a maximum of 99 year, which could be extended for one or more of the same period.⁴²⁷

A joint stock company is supposed to live an indefinite life due to the non-importance of the shareholder personality; in fact, the ease of shares transfer reflects this fact along with the separation of ownership from management attributes.⁴²⁸ Professor Robert Clark’s comments

⁴²² MBCA § 8.01(b) which states that: “[a]ll corporate powers shall be exercised by or under the authority of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors....” *See also* Del. § 141(a); Cal. § 300(a).

⁴²³ *See* GEVURTZ, *supra* note 404, at 4, where he said “[p]resumably drawing from ideas of republican government, control over the corporation resides in board (the board of directors). The shareholders elect the board of directors each year. The board then appoints officers to carry out day-to-day management.”

⁴²⁴ ROBERT CHARLES CLARK, *CORPORATE LAW* 21 (1986). Professors Henry Hansmann and Reinier Kraakman compare centralized management in a public company with management structures in other business forms: “[t]his is not to say that other legal entities, such as partnerships, business trusts, or limited liability companies, cannot have a board structure similar to that of a typical corporation; in fact, they often do. But those forms, unlike the corporation form, do not presume a board of directors as a matter of law.” *See* Hansmann & Kraakman, *supra* note 415, at 11 n.23.

⁴²⁵ *See* CLARK, *supra* note 424, at 23.

⁴²⁶ *Id.* at 24.

⁴²⁷ Article (4) of the Mandatory Bylaw Form of the joint stock Companies.

⁴²⁸ *See* CLARK, *supra* note 424, at 19.

regarding the relation of the shares transfer mechanism in publicly held companies and the continuous life of public company:

Rarely do common shareholders in public corporations have a right to force the corporation to buy back their shares. Nor are they able, on their own initiative, to force the company to liquidate and thus pay all the shareholders. Consequently, there is no risk, as there is in a general partnership, that the joint exercise of such a right by a number of investors will kill the enterprise. Corporations have a more stable existence. They are more likely to preserve the going concern value of large projects.⁴²⁹

Similarly, but more clearly, American corporate law provides that “every corporation has perpetual duration.”⁴³⁰ Professors Gower and Davis note about the perpetual life of a publicly held corporation that “[t]he death of a member leaves the company unmoved; members may come and go but the company can go for ever.”⁴³¹

Both Saudi and American publicly held forms are supposed to exist for generations so long as no reason for dissolution has occurred. Generally, dissolution in a Saudi joint stock company occurs either voluntarily by shareholders,⁴³² or involuntarily by legal dissolution in the case of capital’s decreasing by seventy-five percent,⁴³³ or by judicial order.⁴³⁴

5. Strict Formalities:

⁴²⁹ *Id.* at 19.

⁴³⁰ MBCA § 3.02, in this juncture, Sir William Blackstone, long time ago, compared a corporation to a river. Just as the water constantly changes, the river remains the same. The same applies to publicly held joint stock companies. *See* WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND, vol. 1, 456 (A Reprint of First edition with supplement Dawson’s of Pall Mall: London, 1966) (he said “for all the individual members that have exi[s]ted from foundation to the pre[s]ent time, or that [s]hall ever hereafter exi[s]t, are but one per[s]on in law, a per[s]on that never dies: in like manner as the river Thames is [s]till the fame river, though the parts which compo[s]e it are changing every in[s]tant.”). *Id.*

⁴³¹ GOWER & DAVIS, PRINCIPLE OF MODERN COMPANY LAW 42 (8th ed. 2008).

⁴³² *See* CL. art. § (15). In American law voluntarily dissolution by the recommendation of the board and the approval of the shareholders meeting. *See* MBCA § 14.02.

⁴³³ CL. art. § (15).

⁴³⁴ *Id.* § (148). For Judicial dissolution under American law. *See* MBCA § 14.30.

Until the early 1980's, there were only five joint stock companies in Saudi Arabia.⁴³⁵ This evidences how difficult it was to form a joint stock company in Saudi Arabia; in fact, businessmen often did not even attempt such an action. However, the law introduced some amendments to the provisions of incorporation to facilitate the formation of a joint stock company that in fact raised that small number to more than one hundred joint stock companies at the end of the last century. The establishment of the Saudi capital market in 2004 contributed to the spread of public joint stock companies; however, most of the new public joint stock companies⁴³⁶ were originally family,⁴³⁷ state-owned companies⁴³⁸ or companies required by law to be a public joint stock company, such as banks⁴³⁹ and insurance companies.⁴⁴⁰

2.6 CONCLUSION

This chapter was dedicated to furnishing an introduction to the history, economy, and legal system of Saudi Arabia. The Saudi Arabian government is working on diversifying its economy and reducing its reliance on oil which its revenue represents the main driving force of Saudi

⁴³⁵ See MOHAMMAD HASAN AL-JABOR, SAUDI COMMERCIAL LAW 287 (4th ed. 1996)

⁴³⁶ For more improation about economic strucutre of saudi publicly traded companies, see chapter VI.

⁴³⁷ There are many listed companies that still bear the name of the founding family business, such as al-Othiam, Shaker, al-Rajhi (bank), al-Babtain, al-Abdullatif, al-Hokair, Fitaihi, and al-zamil.

⁴³⁸ For example, Saudi Basic Industries Corporation (SABIK), Rabigh Refining and Petrochemical Company (Petrorabigh), Saudi Kayan Petrochemical Company (Kayan), and Yanbu National Petrochemical Company (YANSAB).

⁴³⁹ There are eleven listed banks which are all required to be listed according to Saudi Banking Control Law [hereinafter B.C.L.] which requires all licensed banks in Saudi Arabia to be joint stock companies. See B.C.L. art. § (3)(1).

⁴⁴⁰ About thirty one insurance companies were established after 2003, the year of regulating and legitimizing the insurance industry in Saudi Arabia. It is noteworthy that the law compelled insurance company promoters to form publicly held joint stock companies to conduct insurance activities in Saudi Arabia.

economy. Theoretically, the Saudi government comprises three branches: administrative, legislative and judiciary. However, the King is the true holder of the mentioned powers. In other words, the modern constitutional concept of separation of power is not recognized under the Saudi constitutional system. Saudi Arabian Legal authority found its sources in Islamic law and legislations enacted by the government. Rules in Islamic law are deduced from either the primary sources, that is the Koran and *Sunna*, or supplementary sources such as *Ijma* and *Qiace*. Islamic law, also, is complemented by modern legislations enacted by the Saudi government. However, Islamic rules have a supremacy over all forms of legislations, including the Basic Law of Governance. A notable legislation is the Companies Law of 1965, which recognizes a number of business organization forms, including joint stock companies, as the only available legal vehicles for publicly traded companies in Saudi Arabia.

3.0 CORPORATE GOVERNANCE I: CONCEPT AND VALUE

3.1 INTRODUCTION

This Chapter will discuss the concept of corporate governance by summarizing the different point of views attempting to define this controversial concept. One of the chapter's goals is to show that corporate governance can be defined in different ways, depending on the perspective. The chapter also moves to shed light on the sources of corporate governance. Corporate governance players such as stakeholders and gatekeepers will also be discussed. Finally, the chapter will address the driving factors of implementing and reforming corporate governance, such as securing low cost external finance, market crashes, globalization, and privatization.

3.2 CORPORATE GOVERNANCE ORIGIN

Corporate governance is an old concept in modern clothes because conventionally, the essence of corporate governance is centered on the diversion of interest between the principal and the agent: the agency cost problem.¹ Accordingly, the agency cost problem has, presumably, existed hand

¹ For more detailed discussion of agency cost problem see chapter IV.

in hand with the first agency relation formed in history.² Through business history, sole proprietorships and then partnerships were the main forms of business vehicles, but agency costs did not pose a real problem to the business world due to the heavy involvement of the principal in management or the supervision of business affairs.³

However, the western renaissance coupled with industrial revaluation induced the formation of large publicly traded corporations with thousands of small, fragmented, and passive investors. The first notable example was the British company, East India, which had a legal structure similar to the publicly traded corporation in our modern time.⁴ This business form caused a serious agency cost problem which is likely the starting point of modern corporate governance literature. Adam Smith was one of the pioneer scholars who shed light on the agency cost problem associated with large publicly traded corporations.⁵ Although corporate governance as a concept had existed for ages, its distinctive name was produced recently (1962) in Richard Eells book “The Government of Corporations” in which Eells titles one the book chapters “The Study of Corporate Governance.”⁶ The etymology of the phrase “corporate governance” is traced to old European languages. The word “corporate” is derived from the Latin word “*corpus*” which means “body” or a “body of people.”⁷ “Governance” comes from the old Greek word, *Kybernao*, which means “to steer.”⁸

² No one can specify when that took place. All that can be asserted is that agency costs happened a very long time ago.

³ See chapter IV.

⁴ See chapter IV.

⁵ See chapter IV.

⁶ See RICHARD EELLS, THE GOVERNMENT OF CORPORATIONS 3 (1962).

⁷ THOMAS CLARKE, INTERNATIONAL CORPORATE GOVERNANCE: A COMPARATIVE APPROACH 1 (Routledge 2007). See also JOHN FARRAR, CORPORATE GOVERNANCE: THEORIES, PRINCIPLES, AND PRACTICE 3 (2d ed. Oxford

3.3 CONTEMPORARY MEANING OF CORPORATE GOVERNANCE

Currently, the corporate governance concept has transcended its literal meaning and become a global phenomenon that attracts the attention of diverse groups of researchers and policy makers.⁹ Although the study of this concept is fairly current,¹⁰ the divergence in literature with regard to its definition is notorious.¹¹ Some of the definitions are wide while some are concise and narrow. Professor John Farrar said corporate governance “is a fashionable concept [which] ... is somewhat ambiguous and a bit of a cliché.”¹² For contemporary scholars the concept is clear; however, framing a well-rounded definition for it is still lacking effort and luck. Thus, to some degree we may agree with some scholars’ description of corporate governance as “an indefinable term, something – like love and happiness – which essentially know the nature of, but for which words do not provide an accurate picture.”¹³

One of the most widespread definitions, for instance, is one of Sir Adrian Cadbury’s inaugural attempts to define corporate governance: “[c]orporate governance is the system by

Univ. Press, N.Y. 2005) (“The etymology of ‘governance’ comes from the Latin words *gubernare* and *gubernator*, which refer to steering a ship and to the steerer or captain of the ship. This is the origin of the word ‘governor.’”).

⁸ CLARKE, *supra* note 7. *See also* FARRAR, *supra* note 7 (“The word ‘governance’ comes from the old French word ‘gouvernance’ and means control and the state of being governed.”).

⁹ *See* FARRAR, *supra* note 7.

¹⁰ JILL SOLOMON, *CORPORATE GOVERNANCE AND ACCOUNTABILITY* 12 (John Wiley & Sons, Ltd., 2d ed. 2007).

¹¹ *Id.*

¹² FARRAR, *supra* note 7.

¹³ JEAN JACQUES DU PLESSIS, JAMES MCCNVILL & MIRCO BAGARIC, *PRINCIPLES OF CONTEMPORARY CORPORATE GOVERNANCE* 1 (Cambridge Univ. Press, N.Y. 2005).

which companies are directed and controlled.”¹⁴ The Organization of Economic Cooperation and Development (OECD) formed a more detailed definition which states:

Corporate governance ... involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.¹⁵

However, this definition does not include the nonbinding forces of corporate governance, as Professor Jonathan Macey offers in his definition of corporate governance:

Corporate governance describes all of the devices, institutions, and mechanisms by which corporations are governed. Anything and everything that influences the way that a corporation is actually run or mechanism that exercises power over decision-making within a corporation is part of the system of corporate governance for that firm.¹⁶

On the other hand, some definitions intertwine corporate governance with good corporate governance attributes. For instance, some scholars define corporate governance as:

[T]he process of controlling management and balancing the interests of all internal stakeholders and other parties ... who can be affected by the corporation’s conduct in order to ensure responsible behaviour [Sic] by corporations and to achieve the maximum level of efficiency and profitability for a corporation.¹⁷

Similarly, other scholars’ definitions reflect their views on the optimal corporate governance model:

[C]orporate governance is ... the system of check and balances, both internal and external to companies, which ensures that companies discharge their

¹⁴ Report of the Committee on the Financial Aspects of Corporate Governance, Para (2.5) (Gee Publishing Ltd. 1992).

¹⁵ OECD PRINCIPLES OF CORPORATE GOVERNANCE 11 (2004).

¹⁶ JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 2 (Princeton Univ. Press 2008).

¹⁷ DU PLESSIS ET AL., *supra* note 13, at 6–7.

accountability to all their stakeholders and act in socially responsible way in all areas of their business activity.¹⁸

This attempt to define corporate governance encapsulated the concepts of efficiency, profitability, accountability to stakeholders, and behaving with social responsibility. Obviously, those words are beyond the scope of the corporate governance definition but they are a theoretical foundation of the national corporate governance system which varies from one country to the other. For example, for some countries the protection of the interest of part of the stakeholders – such as workers – is more important than achieving the ultimate economic efficiency and profitability when a compromise of one has to be made to secure the other.¹⁹

In short, the corporate governance literature and practice reveal that “[t]here is no single, accepted definition of corporate governance. There are substantial differences in definition according to which country is considered.”²⁰ Clearly, corporate governance definition “depend[s] on the viewpoint of the policy maker, practitioner, researcher or theorist.”²¹ Some scholars confuse the corporate governance concept with corporate law and many times use them interchangeably. Nonetheless, corporate governance has a wider scope than corporate law.²²

¹⁸ SOLOMON, *supra* note 10, at 14 (emphasis omitted).

¹⁹ See generally Marleen O’Connor, *Labor’s Role in the American Corporate Governance Structure*, 22 COMP. LAB. L. & POL’Y J. 97 (2000).

²⁰ SOLOMON, *supra* note 10.

²¹ *Id.*

²² Corporate governance is about binding legal rules and non binding ethical standards, whereas corporate law is primarily devoted to binding rules. Moreover, corporate governance intertwines with multiple disciplines in contrast to corporate law.

3.4 CORPORATE GOVERNANCE SOURCES

3.4.1 Hard sources

Corporate governance hard sources are “traditional black-letter law”²³ which normally consists of binding legal rules such as laws, regulations, and case law (in common law tradition countries as U.S. and U.K.)²⁴ The Corporate Acts (statutes) are the oldest hard source of corporate governance wherein most of the corporate governance norms were prescribed.²⁵ Currently, this is still the case at least for developing countries that have underdeveloped governance enforcement institutions.²⁶ In modern era capital markets, regulations and acts are becoming very important sources of corporate governance authority, especially in developed economies. For example, the U.S. capital market regulations and law play a role that exceeds the role of corporate law.²⁷

²³ JEAN JACQUES DU PLESSIS ET AL., *PRINCIPLES OF CONTEMPORARY CORPORATE GOVERNANCE* 162 (Cambridge Univ. Press 2d ed. 2011).

²⁴ See FARRAR, *supra* note 7, at 3–4. However, case law is not always true to be a hard source of corporate governance because case law plays fewer roles in civil law tradition countries than common law tradition countries since it does not constitute a binding rule of law. It is merely an authoritative or secondary source. See, e.g., PETER DE CRUZ, *COMPARATIVE LAW IN A CHANGING WORLD* 68–69 (2d ed. 1999). See also Arthur R. Pinto, *An Overview of United States Corporate Governance in Publicly Traded Corporations*, 58 AM. J. COMP. L. 257, 261 (2010) (he states that: “[t]he common law system in the United States allows the courts to create law along with the legislatures. While there are significant federal and state statutes and rules which apply to publicly traded corporations, case law created by the state and federal judiciary plays a significant role in both the interpretation and creation of law.”) (footnote omitted).

²⁵ In fact, there is an inverse proportion between the development of corporate governance enforcement institutions’ capacity and the degree corporate law plays as a source of corporate governance in a country. In other words: the more that external mechanisms of governance are efficient, the less corporate law is important to corporate governance.

²⁶ See Bernard Black & Reinier Kraalman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1913 (1995–1996) (he noted that: “emerging economies cannot simply copy the corporate laws of developed economies. These laws depend upon highly evolved markets, legal and governmental institutions and cultural norms that often do not exist in emerging economies.”).

²⁷ See Pinto, *supra* note 24 (“the public markets drive much of the regulation and issues of corporate governance”).

Moreover, the case law plays a critical role in gap filling the corporate governance norms, especially in the common law tradition systems. In those systems, courts invented the fiduciary duties of the board of directors.²⁸ Such an invention has contributed to the corporate governance structure of common law tradition countries²⁹ and has affected recent legal reform in other civil law tradition countries through the transplantation of those fiduciary duties.³⁰

Other disciplines contribute more importantly to the corporate governance norms such as bankruptcy, labor, and environment. Bankruptcy law, for instance, became a cornerstone for corporate governance norms at the time of corporate reorganization and liquidation by shifting the fiduciary duty of the board of directors from maximizing shareholders' value (or stakeholders' value in other models) towards the protection of the interests of the corporation creditors.³¹ Moreover, Labor law interacts with corporate governance³² – especially at the stage of reorganization, downsizing, and consolidation – and most likely such actions will cause a

²⁸ See Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Governance Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055, 1075 (2003–2004) (he noted that: “To the extent substantive corporate law matters in the United States, it is not the law on the books but the common law of fiduciary duties that judges craft. Billions of shares exchange hands daily on the New York Stock Exchange and NASDAQ, not because of strong laws on the books that favor shareholders, but despite weak ones.”). There are two stages of judicial analysis with regard to the directors' duties: the first is duty of care and second is duty of loyalty. Pinto, *supra* note 24, at 257, 278. For an overview of fiduciary duty in U.S. Law see ARTHUR R. PINTO & DOUGLAS BRANSON, UNDERSTANDING CORPORATE LAW 215–39 (3d ed. 2009). See also Frank H. Easterbrook, *International Corporate Differences: Markets or Law*, in GLOBAL CORPORATE GOVERNANCE 47 (Donald H. Chew & Stuart L. Gillan eds., 2009) (“Indeed, I think that the influence of law on corporate governance and structure is far less in the United States than in Europe and Japan. Perhaps the courts play a larger role in the United States, in the course of enforcing contracts and fiduciary duties, but law plays less.”).

²⁹ See Easterbrook, *supra* note 28 (“I think that the influence of law on corporate governance and structure is far less in the United States than in Europe and Japan. Perhaps the courts play a larger role in the United States, in the course of enforcing contracts and fiduciary duties, but law plays less.”).

³⁰ See generally Lynn A. Stout, *On the Export of U.S. – Style Corporate Fiduciary Duties to Other Cultures: Can a Transplant Take?*, in GLOBAL MARKETS, DOMESTIC INSTITUTIONS: CORPORATE LAW AND GOVERNANCE IN A NEW ERA OF CROSS-BORDER DEALS 46–76 (Curtis J. Milhaupt).

³¹ See generally MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 23–26 (1995).

³² FARRAR, *supra* note 7, at 4.

termination of countless employees' contracts. In this juncture, some countries' labor laws are strict in allowing the corporation to terminate the contract of workers even if the result of allowing such action against workers is not efficient.³³ In other words, some legal systems are prone to elevate the right of the workers above the interest of the shareholders. In addition, environmental laws and regulations impose a social responsibility on the corporation that affects the way of governing the corporation.

3.4.2 Soft Sources

Corporate governance soft sources comprise “voluntary sources of corporate governance standards that companies have the freedom to adopt or not”³⁴ which are found in non-binding norms and principles that are adopted by corporate governance interested institutions.³⁵ For example, (OECD)³⁶ and (UNCTAD)³⁷ intend to promote good corporate governance culture within the world's business society. Recently, most developing countries have adopted corporate

³³ For example, “Iranian labour laws are very employee-friendly and make it extremely difficult to lay off staff. Employing staff on consecutive six-month contracts is illegal. So is firing staff unless a serious offence can be proved. Labour disputes are settled by a special labour council, which usually rules in favour of the employee. As such, a small problem can turn into a major issue, taking a lot of an expatriate manager's time and energy to solve.” Available at <http://www.ftz-services.org/map/Challenges.htm> (accessed on May 15, 2011).

³⁴ DU PLESSIS ET AL., *supra* note 23.

³⁵ See, e.g., American Law Institute (ALI) Principles of Corporate Governance: Analysis and recommendations.

³⁶ The Organization of Economic Cooperation and Development (OECD) Principles of Corporate Governance (2004), available at <http://www.oecd.org/dataoecd/32/18/31557724.pdf> (accessed on May 15, 2011).

³⁷ The United Nations Conference on Trade and Development (UNCTAD) Guidance on Good Practices in Corporate Governance Disclosure (2006), available at http://www.ecgi.org/codes/documents/un_cgdisclosure_guidance_2006_en.pdf (accessed on May 15, 2011).

governance principles that are heavily influenced by international best practices.³⁸ Conducting business in several jurisdictions forced multinational corporations to elect globally accepted corporate governance (soft) standards rather than the governance structure of corporate origin (headquarter location).³⁹

Moreover, religious values and commands play a crucial role in many corporate governance systems, especially in religious attached societies.⁴⁰ Moreover, society's general values and culture affect corporate governance practices and limits in that some behavior might be promoted and otherwise restrained.⁴¹ For instance, Indonesian culture is promoting a collective value when rendering a decision within the corporation in which the consideration and approval of all involved parties are encouraged by culture and corporate law.⁴² By contrast, western democracies are culturally linked to the background of the rule of majority and the respect for minority rights,⁴³ whereas Islamic core values in Indonesian corporate governance to

³⁸ See, e.g., *The Guidance of Corporate Governance in Yemen Arab Republic* (2010) which cited and referred to several international corporate governance best practices documents and other literature, available at http://www.ecgi.org/codes/documents/cg_guidelines_yemen_mar2010_ar.pdf (in Arabic) (accessed on May 15, 2011).

³⁹ See Douglas Branson, *Teaching Comparative Corporate Governance: The Significance of "Soft Law" and International Institutions*, 34 GA. L. REV. 669, 670 (1999–2000).

⁴⁰ For example, Arab countries are influenced heavily by Islamic Principles. See, e.g., Arab Republic of Yemen Corporate Governance which clearly states in the Guidance goals that corporate governance main principles such as accountability and transparency coincide with Islamic religious principles prescribed by The Koran and Prophet Mohammad's tradition. *The Guidance of Corporate Governance in Yemen Arab Republic* 9 (2010), available at http://www.ecgi.org/codes/documents/cg_guidelines_yemen_mar2010_ar.pdf (in Arabic) (accessed on May 16, 2011).

⁴¹ See FARRAR, *supra* note 7, at 6 (he said: "[e]very country approaches corporate governance from the background of its own distinctive culture").

⁴² See Article § (87)(1) of Indonesian Limited Liabilities Companies Law of (2007) ("GMS [General Meeting of Shareholders] resolution shall be adopted on the basis of deliberation to reach consensus."), available at <http://mutiaraconsultantbali.com/company-law-uu-40-2007.pdf> (accessed on Dec. 28, 2011). See also Douglas M. Branson, *The Very Uncertain Prospect of "Global" Convergence in Corporate Governance*, 34 CORNELL INT'L L.J. 321, 346 (2001).

⁴³ For the rule of majority, see generally John Gilbert Heinberg, *History of the Majority Principle*, 20 AM. POL. SCI. REV. 52 (1926).

act collectively is more likely not observed in corporate practices.⁴⁴ On the other hand, some corporate governance rules are clearly not hard laws or soft laws, too, like “listing rules ... and Statements of Accounting Practice,” which Professor Farrar called “hybrids or ... hard soft law.”⁴⁵

3.4.3 Corporate Law Role in Corporate Governance

Corporate law used to be the main source of corporate governance rules in all national corporate governance systems. However, constitutional and institutional variations among nations have played a part in undermining corporate law’s role in corporate governance. For instance, corporate statutes in the U.S. do not play an essential part in corporate governance fabric⁴⁶ due to the U.S. federal nature under which each of the fifty states has its own corporation act.⁴⁷ This regulatory framework caused a “race to the bottom” in corporate acts in the U.S. among American states.⁴⁸ This race is not a new phenomenon.⁴⁹ Decades ago, Justice Brandies, in his dissenting opinion, commented on that by saying:

Lesser states, eager for the revenue derived from the traffic in charters, had removed safeguards from their own incorporation laws. Companies were early formed to provide charters for corporations in states where the cost was lowest

⁴⁴ For Islamic perspective on corporate Governance, see *infra* chapter (V).

⁴⁵ FARRAR, *supra* note 7, at 4. See also DU PLESSIS ET AL., *supra* note 23 (he said that: “hybrids fall somewhere between the two [categories of governance sources]: neither mandatory nor purely voluntary”).

⁴⁶ See Easterbrook, *supra* note 28.

⁴⁷ See Pinto, *supra* note 24, at 257, 262.

⁴⁸ For the race to the bottom theory, see, e.g., William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1973–1974) (he proposed for federal intervention on corporate law matters instead of keeping them to states standards). *Id.* at 663.

⁴⁹ New Jersey was the first state adopting a liberal structure of corporate law for the sake of attracting more chartering. See Cary, *supra* note 48, at 663, 663.

and the laws least restrictive. The states joined in advertising their wares. The race was one not of diligence but of laxity.⁵⁰

Theoretically, corporation promoters or manager opt to “incorporate” or reincorporate in the best jurisdiction for shareholders.⁵¹ Delaware is the most notorious state which succeeded in lowering the standard of protection to shareholders commonly provided by the corporate statutes of other states.⁵² Accordingly, the winner of this race is the state which could attract more new corporations to incorporate, or existing corporations to reincorporate, according to the board of director friendly regulatory framework.⁵³ In other words, the “race to the bottom” generates a jurisdictional arbitrage between the U.S. states to host businesses for several reasons, but mainly taxation and allowing directors to follow their favorite legal structure within which to operate which in turn depends upon a state’s limitation of the directors’ liability. This legislative contest among states’ legislatures has motivated the transformation of U.S corporate statutes from mandatory to default structure.⁵⁴ Accordingly, the comparative advantages in those acts herein

⁵⁰ *Liggett Co. v. Lee*, 288 U.S. 518, 557–59 (1933) (Brandies, J., dissenting).

⁵¹ FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 5–6 (1991).

⁵² *See* Pinto, *supra* note 24, at 257, 262.

⁵³ *Cf.* EASTERBROOK & FISCHER, *supra* note 51, at 5 (“[t]he founders of the firm will find it profitable to establish the governance structure that is most beneficial to investors, net of the cost of maintaining the structure. People who seek resources to control will have to deliver more returns to investors. Those who promise the highest returns – and make the promises binding, hence believable–will obtain the largest investments.”).

⁵⁴ *See, e.g.*, Easterbrook, *supra* note 28, at 49–50 (he noted that: “[o]ne may ask how corporate law came to be enabling rather than directory in the United States. The answer lies in competition among jurisdictions–still another form of investor protection. States that tried inefficient regulation would drive capital and corporate structures out of their jurisdictions. Ease of movement within the large U.S. market made this possible. So states lost the ability to do substantial injury. Could they do good? Well, they could be more hospitable to competition, and the structure of federalism in the United States made this possible. Courts restricted states’ ability to discriminate against corporations that had their headquarters in other states. Firms could move their charters without moving their operations – quite unlike the “real seat” doctrine in Europe, which was created by France in the 19th century to block completion from England! And it happened that Delaware was small enough to make a binding commitment to have an efficient law. It gathers about 20% of the state budget from corporate charter fees, a bond of good faith toward corporations that lack votes in the legislature. No surprise when the head of the committee that drafted the most recent version of the Delaware Code become Chief Justice of Delaware.”). *See also* Jonathan R. Macey, *Institutional*

are centered on the extent a state act differs from other states acts by trying to furnish more efficient default rules, as if contracting out of them by corporate constituencies is costly.⁵⁵ Nonetheless, not just a few scholars have taken issue with the “race to the bottom” hypothesis. They have asserted that U.S. states regulatory contest are more likely to lead to a “race to the top” rather than to the bottom, as incorporating in shareholder low protection states will not attract investors to the new enterprise. Thoughtful judge and scholar Frank Easterbrook argued:

Managers in the United States must select the place of incorporation. The fifty states offer different menus of devices (from voting by shareholders to fiduciary rules to derivative litigation) for the protection of investors. The managers who pick the state of incorporation that is most desirable from the perspective of investors will attract the most money. The states that select the best combination of rules will attract the most corporate investment (and therefore increase their tax collections. So states compete to offer – and manager to use – beneficial sets of legal rules. These include not only rules about governance structures but also fiduciary rules and prohibitions of fraud.⁵⁶

Conversely, in unitary non-federal states the corporate law is the umbrella for all operating corporations. Moreover, the vital role of corporate law to corporate governance in developing countries is attributed to the weakness of other corporate governance external enforcement institutions.⁵⁷ Accordingly, the corporate law is the *only* mechanism available to

Investors and Corporate Monitoring: A Demand-Side Perspective in a Comparative View, in *COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH* 907 (Klaue et al. eds., 1998) (she noted that: “while there is robust debate about whether the missing terms [of corporation incomplete contract] supplied by the legal system should be mandatory or enabling, there is no debate that corporate governance systems should supply the missing terms”).

⁵⁵ See EASTERBROOK & FISCHER, *supra* note 51, at 34 (he said that: “corporate law is a set of terms available off-the-rack so that corporate ventures can save the cost contracting”).

⁵⁶ EASTERBROOK & FISCHER, *supra* note 51.

⁵⁷ See Black & Kraalman, *supra* note 26, at 1911, 1924 (he described the underdeveloped corporate governance structure in developing countries by saying: “in emerging economies, where informational asymmetries are severe, markets are far less efficient, contracting costs are high because standard practices have not yet developed, enforcement of contracts is problematic because of weak courts, market participants are less experienced, reputable intermediaries are unavailable or prohibitively expensive, and the economy itself is likely to be in flux”).

enforce the corporate governance norms.⁵⁸ Yet, enforcement institutions in the developed world are solid enough to perform an equal role support the national framework of corporate governance.⁵⁹ The Securities Exchange Commission's (SEC) nationwide regulatory authority in the U.S. plays a role with regard to the binding corporate governance norms as in the recently enacted Sarbanes-Oxley Act.⁶⁰

⁵⁸ This model is called the self-enforcing model. See Black & Kraalman, *supra* note 26, at 1911, 1924.

⁵⁹ See, e.g., Paredes, *supra* note 28 (he noted that: “[t]o the extent substantive corporate law matters in the United States, it is not the law on the books but the common law of fiduciary duties that judges craft. Billions of shares exchange hands daily on the New York Stock Exchange and NASDAQ, not because of strong laws on the books that favor shareholders, but despite weak ones.”).

⁶⁰ The SEC established according to the Securities Act Of 1934 which provides in Section § 4 (a):

There is hereby established a Securities and Exchange Commission (hereinafter referred to as the “Commission”) to be composed of five commissioners to be appointed by the President by and with the advice and consent of the Senate. Not more than three of such commissioners shall be members of the same political party, and in making appointments members of different political parties shall be appointed alternately as nearly as may be practicable shall be members of the same political party, and in making appointments.

Currently, the SEC is implementing many important acts that are (listed chronologically) the Securities Act of 1933, the Securities Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Sarbanes – Oxley Act of 2002. Moreover, the (SEC) has a role under the Securities Investors Protection Act of 1970 and Bankruptcy Reform Act of 1978. For a general overview of those acts, see LOUIS LOSS & JOEL SELINGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 45–71 (5th 2004). See also Jennifer G. Hill, *Regulatory Responses to Global Corporate Scandals*, 23 WIS. INT’L L.J. 367, 377 (2005) (“[a] global trend has emerged for stock exchanges to be more involved in corporate governance regulation”).

3.5 CORPORATE GOVERNANCE PLAYERS

3.5.1 Stakeholders

The word “stakeholders” may cover a broad variety of “interests,” as it could be attached “to any individual or group on which the activities of the company have impact.”⁶¹ Stakeholders are generally defined as “[a]ll persons and institutions that have an interest in seeing a venture or company succeed.”⁶² In fact, stakeholders are the corporate governance ends and means because various portions of the corporation wealth or loss will be distributed to (or inflected on) them in one way or other. Three scholars described this scenario as follows:

The flows between the firm and its stakeholders run in both directions; each stakeholder is perceive[ed] as contributing something and receiving something from [the] corporation (even involuntary and essentially passive stakeholders contribute by tolerating the existence and operation of the firm, and receive some combination of benefits and harms as a result).⁶³

Shareholders, who reside at the top of the stakeholders list, supply the equity finance to the corporation and are also the ultimate claimants of the corporation’s residual assets.⁶⁴ Shareholder stakes reside mainly in receiving dividends, selling their shares for profit in the stock market, or in the worst situation, receiving something back from their investment if the

⁶¹ CHRISTINE MALLIN, *CORPORATE GOVERNANCE* 49 (2d ed. 2007), cited in DU PLESSIS ET AL., *supra* note 23, at 23.

⁶² See the definition of stakeholders in “the Free Dictionary,” *available at* <http://financial-dictionary.thefreedictionary.com/Stakeholders> (accessed on Mar. 3, 2001).

⁶³ J.E. POST, L.E. PRESTON & S. SACHS, *REDEFINING THE CORPORATION: STAKEHOLDER MANAGEMENT AND ORGANIZATIONAL WEALTH* 22 (2002), quoted in DU PLESSIS ET AL., *supra* note 23, at 23.

⁶⁴ *See* DU PLESSIS ET AL., *supra* note 23, at 35. For a general overview of shareholders’ role in publicly traded corporation see PINTO & BRANSON, *supra* note 28; JAMES D. COX & THOMAS LEE HAZEN, *CORPORATIONS* 327–81 (2d ed. 2003); ROBERT CHARLES CLARK, *CORPORATE LAW* 93–105 (1986).

company is liquidated.⁶⁵ The corporation's directors⁶⁶ and officers⁶⁷ are the integral decision-making authority whereby the eventual success or failure of the corporation will be attributed to them.

Moreover, creditors of the corporation have a stake in the corporation to the extent they are expecting the corporation to meet its obligation to pay back the contracted amount in return.⁶⁸ Suppliers want the corporation to expand or at least keep its business as a source of profit.⁶⁹ Workers, also, are a vital part of the corporation as their interests are in the corporation's keeping their employment contracts at the corporation and, at a time of corporate prosperity, they perhaps will receive raises, bonuses and other "employee benefits, including securing retirement benefits from the company."⁷⁰ Otherwise, if the corporation did not do well it might go out of business, or at least shrink by downsizing, thus making the corporation compelled to lay off many (or few) employees. In some countries, workers' stakes in the corporation are protected by granting employees participation power in corporate decision making.⁷¹

The corporation's customers have an interest in the corporation to the extent of its product quality and safety.⁷² The community in general also has stake in the corporation

⁶⁵ See DU PLESSIS ET AL., *supra* note 23, at 35.

⁶⁶ For functions and powers of directors, see, e.g., PINTO & BRANSON, *supra* note 28, at 131–33; COX & HAZEN, *supra* note 64, at 135–81; CLARK, *supra* note 64, at 105–13.

⁶⁷ For general overview of officers' positions in a publicly traded corporation see PINTO & BRANSON, *supra* note 28, at 134–36; COX & HAZEN, *supra* note 64, at 117–30; CLARK, *supra* note 64, at 113–23.

⁶⁸ DU PLESSIS ET AL., *supra* note 23, at 35. For an overview of publicly traded corporation obligations towards its creditors, see CLARK, *supra* note 64, at 35–92.

⁶⁹ DU PLESSIS ET AL., *supra* note 23, at 35.

⁷⁰ See *id.*

⁷¹ For example German Publicly traded corporation law granted the worker the power of decision. See, e.g., The German Codetermination Act; The German Coal and Steel Codetermination Act.

⁷² See DU PLESSIS ET AL., *supra* note 23, at 35.

whereby the corporation's success is ultimately reflects on that community's inhabitants in terms of job creation and raising the standards of living, especially with regard to "the corporations adhere[nce] to good practice in corporate governance and do[ing] business in an environmentally friendly manner."⁷³ Governments are interested in the success of national corporations as they generate revenues to states directly through taxes, fees, and royalties and indirectly to be a wealth-creating engine for the benefit of that state's general public.⁷⁴ Standard examples of such a government interest are Delaware and the small countries in the world that generate most of their public income from incorporation and its resulting revenue, such as the Cayman Islands.⁷⁵

3.5.2 Gatekeepers

Gatekeepers⁷⁶ are "private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers,"⁷⁷ or "the independent professionals who serve investors by preparing, verifying, or assessing the disclosures that they receive."⁷⁸ Normally, a good "reputation" is the gatekeeper's indispensable capital so "that they will not sacrifice that

⁷³ *Id.*

⁷⁴ *See id.* at 35–36.

⁷⁵ In the Cayman Islands, there are no corporate taxes nor income taxes and no restrictions on ownership of land by foreigners. *See* http://www.gov.ky/portal/page?_pageid=1142,1481212&_dad=portal&_schema=PORTAL (accessed on May 23, 2011).

⁷⁶ Gatekeeper is a new concept in corporate law. *See generally* Peter B. Oh, *Gatekeeping*, 29 J. CORP. L. 735 (2003–2004).

⁷⁷ Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third – Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 53 (1986).

⁷⁸ John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293, 1296 (2003) (footnote omitted).

reputation to assist a client in wrongdoing.”⁷⁹ It seems that the more professional gatekeepers are in doing their jobs, the more trustworthy the corporate governance system becomes and the higher the investor confidence is of that governed system. Gatekeepers include auditors, rating agencies, securities analysts,⁸⁰ investment bankers, and underwriters.⁸¹ Auditors confirm that the corporation’s financial statements are prepared in accordance with generally accepted accounting principles (GAAP).⁸² Securities analysts provide investors with information about the corporation’s prospects and “competitiveness.”⁸³ Credit rating agencies appraise the securities’ “issuer’s credit-worthiness.”⁸⁴ Investment bankers provide a “fairness opinion” with regard to valuation “of a merger.”⁸⁵ Underwriters have to carry out “due diligence” if they are underwriting a corporation’s “initial public offering.”⁸⁶

Lawyers are similar to “gatekeepers” in that they care about maintaining their “reputation capital.” They also, have the ability to bar deals or decelerate public authority consent for deals that are critical to their business patrons.⁸⁷ For example, in a securities-related transactions,

⁷⁹ Pinto, *supra* note 24, at 257, 274.

⁸⁰ See Section 501 of the Sarbanes-Oxley Act of 2002.

⁸¹ See Coffee, *supra* note 78, at 1293, 1296–97.

⁸² For detailed discussion of the auditors as a gatekeeper in publicly traded corporations see JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 108–91 (2006).

⁸³ Coffee, *supra* note 78, at 1293, 1296–97. For detailed discussion of the securities analyst as a gatekeeper in publicly traded corporations, see COFFEE, *supra* note 82, at 245–82.

⁸⁴ *Id.* For a detailed discussion of the rating agencies as a gatekeeper in publicly traded corporations, see COFFEE, *supra* note 82, at 283–14.

⁸⁵ See Coffee, *supra* note 78, at 1293, 1296–97. See also Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 620 (1984) (they said that: “the critical role of the investment banker as a reputational intermediary becomes clear. In essence, the investment banker rents the issuer its reputation. The investment banker represents to the market (to whom *it*, and not the issuer, sells the security) that it has evaluated the issuer’s product and good faith and that it is prepared to stake its reputation on the value of the innovation.”). *Id.*

⁸⁶ See Coffee, *supra* note 78, at 1293, 1296–97.

⁸⁷ *Id.* at 1293, 1298.

lawyers could interfere with a deal “simply by signaling their displeasure” to the capital market authority.⁸⁸ A commentator draws comparison between the function of lawyers and auditors in securities transactions by saying:

I would suggest that in securities matters (other than those where advocacy is clearly proper) the attorney will have to function in a manner more akin to that of auditor than to that of the attorney. This means several things. It means that he will have to exercise a measure of independence that is perhaps uncomfortable if he is also the close counselor of management in other matters, often including business decisions. It means he will have to be acutely cognizant of his responsibility to the public who engage in securities transactions that would never have come about were it not for his professional presence. It means that he will have to adopt the healthy skepticism toward the representation of management which a good auditor must adopt. It means that he will have to do the same thing the auditor does when confronted with an intransigent client—resign.⁸⁹

The expansion of the lawyer’s role to be gatekeeper has created controversies in the literature.⁹⁰ The most authoritative one that critics have noted is that the statutory imposed duty

⁸⁸ *Id.*

⁸⁹ A.A. Sommer, Jr., *The Emerging Responsibilities of the Securities Lawyer, Address to the Banking, Corporation & Business Law Section, N.Y. State Bar Ass’n* (Jan. 24, 1974), in LARRY D. SODERQUIST & THERESA GABALDON, *SECURITIES REGULATION* 617–19 (4th ed. 1999), cited in Coffee, *supra* note 78, at 1293, 1299. *See also id.* at 1293, 1309–10 (he noted that: “the principal practical effect of imposing gatekeeper obligations on attorneys is that a client who has been advised by an attorney that contemplated action is unlawful now has greater reason to heed that attorney’s advice – again precisely to the extent that the client believes that the attorney may be under a legal obligation to report material misconduct (either within the corporation or outside to the SEC). Thus, even if it were true that clients would consult their lawyers less often, this impact could be more than fully offset by the fact that it would become more dangerous to disregard the lawyers’ advice. Add to this mix the likelihood that *ex ante* advice will not be chilled, and the net impact is to increase the attorney’s leverage over the client by making it more dangerous to ignore the attorney’s advice. If law compliance is the goal, such an impact seems socially desirable. Put simply, the logical remedy for gatekeeper failure is to empower the gatekeeper, and a noisy withdrawal obligation makes it more costly for the client to ignore the lawyer.”).

⁹⁰ Professor John C. Coffee, Jr. presented an eloquent summary for both sides of argument by stating that:

[N]ontrivial arguments can be advanced that securities attorneys will not make good gatekeepers. Chiefly, skeptics object either that (1) the responsibilities of a gatekeeper conflict with the traditional obligations of loyalty that attorneys owe to their clients, or (2) imposing gatekeeping obligations on attorneys will chill attorney-client communications that also serve to promote law compliance. In response, ... that: (1) securities attorneys have long recognized gatekeeper-like obligations (and thus differ from their litigator colleagues in a profession that is considerably more heterogeneous than is generally recognized); (2) the differences between attorneys and auditors are less fundamental and more marginal than opponents of the SEC’s proposed noisy withdrawal standard have recognized; (3) in some respects, it may be easier to impose gatekeeper obligations

on a lawyer to be a gatekeeper contradict, or at least narrow, the scope of the “policy” encouraging lawyer-client arms-length interaction.⁹¹ The Sarbanes-Oxley Act settled this controversy by imposing a statutory obligation on lawyers – besides their traditional role of being “advocate and transaction engineer”⁹² – to be whistleblowers (gatekeepers) for capital markets and stewardships of corporate governance’s integrity.⁹³

3.6 GOOD CORPORATE GOVERNANCE AGENDA

Corporate governance can be viewed in two different dimensions. First to be considered is the national corporate governance structure of a country. The second is the governance structure of each individual corporation operating within that national system. In other words, a national governance system is the forest and individual corporations are the trees in that forest. In such a framework, those two models of governance coexist and complement each other to the extent benefiting both of them. But in both cases it is easily recognized that “[t]here is no single model of good corporate governance.”⁹⁴ Both structures of governance opt to be tailored to match the country or the corporation’s wants and goals. National governance in fact is more critical to the

on attorneys than on auditors; and (4) imposing gatekeeper obligations on attorneys is likely neither to chill socially desirable client communications nor to reduce attorneys’ influence over their clients, but may actually increase attorneys’ leverage over their most intransigent clients.

Coffee, *supra* note 78.

⁹¹ Coffee, *supra* note 78, at 1293, 1302.

⁹² *Id.*

⁹³ See Section 307 of the Sarbanes-Oxley Act of 2002. For a detailed discussion of the lawyer as a gatekeeper in publicly traded corporations see COFFEE, *supra* note 82, at 192–244.

⁹⁴ OECD PRINCIPLES OF CORPORATE GOVERNANCE 13 (2004).

study of corporate governance because it delineates the narrow governance model of the individual corporation.

Well-designed national corporate governance encompasses some flexibility to allow different corporations to adjust their particular governance models within its broad framework. In addition and most importantly, a good national corporate governance system takes into account national factors of such as “legal, regulatory, and institutional environment.”⁹⁵ For instance, most of American “corporate governance focuses on balancing the costs and benefits of ... separation [of ownership from control] and utilizing different monitoring devices available to protect shareholders from losses resulting from ... [this] separation.”⁹⁶ By contrast, for the majority of other countries, except the U.K., corporate governance is (or in some cases should be) devoted to “address how the legitimate interests of minority investors are both protected and promoted.”⁹⁷ Overall, there are common goals most corporate governance systems desire to secure, generally speaking, the promotion of economic efficiency and social values by skillfully reducing agency costs and raising accountability. In this juncture, Sr. Adrian Cadbury held:

Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporation and society.⁹⁸

Moreover, an efficient corporate governance model has to “promote [a] transparent and efficient market, be consistent with the rule of law and clearly articulate the division of

⁹⁵ *Id.* at 11.

⁹⁶ Pinto, *supra* note 24, at 257, 260.

⁹⁷ J. MARK MOBIUS, ISSUES IN GLOBAL CORPORATE GOVERNANCE, CORPORATE GOVERNANCE: AN ASIA-PACIFIC CRITIQUE 40 (Low Chee Keong ed., Sweet & Maxwell 2002).

⁹⁸ Sir Adrian Cadbury, *Forward*, in CORPORATE GOVERNANCE: A FRAMEWORK FOR IMPLEMENTATION VI (Magdi R. Iskander & Nadereh Chamlou eds., World Bank Group 2000).

responsibilities among different supervisory, regulatory and enforcement authorities.”⁹⁹ This model, also, should be fair to all stakeholders, especially minority shareholders.¹⁰⁰ A promising corporate governance model has to “provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring.”¹⁰¹ Not to be forgotten, good governance structure surpasses the mentioned economic factors with psychological ones by “attempt[ing] to rebuild society’s trust in companies, investment institutions and other organizations.”¹⁰² To be sure, securing good corporate governance does not happen overnight, or by merely transplanting corporate governance related legislations and codes. Rather, it is a product of ongoing effort from private and public sectors, in any country, which diligently rely on the best available external and internal governance mechanisms to bring accountability and efficiency to the implementing country.¹⁰³

⁹⁹ OECD PRINCIPLES OF CORPORATE GOVERNANCE, Principle (I) (2004).

¹⁰⁰ See MOBIUS, *supra* note 97, at 41.

¹⁰¹ OECD PRINCIPLES OF CORPORATE GOVERNANCE 11 (2004).

¹⁰² SOLOMON, *supra* note 10, at 5.

¹⁰³ External mechanisms include hostile takeovers and public enforcement including that by the judiciary. But internal mechanisms are related to the corporation bodies – mainly the board of directors and shareholders general meeting. See generally CORPORATE GOVERNANCE: A FRAMEWORK FOR IMPLEMENTATION VI, at 22, 40-42 (Magdi R. Iskander & Nadereh Chamlou eds., World Bank Group 2000).

3.7 DRIVING FORCES OF IMPLEMENTING GOOD CORPORATE GOVERNANCE

3.7.1 Introduction

Implementation of sound corporate governance has become a goal for most countries of the world and publicly-held corporations. The constant quest for an optimal corporate model is motivated by several factors. First of all, a good corporate governance structure – whether at the national level or at the corporate level – pays back clearly with regard to offering a competitive external finance cost, not only from local finance suppliers but international institutional ones as well. Second, a good corporate governance structure facilitates the integration of standards, devices, and practices emanating from ongoing globalization. Good corporate governance is not static; instead, it is subject to a constant reform and modification often triggered by corporate scandals and capital markets crises. Third, economic reform in the last three decades necessitated the transfer of state-owned enterprises to private owners, wherein the success of the privatization programs required a strong corporate governance system.

3.7.2 External Finance

External finance is not a new factor; however, it may be considered the primary factor driving for implementing good corporate governance. Basic finance dictates that companies need money to conduct operations and further expansions. The company manages to supply the needed money from either its retrained earnings (internal finance) or through external finance (debt or

equity).¹⁰⁴ Commonly, internal finance will not suffice for all of a corporation's projects or expansions or, in many cases cover the costs of its operations. Thus, external finance is the ideal source of finance for companies. But external finance providers (financiers) want to ensure that they will not only get their money back but also receive a return either as provided in the contract in debt finance or as reasonable expectations in equity finance. In layman's terms: in the business world there is no free lunch; people expect to get profits from their invested money.

Accordingly, well-implemented corporate governance "enhance[s] investor confidence" to invest in the capital market.¹⁰⁵ Without a solid governance structure, investors will be hesitant to "provide capital," an action which will deter the development of "capital markets."¹⁰⁶ Sound corporate governance system offers national enterprises low-cost finance due to the chance of such a system's fostering higher performance and integrity.¹⁰⁷ Conversely, in ill-functioning corporate governance system, investors most likely "lack control over the corporation [in which they] find it risky and costly to protect themselves from the opportunistic behavior of managers or controlling shareholders."¹⁰⁸ The elevated risk assessment of ill-governed capital markets tends to make the investors discount the share price in equity finance, raise the interest on debt finance, or decline to make the investment under any circumstance. For instance, if the fair

¹⁰⁴ External finance comes from two main sources: equity finance and debt finance. Equity finance comes either through public offering of the corporation's shares or venture capital. For public offering, see generally EILIS FERRAN, *PRINCIPLES OF CORPORATE FINANCE LAW* 409–73 (2008). For venture capital, see generally RICHARD A. BREALEY ET AL., *PRINCIPLES OF CORPORATE FINANCE* 408–12 (9th ed. 2008). There are various methods of securing external finance, most notably bonds. *See generally id.* at 313–45.

¹⁰⁵ OECD *PRINCIPLES OF CORPORATE GOVERNANCE* 11 (2004).

¹⁰⁶ MAGDI R. ISKANDER & NADEREH CHAMLOU, *CORPORATE GOVERNANCE: A FRAMEWORK FOR IMPLEMENTATION 2* (The World Bank Group 2000).

¹⁰⁷ Art Durnev & E. Han Kim, *Explaining Differences in the Quality of Governance Among Companies: Evidence from Emerging Markets*, in *GLOBAL CORPORATE GOVERNANCE* 53, 54 (Donald H. Chew & Stuart L. Gillan eds., 2009).

¹⁰⁸ ISKANDER & CHAMLOU, *supra* note 106.

market value of a share is \$10.00 but investors believe that the management of the corporation may exploit some part of the corporate profit, the investor more likely will buy the share at a lower price than the \$10.00 fair market value to equalize the expected exploitation, for the cost of financing the corporation is higher than it would be if the corporation would operate in a sound corporate governance system. This scenario is plausible in a dispersed ownership model. But, in concentrated ownership patterns, this scenario is different, at least to the controlling shareholder(s), where the price of his share may be sold above its fair market value as a “premium” of the *de facto* entitlement to the corporation and minority shareholders assets. In either case, both scenarios raise the cost of the corporation’s external finance regardless of who is in control or in a position to exploit the corporation’s resources.

Good corporate governance will attract both national and international investors to supply the capital market with equity and debt finance. Some studies suggest that national investors may be more eager to invest in their national capital market as “domestic investors are often captive to the system and face greater risks.”¹⁰⁹ However, good corporate governance will attract foreign investors to invest in the national capital market as well. Attracting foreign investment precipitates a race for reforming corporate governance systems, especially in developing countries which normally have weak corporate governance structures. To invest in a country’s capital market, international institutional investors assess the strength and weakness of the nation’s corporate governance structure. No doubt, the framework of corporate governance plays an important role in guiding international investors to the right place to put their money and how much they should invest.

¹⁰⁹ *Id.*

Sovereign Wealth Funds (SWFs)¹¹⁰ have become a new and important external finance provider.¹¹¹ Good corporate governance will of course attract those funds managers' attention. Most especially, SWFs provide corporations with "long-term" equity finance."¹¹² Assets under the control of SWFs amount to almost \$3 trillion.¹¹³ Most likely this number is going to jump massively,¹¹⁴ particularly if the price of oil stays (or rises above) the current level.¹¹⁵ However,

¹¹⁰ Sovereign Wealth Funds vary from each other. Accordingly, it is burdensome to define them by one definition. As Professors Gilson and Milhaupt said regarding FWFs:

[S]overeign wealth funds defy attempts at straightforward definition. In essence, they are equity investment vehicles established by and under the control of sovereign states. The key characteristic is government ownership of the fund, but this characteristic is shared by a host of other entities.

Ronald Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, 60 STAN. L. REV. 1345, 1354 (2007–2008). Moreover, Generally Accepted Principles and Practices "Santiago Principles" (Oct. 2008) [hereinafter GAPP] defines SWFs as:

[S]pecial purpose investment funds or arrangements that are owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies that include investing in foreign financial assets. SWFs have diverse legal, institutional, and governance structures. They are a heterogeneous group, comprising fiscal stabilization funds, savings funds, reserve investment corporations, development funds, and pension reserve funds without explicit pension liabilities.

International Working Group of Sovereign Wealth Funds, *Sovereign Wealth Funds: Generally Accepted Principles and Practices "Santiago Principles,"* 3 (Oct. 2008). For comprehensive treatment of SWFs economic and governance framework. See EDWIN M. TRUMAN, *SOVEREIGN WEALTH FUNDS: THREAT OR SALVATION?* (2010).

¹¹¹ See Shams Butt et al., *Sovereign Wealth Funds: A growing Global Force in Corporate Finance, in* *Global Corporate Governance* 327 (Donald H. Chew & Stuart L. Gillan eds., 2009).

¹¹² *Id.* at 344 ("SWFs are, by their nature, long-term investors who are likely to stick with asset allocation choices, perhaps even in the event of short-term losses. This can be an important stabilization factor for companies and financial markets. Unlike private equity and hedge fund investors, SWFs do not usually rely on high leverage, do not face capital requirements, and are not likely to face pressures to rapidly liquidate positions based on withdrawals – all of which can make them more stable investors.").

¹¹³ This number is according to the end of 2007 data, see Butt et al., *supra* note 111, at 331.

¹¹⁴ In 2007, one of Morgan Stanley's economists (Joachim Fels) projected that SWFs assets will reach \$12 trillion in 2015. Joachim Fels, *How Big Could Sovereign Funds Be in 2015?* (May 4 2011), available at <http://www.morganstanley.com/views/gef/team/index.html#anchorstephenjen> (accessed on May 6, 2011). Another projection by the International Monetary Fund estimated that the assets of SWFs may reach \$10 trillion in 2013. International Monetary Fund, *Sovereign Wealth Funds – a Working Agenda*, Prepared by Monetary and Capital Markets and Policy Development and Review Departments 6 (Feb. 29, 2008).

¹¹⁵ Brent Crude Oil barrel price on May 6, 2011 was about US \$109, <http://www.oil-price.net/> (accessed on May 6, 2011). Most SWFs are owned by oil exporting countries who will ultimately reinvest the surplus of that revenue or part of it into its own SWFs. See also Gilson & Milhaupt, *supra* note 110, at 1345, 1358 ("The sudden

developed countries have recently shown some distress about SWFs,¹¹⁶ especially since the SWFs are not transparent concerning “their ultimate objectives, institutional structure, investment policies, and risk management.”¹¹⁷ More significantly, developed countries fear political factors may intertwine with (or effect) SWFs investment decisions.¹¹⁸ For example, a SWF may buy a block of stock in a corporation to have access to its trade secrets or know how, only to be transferred to the SWF’s controlling state.¹¹⁹ No evidence has been shown yet that SWFs have done this but the justification for such fear might be that, as two scholars framed it, “the debate takes the potential (and the logic) for such behavior extremely seriously.”¹²⁰ In any situation, international institutional investors, including SWFs, may push the agenda of reforming corporate governance, particularly to developing countries, to attract investment to their capital market and publicly traded corporations. However, the potential of SWFs as a new external finance supplier of stable and low cost finance will more likely face a strong reluctance by developed economies,¹²¹ which may either hinder the SWF’s agenda for expansion in low-risk developed countries, or confine SWFs’ investment in high-risk developing countries.

emergence and growth of SWFs as players in the global capital markets are due to several interrelated factors. One is the spike in world oil prices, which has brought massive revenues to oil exporters such as Norway, Russia, and the Middle East. A second factor is the enormous accumulation of foreign-exchange reserves by Asian central banks, a portion of which has been split off and invested separately in SWFs.”).

¹¹⁶ See, e.g., Gilson & Milhaupt, *supra* note 110, at 1345 (proposing the issuance of nonvoting shares for SWFs to eliminate any concern associated with their ownership); Joel Slawotsky, *Sovereign Wealth Funds as Emergence Financial Superpowers: How U.S. Regulations Should Respond*, 40 GEO. J. INT’L L. 1239 (2009).

¹¹⁷ Butt et al., *supra* note 111. Although the majority of SWFs are not transparent, there are some differences among those funds: their “disclosures.” Gilson & Milhaupt, *supra* note 110, at 1345, 1355.

¹¹⁸ See, e.g., Gilson & Milhaupt, *supra* note 110, at 1345, 1361–62 (“A fair reading of the current SWF debate strongly suggests that the principal concern with SWF equity investments is that they may have a significant strategic element driven by self-interest.”).

¹¹⁹ *Id.*

¹²⁰ *Id.* at 1345, 1362.

¹²¹ The concerns stems from the lack of transparency in SWFs business. See LIXIA LOH, SOVEREIGN WEALTH FUNDS: STATES BUYING THE WORLD 34 (2010). For the position developed countries toward SWIFs. See

However, it should be noted that foreign capital does not always bring positive outcomes. Sometimes foreign external finance hurts the host countries' economies, making some economies worse off – as in the case of developing countries. For instance, two decades ago, East Asian countries' capital markets crashed one after another like a fall of a “domino” stone wall¹²² due to foreign investors' rapid withdrawal from those countries' capital markets. The abrupt liquidation was ignited by fear of those countries' market collapses. In many instances, foreign investments fled without consideration of the economic, political, social impacts such withdrawal might inflict on those countries.¹²³ In other words, it is not always true that the accumulation of foreign investments carries with it good news. Indeed, sometimes it carries unpleasant ramifications due to its opportunistic, un-embedded nature. On the other hand, studies suggest that individual corporations could secure low-cost finance even if the national structure of corporate governance is lagging.¹²⁴ Good corporate governance in such cases is sometimes more noticeable and awarded, especially by local finance suppliers.¹²⁵

ALBERTO QUADRIO CURZIO & VALERIA MICELI, *SOVEREIGN WEALTH FUNDS: A COMPLETE GUIDE TO STATE-OWNED INVESTMENT FUNDS* 157–75 (2010).

¹²² See Hwa-Jin Kim, *International Corporate Governance: A Selected Bibliography*, 8 J. KOREAN L. 201, 203 (2008–2009) (“a corporation's governance is no longer a domestic issue but rather an international one, which may provide a starting point for domino effect, where weakness in a single national or regional economy can cause a world financial crisis”).

¹²³ This abrupt liquidation of securities and withdrawal from capital market by foreign investors called “hot money” problem. See JOSEPH E. STIGLITZ, *GLOBALIZATION AND ITS DISCONTENTS* 17 (2002) (“the influx of hot money into and out of the country that so frequently follows after capital market liberalization leaves havoc in its wake. Small developing countries are like small boats. Rapid capital market liberalization, in the manner pushed by the IMF, amounted to setting them off on a voyage on a rough sea, before the holes in their hulls have been repaired, before the captain has received training, before life vests have been put on board. Even in the best of circumstances, there was a high likelihood that they would be overturned when they were hit broadside by a big wave.”).

¹²⁴ See Durnev & Kim, *supra* note 107, at 54 (“companies with better governance and more transparency should be valued more highly in the stock market because of investors' greater confidence that they will end up with their fair share of firm profits. And, as stated, this positive effect of good governance on firm value is likely to be stronger in countries with weak legal systems. To put it another way, good corporate governance should be valued more highly in countries where it is scarce – namely, in weaker legal regimes.”).

¹²⁵ See Durnev & Kim, *supra* note 107, at 54.

In short, external finance is critical for corporations' operations and expansion. Without a good corporate governance system at the national level, or at least for the individual corporation alone, it would be more expensive to operate and secure low cost finance. Accordingly, Developed and developing countries must engage in corporate governance dialogue, hoping that talk may lead to attracting new capital market investors who "base their decisions not only on a company's outlook, but also on its reputation and its governance."¹²⁶ If corporate governance structure is crafted wisely and effectively, it will ultimately make the investors in capital market investing more confident and encourage low-cost finance through the capital market; thus, the entire national economy will harvest the benefits. In other words, the World Bank is correct when it stated:

Countries wishing to attract investment need to convince potential investors that reliable governance structures are in place, both at the state and corporate level. The other side of the same coin is that institutional investors, who can invest anywhere in the world, will look to place their funds where their standards of disclosure, of timely and accurate financial reporting, and of equal treatment of all shareholders are met.¹²⁷

¹²⁶ ISKANDER & CHAMLOU, *supra* note 106.

¹²⁷ CORPORATE GOVERNANCE AND CHAIRMANSHIP: A PERSONAL VIEW BY ADRIAN CADBURY 13 (N.Y. 2002). Also see MOBIUS, *supra* note 97, which noted that: "With markets becoming increasingly sensitive to company misbehavior [Sic] and corporate governance violations, reports of abusive behavior [Sic] often quickly result in price crashes. The most unfortunate aspect of all this is that it is often the small retail investors that get hurt the most. For fund management companies with billions of dollars to allocate around the world, diversification strategies serve to minimize the exposure to any one single company. However, for the small retail investors, the quick and drastic erosion of share's value is all too often financially crippling."

3.7.3 Globalization

The last century witnessed an unprecedented revolution of communication and transportation, a phenomenon called “globalization.”¹²⁸ Technically speaking, “globalization” signifies “the removal of barriers to free trade and the closer integration of national economies.”¹²⁹ Globalization is a product of two main elements: technological advancement and free trade. Money and labor in a globalized economy have a better chance to produce “sophisticated work” at a lower price.¹³⁰ Globalization, accordingly, allocates production and resources to “the smartest or the cheapest producer, or both.”¹³¹ Accordingly, globalization not only “make[s] the world smaller,”¹³² but also “flat.”¹³³

The root of globalization is traced to a new economic order incepted in the wake of the World War II at the Bretton Woods Convention.¹³⁴ Bretton Woods’ agenda created a triangle of

¹²⁸ There is voluminous literature on globalization see, for example, STIGLITZ, *supra* note 123; THOMAS L. FRIEDMAN, *THE WORLD IS FLAT: A BRIEF HISTORY OF THE TWENTY-FIRST CENTURY* (2005).

¹²⁹ STIGLITZ, *supra* note 123. According to Merriam Webster Dictionary “Globalization,” a word known in 1951, means “the development of an increasingly integrated global economy marked especially by free trade, free flow of capital, and the tapping of cheaper foreign labor markets.” *Available at* <http://www.merriam-webster.com/dictionary/globalization> (accessed on May 2, 2011).

¹³⁰ FRIEDMAN, *supra* note 128, at 21. Developed countries argue against some aspects of globalization such as using cheap child labor in developing countries to manufacture products that are sold mainly in the west and other rich countries, but this argument depicts the truth from a developed country’s perspective which disregards the real situation of those children before globalization forces reached their location, as Dr. Stiglitz notes: “People of the west may regard low-paying jobs at Nike as exploitation, but for many people in the developing world, working in a factory is a far better option than staying down on the farm and growing rice.” STIGLITZ, *supra* note 123, at 4.

¹³¹ FRIEDMAN, *supra* note 128, at 14.

¹³² JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, *SECURITIES REGULATION: CASES AND MATERIALS* 98 (16th ed., Aspen Publishers 2009).

¹³³ *See* FRIEDMAN, *supra* note 128, at 7. In a globalized world the earth community “are ... connecting all knowledge centers on the planet together into a single global network” *Id.* at 8.

¹³⁴ The convention was held in Bretton Wood in New Hampshire, U.S.A. The convention concluded with the international agreement called “Bretton Wood Agreement,” signed in 1944. *See* MITSUO MATSUSHITA ET AL., *THE WORLD TRADE ORGANIZATION: LAW PRACTICE, AND POLICY* 1–2 (2003).

international economic institutions: the World Bank, International Monetary Fund,¹³⁵ and the International Trade Organization.¹³⁶ The goal intended was to entrust those institutions with the supervision of the post World War II economic order.¹³⁷ Shortly after that, in 1947 the General Agreement on Tariffs and Trade (GATT) was signed.¹³⁸ However, the General Agreement on Trade in Services came to force in 1995 as a result of the Uruguay Round which began in 1986. Since 1995, the World Trade Organization (WTO) has been in charge of the administration and implementation of the international free trade agreements (GATT and GATS).¹³⁹ Currently, 153 out of 195 countries of the world are members of World Trade Organization (WTO).¹⁴⁰ The WTO's chief goal is to enhance free trade among members in goods and services.¹⁴¹ Although there is no international investment agreement that could legally facilitate the flow of cash over the globe in contrast to GATT and GATS' multilateral agreements,¹⁴² modern "technology ...

¹³⁵ For the Bretton Woods' system, see generally BARRY EICHENGREEN, *GLOBALIZING CAPITAL: A HISTORY OF THE INTERNATIONAL MONETARY SYSTEM* 90–133 (2008).

¹³⁶ The ITO did not come to the existence as was planned. See generally MATSUSHITA ET AL., *supra* note 134.

¹³⁷ The World Trade Organization (WTO) was established in (1995) as a successor of the intended but failed to be established International Trade organization (ITO) at the middle of the last century. See MATSUSHITA ET AL., *supra* note 134, at 2 n.2.

¹³⁸ For general overview of GATS see MATSUSHITA ET AL., *supra* note 134.

¹³⁹ WTO's existence can be traced to the time of GATT's entering the force as a de facto administrative deciding body for that agreement. See the WTO website, *available at* http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact1_e.htm (accessed on May 4, 2011).

¹⁴⁰ 153 members are in the World Trade Organization (WTO), http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm (accessed on Apr. 30, 2011). The world consists of 195 countries: all of them are members of the United Nations except for Kosovo, Taiwan, and Vatican City.

¹⁴¹ There is no comprehensive multilateral agreement on investment under the supervision of the WTO or anywhere else. See generally Dr. Rainer Geiger, *Towards a Multilateral Agreement on Investment*, 31 CORNELL INT'L L.J. 467 (1998).

¹⁴² Investments are still governed by customary public international law principles and bilateral and regional agreements.

allow[s] money to move quickly throughout the world ... [which] has contributed mightily to globalization of capital markets.”¹⁴³

In our modern era, not only does globalization have a positive impact on the world’s “standard of living”¹⁴⁴ and “knowledge” accessibility,¹⁴⁵ but also on businesses around the world which are “compet[ing] with one another.”¹⁴⁶ In such an advanced state of affairs the winner is whomever can produce and sell the most efficiently – which is not easy to secure without good corporate governance in place. The loser has two options: either to lose under its current outmoded governance model and practices, or reform its governance model to rejoin the competition. Put differently, high-quality corporate governance is a vital part of being a competitor; otherwise and eventually, the globalized economic forces will drive the uncompetitive firm outside the market.¹⁴⁷ Accordingly, firms around the world have to restructure their governance model to minimize costs, elevate performance and increase revenue. In this juncture, Professor Jeffery Gordon noted: “as trade barriers erode, the locally protected product marketplace disappears. A country’s firm’s performance is more easily measured against global standards. Poor performance shows up more quickly when a competitor takes away market share, or innovates quickly.”¹⁴⁸

¹⁴³ COX ET AL., *supra* note 132.

¹⁴⁴ See STIGLITZ, *supra* note 123, at 4, where he remarks that “Because of globalization many people in the world now live longer than before and their standard of living is far better.”

¹⁴⁵ *Id.* (“Globalization has reduced the sense of isolation felt in much of the developing world and has given many people in the developing countries access to knowledge well beyond the reach of even wealthiest in any country a century ago.”).

¹⁴⁶ Jeffrey N. Gordon & Mark J. Roe, *Introduction*, in *Convergence and Persistence in Corporate Governance 1* (Jeffrey N. Gordon & Mark J. Roe eds., Cambridge Univ. Press 2004).

¹⁴⁷ *See id.*

¹⁴⁸ *See id.*

On the other hand, globalization poses a special problem for developing economies if those countries do not plan wisely how, in what order and to what level the elevation of the restrictions on trade in goods and services will be. Otherwise, “open[ing] up [markets] for competition too rapidly ... [leads] to rising unemployment and increased poverty.”¹⁴⁹ In short, corporate governance structure is becoming an important topic now more than any other time in history. Now competition has moved from a national level to an international level and the future promises more integration. In this changing globalized world, the state and individual firm’s governance structure do make difference. Put simply, the more the world economy is integrated, the more corporate governance structure matters to individual firms and to the national and (ultimately) global economy at large.

3.7.4 Capital Market Crisis and Corporate Scandals

3.7.4.1 Capital Market Crisis

The Efficient Capital Market Hypothesis (ECMH) theorizes that the index price of a stock “reflects” the share’s true value.¹⁵⁰ There are three levels of market efficiency: weak, semi-strong, and strong.¹⁵¹ Most capital market’s price efficiency is either weak or semi-strong.¹⁵² In a weak form of efficiency, the market price of a share reflects the share’s related historical

¹⁴⁹ STIGLITZ, *supra* note 123, at 18.

¹⁵⁰ Eugene F. Fama, *Efficient Capital Markets: A Reviewer of Theory and Empirical Work*, vol. 25, No. 2 J. FINANCE 388 (1970). For general discussion of Efficient Market Hypothesis, see JAMES H. LORIE, PETER DODD & MARY HAMILTON KIMPTON, *THE STOCK MARKET: THEORIES AND EVIDENCE* 55–87 (2d ed. 1985); HENDRIK S. HOUTHAKKER & PETER J. WILLIAMSON, *THE ECONOMICS OF FINANCIAL MARKETS* 130–140 (1996).

¹⁵¹ Fama, *supra* note 150.

¹⁵² *Id.* (he noted that “there is no important evidence against the [Efficient Market] hypothesis in the weak form and semi-strong form tests). *Id.* at 88.

information.¹⁵³ In a semi-strong market efficiency market prices reflect both historical and newly-available public information.¹⁵⁴ For example, if corporation (X) discloses its financial results and the corporation's share price changes the next day, that means the capital market absorbed the new information and incorporated it into the share price. Thus, in this situation, the capital market is considered semi-strong. However, if in the next day's trading the stock price did not change or took a long period to do so, then the market is a weak efficient capital market, or demonstrates weak efficiency as to that stock. On the other hand, a strong efficiency form reflects all corporation information which either is publicly disclosed or held by privileged persons.¹⁵⁵ Nonetheless, the widespread strong form efficiency is not plausible due to its contradiction with most capital markets' regulations, which prohibit non-disclosed information, notoriously known as "insider trading prohibition."¹⁵⁶

To the contrary of the ECMH premise, historical records indicate that capital markets tend to be inflated to a point that does not reflect the true value of the share: a capital market bubble.¹⁵⁷ In other words, an injection of enormous amounts of money into the capital market causes a greatly overpriced stock market. Capital market bubbles, like other financial bubbles, are temporary: sooner or later they burst and cause a financial crisis.¹⁵⁸ For example, in 1636 the first recorded financial crisis occurred in the Netherlands due to the crash of tulip bulb prices

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

¹⁵⁶ The prohibition of insider trading is considered a good corporate governance practice. See THE OECD CORPORATE GOVERNANCE PRINCIPLES 44 (2004) which states that "[i]nsider trading ... should be prohibited." For the Economic Justification for the Prohibition of insider trading, see Hayne E. Leland, *Insider Trading Should It Be Prohibited?*, vol. 100, No. 4 J. POL. ECON. 859–87 (1992).

¹⁵⁷ See generally HAROLD L. VOGEL, FINANCIAL MARKET: BUBBLES AND CRASHES 121–23 (2010).

¹⁵⁸ See CHARLES P. KINDLEBERGER & ROBERT ALIBERT, MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES 11–12 (15th ed. 2005).

shortly after the price had jumped dramatically.¹⁵⁹ Since that event, the history of inflation bubbles and their bursting has repeated itself. For instance, in the last hundred years, the United States' capital market has undergone three major crises: the Great Depression (1929),¹⁶⁰ the dot.com (2000),¹⁶¹ and subprime mortgages (2008).¹⁶² The effects of capital market crises usually exceed national borders to reach other, interconnected capital markets¹⁶³ such as those in East Asian countries in the 1990s.¹⁶⁴ Consequently, their capital markets fell like “dominoes.”¹⁶⁵

Economic booms appear and fade periodically as no recession or expansion lasts forever due to the business cycle.¹⁶⁶ Usually, economic expansion stimulates capital markets and other financial bubble formations. During this period, investors from all walks of life, including “the widows and orphans,” rush hysterically to invest their savings in the stock market.¹⁶⁷ The temptation of prospective wealth during a capital market bubble is not held exclusively by lay investors but is also shared by many sophisticated investors. Sophisticated investors know that after every bubble there follows an imminent collapse; however, they do not know exactly when such a collapse will occur. Two scholars envisaged the early stage of bubble development by

¹⁵⁹ See VOGEL, *supra* note 157, at 27–29 (2010).

¹⁶⁰ See *id.* at 32–34.

¹⁶¹ See generally KINDLEBERGER & ALIBERT, *supra* note 158, at 7.

¹⁶² See VOGEL, *supra* note 157, at 42–47. For a detailed exploration of the 2008 financial crisis in the U.S.A. See The Financial Crisis Inquiry Report: The Final Report of the National Commission on the Causes of The Financial and Economic Crisis in the United States (2011).

¹⁶³ See KINDLEBERGER & ALIBERT, *supra* note 158, at 125–27.

¹⁶⁴ See *id.* at 156–58 (East Asian financial crisis ignited first in Thailand and then spread like a fire to the rest of the other countries' markets.).

¹⁶⁵ For the “domino” simile see Kim, *supra* note 122, at 201.

¹⁶⁶ See KINDLEBERGER & ALIBERT, *supra* note 158, at 24. See also the U.S.A business cycles expansions and contractions information (1854–2009) in the National Bureau of Economic Research website, *available at* http://www.nber.org/cycles/US_Business_Cycle_Expansions_and_Contractions_20100920.pdf (accessed on Jan. 2, 2012).

¹⁶⁷ See KINDLEBERGER & ALIBERT, *supra* note 158, at 118.

saying “[t]he economic situation in a country after several years of bubble-like behavior resembles that of a young person on a bicycle; the rider needs to maintain the forward momentum or the bike becomes unstable.”¹⁶⁸ At the time of a bubble, investors assume economic prosperity will last forever, so they keep pushing the prices up to the market’s limit;¹⁶⁹ ultimately, “the greatest fool” eventually will endure all sorrows and lose when the bubble implodes.¹⁷⁰ An economist illustrated this situation by saying “[b]ubbles are wonders to behold. They take your breath away and make your pulse race. They make fortunes and – just as fast or faster, in the inevitable stomach-churning crash aftermath – destroy them too.”¹⁷¹

A stock market bubble tends to negatively affect other economic sectors by redirecting various sectors’ resources toward the inflated capital market. For instance, many people will abandon businesses that yield financial returns less than the return the capital market would offer.¹⁷² Put simply, stock market investors, at the time of bubbles, are tempted by capital markets’ high returns (greed) and convenience. The more people invest in capital markets, the greater the consequences for that capital market and national economy if the bubble implodes.

¹⁶⁸ *Id.* at 11.

¹⁶⁹ Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 55 ME. L. REV. 351, 352 (2002–2003) (“optimism was fueled by the quite mistaken belief that the rise in securities prices would continue indefinitely”). See also KENNETH L. FISHER & MEIR STATMAN, BUBBLE EXPECTATIONS, THE JOURNAL OF WEALTH MANAGEMENT 17, 17 (Fall 2002) (“Investors form expectations as if they believe that inflated bubbles will continue to inflate while deflated bubbles will continue to deflate.”).

¹⁷⁰ KINDLEBERGER & ALIBERT, *supra* note 158, at 13 (“[t]he bubble involves the purchase of an asset, usually real estate or security, not because of the rate of return on the investment but in anticipation that the asset or security can be sold to someone else at an even higher price; the term ‘the greater fool’ has been used to suggest the last buyer was always counting on finding someone else to whom the stock or the condo apartment or the baseball cards could be sold.”). *Id.*

See also STATMAN, *supra* note 169, at 17, 19. From risk management point view see Neil A. O’Hara, *The Greater Fool Theory: Managing and Modeling Risk*, J.N.Y. SOCIETY OF SECURITY ANALYSTS 29–33 (The Investment Professional) (2009), available at http://www.theinvestmentprofessional.com/vol_2_no_1/TIP-Vol-2-No-1.pdf (accessed on Jan. 1, 2012).

¹⁷¹ VOGEL, *supra* note 157, at xiii.

¹⁷² See KINDLEBERGER & ALIBERT, *supra* note 158, at 11.

Real estate and capital market bubbles are two normally interlinked phenomena.¹⁷³ People use the wealth acquired by the increase in real estate to invest in the stock market and *vice versa*.¹⁷⁴ So, the collapse of either market will bring the other down with it. For instance, in the 1980s, real estate prices collapsed in Japan after tremendous increases, a situation which led to a financial crash in the Japanese capital market.¹⁷⁵

3.7.4.2 Publicly traded corporation s' Scandals

Throughout history, financial crisis have caused a great deal of public attention, rage¹⁷⁶ and governmental reaction.¹⁷⁷ In most cases, a capital market crisis uncovers fraudulent conducts by directors and officers of publicly traded corporation s.¹⁷⁸ Historically, one of the earliest capital market collapses was caused by two European public companies in 1720 – the British South Sea Company¹⁷⁹ and the Mississippi Company¹⁸⁰ – that lead the vibrant Irish poet Jonathan Swift to say of the former:

¹⁷³ *Id.* at 117.

¹⁷⁴ *Id.*

¹⁷⁵ *See generally* VOGEL, *supra* note 157, at 34–38; KINDLEBERGER & ALIBERT, *supra* note 158, at 145–56.

¹⁷⁶ For example occupy Wall Street movement in the U.S. mainly triggered by the 2008 financial crisis.

¹⁷⁷ For example government normally launches investigation for any criminal misconduct or loopholes in governance structure.

¹⁷⁸ Klaus J. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation*, 59 AM. J. COMP. L. 1, 16–17 (2011).

¹⁷⁹ *See generally* VOGEL, *supra* note 157, at 29–30.

¹⁸⁰ “Mississippi Company” was enjoying trading “privileges” (concession) between France as a colonial power and its new territory in the newly discovered land of Louisiana in America. The company created a scheme where people bought the company stock and bonds in return for cash. People rushed to underwrite this company not only in France but also from other parts of Europe due to the expectation of the wealth that this company might generate, especially with regard to discovering gold and silver in the new world (America). Accordingly, in 1719, the price of the company share jumped massively from 500 to 1,000 livres (the French currency at that time). However, the bubble imploded due to the vast sale of the company shares by stock holders. At the end of 1720, the share price of the company declined to 500 livres. Jon Moen, *John Law and the Mississippi Bubble: 1718–1720*

One fool may from anther win,
And then get off with money stored;
But if a sharper once comes in,
He throws at all, and sweeps the board,
As fishes on each other prey
The great ones swallowing up the small;
So fares it in the Southern See;
But, whale directors eat up all ...
The nation then too late will find
Computing all their cost and trouble,
Directors' promises but wind,
South Sea at best a mighty bubble.¹⁸¹

Recently, the American capital market crash at the beginning of the millennium was followed by a great deal of public corporate scandals, most notoriously the Enron scandal.¹⁸² Enron's collapse shocked not only the American corporate governance system but also the global corporate governance system.¹⁸³ Enron began as a classical energy corporation which then transformed its business structure and operation line to be a "virtual [holding] corporation"¹⁸⁴ that specialized in energy trading.¹⁸⁵ At the end of the last century, Enron reached the zenith of its success when it was ranked as one of the top ten companies in the nation.¹⁸⁶ Enron's

(Oct. 2001), available at <http://mshistory.k12.ms.us/articles/70/john-law-and-the-mississippi-bubble-1718-1720> (accessed on May 12, 2011).

¹⁸¹ Jonathan Swift, *Upon the South Sea Project*, in *Jonathan Swift: The Complete Poems* 209–14 (Pat Rogers ed., 1983) (emphasis omitted).

¹⁸² Literature discussing Enron scandals is voluminous, see, e.g., William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2001–2002). Corporate scandals had occurred after scandals in WorldCom, Tyco, Adelphia are other corporations. For discussion of the U.S. corporate governance shortcoming that might not prevent those scandals including Enron from happening, see John C. Coffee, Jr., *What Cause Enron? Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269 (2003–2004).

¹⁸³ See generally Hill, *supra* note 60, at 367; Douglas M. Branson, *Enron-When Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?*, 48 VILL. L. REV. 989 (2003); Paul Davies, *Enron and Corporate Governance Reform in UK and the European Community*, in *AFTER ENRON: IMPROVING CORPORATE LAW AND MODERNIZING SECURITIES REGULATION IN EUROPE AND THE U.S.* 415–44 (Johan Armour & Joseph A. McCahery eds.).

¹⁸⁴ See Bratton, *supra* note 182, at 1275, 1288–94.

¹⁸⁵ C. William Thomas, *The Rise and Fall of Enron*, J. ACCOUNTANCY 41, 41 (Apr. 2002).

¹⁸⁶ See Bratton, *supra* note 182, at 1275–76.

management, in complicity with its auditing and consulting firm, Arthur Andersen, had managed for years to conceal the company's liabilities.¹⁸⁷ Enron and Andersen pushed off balance sheet liabilities previously listed on Enron's financial statements.¹⁸⁸ The fraud was facilitated by the unique structure of the company, which was a conglomerate consisting of numerous special purposes entities whose financial statements were not consolidated with Enron's as required by accounting standards in the case of a parent-subsidary financial relation.¹⁸⁹ After Enron's managerial misconduct had been exposed publicly, the price of its shares dropped precipitously.¹⁹⁰ Enron shares become worthless. The company filed for bankruptcy in December 2001.¹⁹¹ Unfortunately, the most affected parties among the corporation stakeholders were the employees, shareholders, and creditors,¹⁹² and not, unbelievably to some, the malfeasors (the board, the management, and gatekeepers.)

In conclusion, reoccurring crises and scandals in various capital markets prove that no corporate governance model may prevent capital market crises or scandals, no matter how well-governed a market may be. Indeed, the only difference between a good and a weak governance system may be that the good system opts to respond to crises and scandals in a more efficient manner by allowing for less damage to investors and to the national economy, in general, in comparison to the response of the weak governance system. Moreover, a good corporate governance system has mechanisms to constantly modernize (adapt?) itself: one of the main

¹⁸⁷ See Thomas, *supra* note 185, at 41, 47–48.

¹⁸⁸ See *id.* at 41, 43.

¹⁸⁹ *Id.*

¹⁹⁰ *Id.* at 41, 44.

¹⁹¹ *Id.*

¹⁹² See Bratton, *supra* note 182, at 1275, 1277. See also ALAN CALDER, CORPORATE GOVERNANCE: A PRACTICAL GUIDE TO THE LEGAL FRAMEWORKS AND INTERNATIONAL CODES OF PRACTICE 2 (2008).

forces behind such modernization is a capital market crisis or scandal. From the 1720 British Bubble Act to the 2002 U.S. Sarbanes Oxley Act, bubbles and corruption have played vital roles in developing and enhancing corporate governance and have provided a real life “test drive” for the installed reform. In some cases, however, the will of reform triggers an “over reactive”¹⁹³ and “rushed” regulatory response.¹⁹⁴

3.7.5 Privatization

The last century was affected by two contradictory economic trends toward ownership of economic activities: nationalization and privatization.¹⁹⁵ At the beginning, the state “nationalized” many economic enterprises.¹⁹⁶ For example, roads, trains, airlines, electricity, banking and other industries were mostly owned and managed by the state.¹⁹⁷ Government

¹⁹³ Hopt, *supra* note 178, at 1, 17 (he remarked about government responses to governance scandals by saying that: “experience shows that legislators and rule makers tend to overreact to these events, as scandal-driven legislation often goes a step too far”). *Id.*

¹⁹⁴ See Bratton, *supra* note 182, at 1275, 1277 (he said about Enron scandal that: “[c]orporate failures as big and fast as this one tend to be held out as example for future business regulation. Enron’s failure is no exception, implicating a long list of regulatory topics well before completion of formal investigations into the company’s management and the collapse’s cause.”). See also Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

¹⁹⁵ See Pierre Guislain, *The Privatization Challenge: A Strategic, Legal, and Institutional Analysis of International Experience*, WORLD BANK REGIONAL AND SECTORAL STUDIES 3 (1997). However, the expansion of SWFs may have contrary effects on the privatization program. See Butt et al., *supra* note 111, at 328 (“worrisome to some, acquisitions by entities supported by foreign government appear to have the potential to reverse a trend toward privatizations that has occurred in many economies and would possibly undo some of the economic benefits that prompted these privatizations”).

¹⁹⁶ Guislain, *supra* note 195. See also William L. Megginson & Dario Scannapieco, *The Financial and Economic Lessons of Italy’s Privatization Program*, in GLOBAL CORPORATE GOVERNANCE 177, 177–78 (Donald H. Chew & Stuart L. Gillan eds., 2009) (“The modern Italian state is less than 150 years old, and extensive state ownership of business and finance was not part of the nation’s founding ideology. Instead, state ownership principally grew out of the need to rescue very large numbers of failing banks and industrial firms during the great Depression.”).

¹⁹⁷ IAN DUNCAN & ALAN BOLLARD, CORPORATIZATION & PRIVATIZATION: LESSONS FROM NEW ZEALAND 7 (Oxford Univ. Press 1992).

ownership existed through two avenues: production through one of its departments or agencies, or by state-owned enterprises. In both cases, the free market's "invisible hand" was not traceable.¹⁹⁸ Non-efficient production was the result and was accompanied, in most cases, by the waste of national resources, or non-efficient allocation of them. To fill in the gap created by the absence of the free market's control forces, governments enacted laws to ensure proper levels of production and efficiency of its controlled production units. However, the enlargement of public sectors led to counterproductive consequences. Inefficiency and low quality production of the state-owned enterprises led governments to rethink the viability of continuing ownership and control over of production units. In this juncture, Nobel Prize laureate Joseph Stiglitz remarked:

The problem is not so much that the government is too big, but that it is not doing the right thing. Governments, by and large, have little business running steel mills, and typically make a mess of it ...[.] In general, competing private enterprises can perform such functions more efficiently. This is the argument for privatization – converting state-run industries and firms into private ones.¹⁹⁹

Clearly, the states' relinquishment of their control of economic sectors and enterprises became eminent. Consequently, at the beginning of the 1980's the prime minister of Great Britain, Margaret Thatcher, launched a "privatization" program, the first in its kind in a

¹⁹⁸ "Invisible hand" is an economic concept formulated in the eighteen century by Adam Smith where he depicted it as follows:

As every individual ... endeavours as much as he can both to employ his capital in the support of domestic industry and so to direct the industry that its produce may be of greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.

ADAM SMITH, *THE WEALTH OF NATIONS* 572 (Bantam Dell 2003).

¹⁹⁹ Stiglitz, *supra* note 123, at 52.

developed economy, and such a policy spread to other developed countries.²⁰⁰ Transition and developing economies have pursued the trend of privatization.²⁰¹ Nonetheless, America was the least affected of the developed countries regarding the wave of privatization.²⁰² Privatization basically signifies a “transfer of ownership right from a public agency to one or more private parties.”²⁰³ Currently, privatization provides the private sector with an opportunity to deal with economic sectors that were once confined to the public sector such as “infrastructure and natural resources.”²⁰⁴

The chief goal of privatization plans is increasing “economic efficiency;” because government has to take into account other “political, social, and financial” factors.²⁰⁵ At some point, those factors – including the economic ones – contradict each other.²⁰⁶ A privatization agenda in most countries is associated with “deregulation” of the privatized sector, then to be governed by the market economy forces.²⁰⁷ In such “deregulated” business environments, the rules of the game are mostly articulated by the “private” sector instead of the government, as was formerly done.²⁰⁸ Consequently, corporate governance problems arise as to “how the newly

²⁰⁰ See Marko Becht, Patrick Bolton & Alise Roel, Corporate Governance and Control, Finance Working Paper N. 02/2002, at 4, available at http://ssrn.com/abstract_id=343461 (accessed on May 20, 2011) (“The privatization ... in the UK ... was responsible for 58% of OECD and 90% of European Community privatization proceeds in 1991. Since 1995 Australia, Italy, France, Japan and Spain alone have generated 60% of total privatization revenue.”).

²⁰¹ See *id.*

²⁰² Guislain, *supra* note 195.

²⁰³ *Id.* at 10 (footnote omitted).

²⁰⁴ Gordon & Roe, *supra* note 146, at 2.

²⁰⁵ See Guislain, *supra* note 195, at 17.

²⁰⁶ Gordon & Roe, *supra* note 146, at 2.

²⁰⁷ See *id.*

²⁰⁸ *Id.*

privatized corporations should be owned and controlled.”²⁰⁹ Accordingly, good corporate governance is essential to any successful privatization program.²¹⁰ On countries with developed institutions the matter might be simpler as the government has to more or less just transfer state ownership to the private sector and deregulate the privatized sector, as done in the UK and the U.S. But in most developing and transition economies the matter is more complex than just privatizing and deregulating: it requires external and internal governance mechanisms to monitor the newly-launched companies out of the state-controlled enterprises.²¹¹ In other words, “there are preconditions that have to be satisfied before privatization can contribute to an economy’s growth.”²¹² Also, it requires finance where private actors need to raise money to buy enterprises from the state.

For instance, in the aftermath of the fall of communism in Eastern Europe, Russia had undertaken massive privatization programs to promote efficiency and was inclined to a market economy. Nonetheless, Russia’s experiences encompassed a failed privatization model.²¹³ A major factor undermining Russian privatization programs, apparently, was the lack of well-developed corporate governance systems.²¹⁴ Russian weak corporate governances lead to the

²⁰⁹ Becht et al., *supra* note 200.

²¹⁰ See Megginson & Scannapieco, *supra* note 196 (“A complete system of corporate governance laws, regulatory bodies, and self-regulating institutions – should be constructed before large-scale divestments begin.”).

²¹¹ *See id.* at 192.

²¹² STIGLITZ, *supra* note 123, at 52.

²¹³ *See* Bernard Black, Reinier Kraakman & Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731 (1999–2000). For a brief study of several privatization programs launched in some transition economies, see Curtis J. Milhaupt, *Privatization and Corporate Governance in a Unified Korea*, 26 J. CORP. L. 199 (2000–2001).

²¹⁴ *See* Black et al., *supra* note 213 (he concluded that “[a] weak government can’t build the institutions that are needed to control self-dealing and support a complex market economy. Yet without that infrastructure, rapid large-firm privatization won’t help the economy much if it at all). *Id.*

exploitation of the newly privatized corporations' assets by the company management and controlling shareholder(s). Professor Bernard Black's described the Russian privatization program by saying that:

Russian privatization was dirty. On the whole, the bigger the stakes, the dirtier the deal. Its advocates hoped that even if manner of distributing the state's wealth was regrettable, the outcome would be salutary. New owners, motivated by profit, would improve the privatized companies' operations. The new owner would get rich, perhaps undeservedly, but the whole country would benefit from the productivity gains. These hopes have not been fulfilled.²¹⁵

In short, a successful privatization program should start with focusing first on establishing a good corporate governance system; otherwise privatization programs will not achieve their intended economic and social goals.²¹⁶ The newly privatized firms in a deregulated legal environment create a set of governance problems, especially in developing and transition economies. Accordingly, the privatization programs in those weak governance countries may lead the newly-privatized to be worse off in efficiency and accountability than before privatization was launched and not solve the low-efficiency problem of public ownership of the means of production and the control of its owned enterprises.²¹⁷ In this context, economist Joseph Stiglitz notes:

Perhaps the most serious concern with privatization, as it has so often been practiced, is corruption. The rhetoric of market fundamentalism asserts that privatization will reduce what economists call the 'rent-seeking' activity of

For the relation between corporate governance structure and privatization. See John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from securities Market Failure*, 25 J. CORP. L. 1 (1999–2000).

²¹⁵ Black et al., *supra* note 213, at 1731, 1750.

²¹⁶ See Megginson & Scannapieco, *supra* note 196, at 192.

²¹⁷ See Milhaupt, *supra* note 213, at 199, 200 ("simply moving assets from the state to private hands does not ensure a climate conducive to growth, and investment, and effective corporate governance."). *Id.*

government officials who either skim off the profits of government enterprises or award contracts and jobs to their friends.²¹⁸

Truly, because of the lack of a good corporate governance system, a privatization program is more likely to be a failed attempt, even leading to “worse” economic conditions at the privatized firms than before the privatization.²¹⁹ Before engaging in any privatization program, policy makers have to assess the existing corporate governance system of the relevant country and take the level of corporate governance framework into consideration on top of all other factors. Otherwise, the entire situation might be “briberization” – as once sarcastically described.²²⁰

3.8 CONCLUSION

There is no single, agreed-upon definition of corporate governance. However, corporate governance is mainly concerned with answering two questions: 1) who directs the company, and 2) toward whose interests is the company directed? The manner in which such questions are answered depends on the philosophical foundations of governance adopted within a specific company or by a certain country. Notwithstanding these differences, all corporate governance systems aim to reduce agency cost problems. Corporate governance rules are not limited to binding legal provisions but also include advisory and moral standards related to the

²¹⁸ STIGLITZ, *supra* note 123, at 58.

²¹⁹ *Id.*

²²⁰ *Id.* at 58 (“in contrast to what it was supposed to do, privatization has made matters so much worse that in many countries today privatization is jokingly referred to as ‘briberization.’ If a government is corrupt, there is little evidence that privatization will solve the problem. After all, the same corrupt government that mismanaged the firm will also handle the privatization.”).

aforementioned questions. The recent global financial crisis, along with scandals and privatization programs around the world, has increased interest in corporate governance. Implementing sound corporate governance significantly improves the likelihood of decreasing the costs of external finance for national companies. Furthermore, for a country such as Saudi Arabia, sound corporate governance will facilitate integration into the global economy and attract foreign investments.

4.0 CORPORATE GOVERNANCE II: THEORY OF THE FIRM AND OWNERSHIP AND CONTROL

4.1 INTRODUCTION

This chapter addresses fundamental theories of the publicly traded corporation. First, the nature of the publicly traded corporation (theory of the firm) will be discussed including various descriptive theories. Secondly, it will shed light on theories that address the questions of for whom the corporation is operated; in other words, who should be the ultimate beneficiaries of the publicly traded corporation? The last part will be devoted to examining ownership patterns in the publicly traded corporations and different agency cost problems arising accordingly.

4.2 THE NATURE OF THE PUBLICLY TRADED CORPORATION

4.2.1 Traditional theory¹

Based on historical wisdom, a corporation under this theory is defined as a “limited liability partnership”² by which the corporation is regarded as “the private property of its” shareholders.³

¹ This theory is also called property or ownership theory.

Thus, it “is a thing ... owned”⁴ like any other property or asset in life.⁵ Property law provides the basis for this theory. The nature of the corporation itself as real or personal property does not play any role in altering this view. Moreover, the corporation represents an entity “separate” from its shareholders and other stakeholders.⁶ Some scholars view this distinction as no more than “a special form” of shareholder.⁷ In *W. Clay Jackson Enterprises, Inc. v. Greyhound and Financial Corp.*, the court characterizes the separate legal entity of a corporation in a very extreme situation by observing that “[e]ven when all stock is owned by a sole shareholder, there seems no adequate reason to depart from the general rule that the corporation and its shareholders are to be treated as distinct legal persons.”⁸

Noble Laureate Milton Friedman, a strong advocate of this traditional ownership theory, argued that “[t]he whole justification for permitting the corporate executive to be selected by the stockholders is that the executive is an agent serving the interest of his principal.”⁹ Some scholars went even further in defending this theory by claiming that “[t]he principle that shareholders own the companies in which they invest – and are the ultimate bosses of those running them – is central to modern capitalism.”¹⁰ Under this point of view, stockholders who

² William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 267 (1992).

³ Allen, *supra* note 2, at 264–65.

⁴ STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 28 (2002).

⁵ For example movable property.

⁶ Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS. L. REV. 407, 437 (2006).

⁷ Allen, *supra* note 2, at 267.

⁸ *W. Clay Jackson Enterprises, Inc. v. Greyhound and Financial Corp.*, 463 F. Supp. 666 (1979).

⁹ Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES MAG., Sept. 13, 1970.

¹⁰ Arthur Levitt, Jr., *How to Boost Shareholder Democracy*, WALL ST. J., July 1, 2008, at A17 (Mr. Levitt was the Chairman of the Securities and Exchange Commission (SEC) from 1993 to 2001).

are the owners of the corporation chose a group of agents, termed the board of directors, to manage the corporation on their behalf.

An agency relation is defined in the Restatement (Third) Agency as “the fiduciary relationship that arises when one person (a “principal”) manifests assent to another person (an “agent”) that the agent shall act on the principal’s behalf and is subject to the principal’s control.”¹¹ Thus, shareholders are in full control of their assets (which are essentially the corporation) and the management of the corporation conducts itself under the direct control of shareholders as principal. According to agency law, not only management actions but also any wrongful acts by the management within the scope of the agency relation would be attributed to the principal.¹²

This theory, however, has faced much criticism from legal scholars. Professor Richard Booth notes that the theory “does not ... address many of the most important questions that arise these days.”¹³ First, a board of directors in a publicly held corporation is not an agent of the shareholders because the latter does not have the legal mandate to control the former’s actions.¹⁴ In fact, the members of the board of directors act as fiduciaries for the shareholders, *not* agents for them. For instance, case law is not in favor of agent-principal relations between shareholders and a board of directors, stating that the authority of the board is “original and undelegated.”¹⁵

¹¹ RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

¹² For example, the management of a corporation works similarly to the owner of a shop or restaurant. The shop owner hires employees to help run the business. As the business grows, the owner delegates authority and discretion to employees in order to help the owner properly manage the growing business; however, responsibility for the shop or restaurant will always lie with the owner, no matter how much the owner has delegated power.

¹³ Richard A. Booth, *Symposium: Theory Informs Business Practice*, 77 CHI-KENT L. REV. 147, 150 (2001).

¹⁴ ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 106 (2004).

¹⁵ *Manson v. Curtis*, 119 N.E. 559, 562 (1918).

Second, a corporation owns the “assets” of the corporation, not stockholders.¹⁶ The shareholder (as owner under this theory) does not possess the legal authority to sell or use the assets of the corporation. In fact, such acts may be regarded as unlawful.¹⁷ In *W. Clay Jackson Enterprises, Inc. v. Greyhound and Financial Corp.*, the court provides that “even a sole shareholder has no independent right which is violated by trespass upon or conversion of the corporation’s property.”¹⁸ Thus, for example, a shareholder has no right to use or claim corporate assets.

Accordingly, the principle right a shareholder has is the right to sell his shares. Thus, it is clear that a shareholder’s right is in many ways different from the traditional ownership of property in which a person has the full right entitled by ownership that is, specifically the control over the owned property.¹⁹ As Professors Blair and Stout note:

Milton Friedman is a Nobel Prize-winning economist, but he obviously is not a lawyer. A lawyer would know that the shareholders do not, in fact, own the corporation. Rather, they own a type of corporate security commonly called “stock.” As owners of stock, shareholders’ rights are quite limited. For example, stockholders do not have the right to exercise control over the corporation’s assets.²⁰

¹⁶ Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 25051 (1999).

¹⁷ It will be regarded as stealing or trespass of corporate property.

¹⁸ *W. Clay Jackson Enter. Inc. v. Greyhound and Fin. Corp.*, 463 F. Supp. 666, 670 (1979).

¹⁹ Common law of property grants the owner a bundle of rights such as the right to use, transfer, possess and exclude others.

²⁰ Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1191 (2002).

However, according to corporate law, shareholders *to some degree* have an “indirect” effect on the corporate wealth through management based on shareholders’ power of electing and removing the board of directors.²¹

Truly, the property “model” reflects a far-fetched view of the nature of a corporation,²² which distant from the reality of the publicly traded corporation. Thus, the property theory is no longer widely held legal theory of publicly traded corporation.²³ Nonetheless, the theory still exists, accepted by many non-corporate law scholars and the majority of ordinary people.²⁴

4.2.2 The Nexus of the Contracts Approach

Under the nexus of contracts approach,²⁵ a corporation is “an aggregation of people banded together for longer period – permit[ing] greater use of specialization.”²⁶ The corporation is not

²¹ *Id.*

²² Allen, *supra* note 2, at 265.

²³ Because Professor Friedman is the most famous advocate ownership theory professor, critics have discredited this theory by saying “we can throw Friedman’s concept of ownership out the window, along with its associate economic and ethical baggage.” See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 565 (2003).

²⁴ If one were to ask ordinary people, or even lawyers not practicing corporate law, “Who owns a corporation?,” they would probably answer: the shareholders. See LYNNE L. DALLAS, WORKING TOWARD A NEW PARADIGM, IN “PROGRESSIVE CORPORATE LAW” 38 (Lawrence E. Mitchell ed., Westview Press 1995). Furthermore, there is a high chance in receiving the same answer from most stakeholders if they, too, were asked the same question.

²⁵ Some scholars name the contract approach the contract theory or contract model. Likewise, Professor Hamilton has noted that “[i]t is not clear whether the nexus of contracts model should be viewed as essentially normative, or as descriptive, or as both. Its proponents have used it in both contexts.” ROBERT W. HAMILTON, THE LAW OF CORPORATIONS IN A NUTSHELL 58 (5th ed. 2000).

²⁶ FRANK EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 8 (1991).

an entity separate from its stakeholders “but rather a nexus or web of explicit and implicit contracting establishing rights and obligations among the various inputs making up the firm.”²⁷

The nexus of contracts approach does not accept the ownership theory of the corporation. Instead, the shareholders are just a party to multi-contractual relationships among many stakeholders.²⁸ Shareholders, thus, are just “[i]nvestors (who) bear the risk of failure ... and receive the marginal rewards of success.”²⁹ Moreover, an investor is called the “residual” claimant because he only gets “what is left over” after creditors have been paid.³⁰

Nonetheless, “[c]ontract law” is the basis for viewing the “corporation” as a nexus of contracts³¹ yet the meaning of nexus of contract “is not self-explanatory,”³² especially in regard to “what a corporate nexus is supposed to be.”³³ In fact, the meaning of a contract under this approach is very broad, differing from its meaning in the contract law context. Professor Bainbridge described this by noting:

The name ‘nexus of contracts,’ is somewhat unfortunate ... the term carries ... two Hi okay. problematic features. First is the focus on legal notions such as consideration and mutuality. Second, the paradigm seems to be on transactions on markets that are thick and relatively untroubled by asymmetries.³⁴

²⁷ BAINBRIDGE, *supra* note 4, at 27.

²⁸ *Id.* at 28.

²⁹ EASTERBROOK & FISCHER, *supra* note 26, at 10–11.

³⁰ *Id.* at 11.

³¹ PINTO & BRANSON, *supra* note 14, at 104.

³² William W. Bratton, Jr., *The “Nexus of Contracts” Corporation: A Critical Appraisal*, 4 CORNELL L. REV. 407, 412 (1989).

³³ *Id.*

³⁴ BAINBRIDGE, *supra* note 4, at 27.

For example, under this approach stockholders and bondholders are regarded as contracting parties, despite any trace of legal intent to contract with each others.³⁵ Based on that, the only variations between the shareholder and the creditor are the provisions of their agreements.³⁶ However, under this theory, a stockholder is in a more endangered position than other stakeholders, such as creditors, because the former are merely “residual” claimants of corporate “profits” but the latter are entitled to a predetermined “return.”³⁷

The proponents of this approach argue that “[t]he role of corporate law ... is to adopt a background term that prevails unless varied by contract. And the background term should be the one that is either picked by contract expressly or is the operational assumption of successful firms.”³⁸ In other words, under this theory, corporate law should contain default rules only, not mandatory ones.³⁹ In the proponents’ opinion, “corporate law is a set of terms available off-the-rack so that corporate ventures can save the cost contracting.”⁴⁰ Therefore, it is more efficient for contracting sides not to “bother with excessive negotiations; they can be confident that, if some unanticipated event were to occur, the law ensures a reasonable outcome.”⁴¹

However, opponents disagree with the nexus of contracts approach because its proponents disregard shareholders’ lack of bargaining power in a separated ownership and control pattern.⁴² Under a diluted ownership pattern, shareholders do not have the ability to tailor

³⁵ *Id.* at 28.

³⁶ Velasco, *supra* note 6, at 407, 443.

³⁷ *Id.*

³⁸ EASTERBROOK & FISCHER, *supra* note 26, at 36.

³⁹ Velasco, *supra* note 6, at 407, 445.

⁴⁰ EASTERBROOK & FISCHER, *supra* note 26, at 34.

⁴¹ Velasco, *supra* note 6, at 407, 445.

⁴² PINTO & BRANSON, *supra* note 14, at 104.

default rules to their best interests. The lack of bargaining power is not confined to shareholders: other stakeholders do not have any mechanism whatsoever to participate in the corporate decision-making paradigm. The default rule model does not always serve the interest of either shareholders or other stakeholders.

In addition, it has been noted that not all corporate rules are default rules: some of them are “mandatory.”⁴³ Mandatory rules should not be remolded to be default rules because as Professor Douglas Branson indicated, “[t]here must be standard terms that can protect the weaker party who negotiated badly or to protect the minority from being contracted out of existence (steamrolled) by the majority.”⁴⁴ Some legal scholars go further by arguing that “[e]limination of all mandatory rules would certainly create the likelihood of much greater fraud than occurs today.”⁴⁵ Keeping some mandatory rules is good public policy; however, mandatory rules must be restricted unless the non-mandatory provisions obviously cause a sphere of “negative externalities.”⁴⁶ An example of this would be the statutory right of appraisal which is intended to protect minority shareholders from being ripped-off (cheated) by the majority shareholders, especially at the time of merger or acquisition.⁴⁷

⁴³ Douglas M. Branson, *The Death of Contractarianism and the Vindication of Structure and Authority in Corporate Governance and Corporate Law*, in PROGRESSIVE CORPORATE LAW 95 (Lawrence E. Mitchell ed., 1995).

⁴⁴ Branson, *supra* note 43, at 94 (Professor Branson relied on comparative to support this argument by providing that “[e]verywhere in the world company law is moving toward mandatory structure ... for corporations); *id.* at 95, 95

⁴⁵ HAMILTON, *supra* note 25, at 60.

⁴⁶ BAINBRIDGE, *supra* note 4, at 32.

⁴⁷ See, for example, the Model Business Corporate Act (MBCA) § 13.02(a) which provides that “[a] shareholder is entitled to appraisal rights, and to obtain payment of the fair value of that shareholder’s shares...”

Regardless of the rejection of some scholars of the Nexus of Contract Approach, it remains the dominant theory of the “legal academy.”⁴⁸ Moreover, it has been noted that discussion over this approach has ended not because of the invalidity of other points of view but, as Professor Bainbridge articulated, it “has been fully played out.”⁴⁹ Therefore, the focus of proponents of this theory should shift to “using it as heuristic for exploring the nooks and crannies of corporate law.”⁵⁰

4.2.3 Entity Theory

Under this theory, the corporation is neither an aggregate of co-owners nor a nexus of contracts: it is an independent organization that is not real but “artificial.”⁵¹ This artificial entity is responsible for its liabilities, not the stockholders.⁵² The stakeholders do not have a direct legal relationship with each other, but each of them has his own “contract” with this artificial person.⁵³ In fact, the principal independent personality is rooted in “Anglo – American” corporate

⁴⁸ BAINBRIDGE, *supra* note 4, at 33. Professor Bainbridge foresaw that the nexus of contracts approach “is steadily working its way into judicial decision-making.” *Id.* Justice Veasey believes that: “[a]lthough the contract analogy is imperfect, it comes reasonably close to a working hypothesis. I think court might consider using as a point of departure – but not necessarily a controlling principle – what they perceive to be the investors’ reasonable contractual expectations.” (footnote omitted); E. Norman Veasey, *An Economic Rationale for Judicial Decision-making in Corporate Law*, 53 BUS. LAW. 681, 684 (1998). In addition, Professor Hamilton noted “that most teachers of corporation law today accept it as a useful approach in evaluating legal principles, and some certainly accept it as an appropriate normative model for corporation law.” HAMILTON, *supra* note 25, at 61.

⁴⁹ BAINBRIDGE, *supra* note 4, at 31. Also, he said (“Contractarians and noncontractarians no longer have much of interest to say to one another; indeed, they barely speak the same language”); *id.*

⁵⁰ BAINBRIDGE, *supra* note 4, at 31–32.

⁵¹ HAMILTON, *supra* note 25, at 46.

⁵² *Id.* at 47.

⁵³ STEPHEN M. BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE* 25 (2008).

legislation. It is interesting, however, that no corporate law of Anglo – American countries provides clearly that the corporation is only responsible for its debt and not its stockholders.⁵⁴

This independent artificial personality has only acquired a “privilege,” “concession,” “franchise,” or “grant” from the state that permits the owners and investors to conduct business as a corporation.”⁵⁵ It is settled in Anglo – American legal practice that people do not have the ability to form a “corporation” on their own.⁵⁶ State enfranchisement or approval is always necessary but, modern general corporation statutes have become a ministerial act. In any event, under the worse scenario, “[a] corporation, at least its legal form, is a creation of the state.”⁵⁷

Nonetheless, the personality of a corporation is not real but rather a mere legal “fiction,” recognized in the eyes of the law.⁵⁸ However that fiction may be practical.⁵⁹ It is difficult to imagine the conduct of huge “business” projects, or even may be similar ones, without using a corporation,⁶⁰ not for limited liability but for other purposes as well. Professor Bainbridge provides an example for the utility of the legal personality of the corporation where stating:

Consider a large forestry company, owning forest land in many states. If the company were required to list all of its owners – i.e., every shareholder – on every deed recorded in every county in which it owned property, and also had to amend those filings every time a shareholder sold stock, there would be an intolerable burden not only to the firm but also on government agencies that deal with the firm.⁶¹

⁵⁴ HAMILTON, *supra* note 25, at 47.

⁵⁵ *Id.* at 50.

⁵⁶ Larry D. Soderquist & A.A. Sommer Jr., *Understanding Corporation Law*, Practising Law Institute, New York City, 2 (1990).

⁵⁷ *Id.*

⁵⁸ BAINBRIDGE, *supra* note 4, at 7.

⁵⁹ *See id.*

⁶⁰ BAINBRIDGE, *supra* note 53.

⁶¹ BAINBRIDGE, *supra* note 4, at 7 (footnote omitted).

Some scholars contend that the entity theory is “unrealistic”⁶² and that “an artificial entity has no will of its own and no arms, legs, mouth, or eyes that permit it to take action.”⁶³ On the other hand, a “more realistic view, [is] that a corporation is but a group of individuals associated under legal sanction, eliminate[ing] the difficulties arising from the alleged difference between the physical characteristics of an individual and the nonphysical charter of a corporation.”⁶⁴ In any event, it is not clear from this position why the law should be prohibited from permitting the creation of such an artificial useful form of business.⁶⁵

In the end, the entity theory provides an “explanation of what a corporation ... is.”⁶⁶ Clearly, the entity theory provides justification for the concept of limited liability, namely that, a separate juridical person should be liable for its own debts.⁶⁷ In addition, Professor Hamilton notes that “the artificial entity concept gives no indication of the goals or objectives of a corporation. It does not address the role of corporations in modern society or the complex interrelationships of persons who participate in, profit from, or are affected by, the corporation.”⁶⁸ Also, this theory plays a role in the facilitation of doing business which of course “will enhance the economic productivity of the corporation.”⁶⁹ However, an artificial entity is a

⁶² HAMILTON, *supra* note 25, at 48–49.

⁶³ *Id.*

⁶⁴ ROBERT S. STEVENS, HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS 52 (1936).

⁶⁵ This artificial person enjoys many constitutional rights, such as citizenship and liberty, which in fact were historically intended to be for human beings. *See generally* JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS 4–6 (2d ed. 2003).

⁶⁶ HAMILTON, *supra* note 25, at 52.

⁶⁷ It is important to note that limited liability does not mean no liability. Investors (shareholders) contributed to the corporation but, because of limited liability, the risk will not extend to their personal assets. See chapter three.

⁶⁸ HAMILTON, *supra* note 25, at 50.

⁶⁹ Allen, *supra* note 2, at 261, 272.

creature of law, useful as a legal concept, not an economic one, as in economics such a notion does not exist.⁷⁰

4.2.4 Team Production Theory

Professors Blair and Stout provide legal literature with a new school of thought regarding the nature of the publicly traded corporation : the Team Production Theory.⁷¹ In fact, the Team Production Theory is well known in economic literature where it laid the foundation for Professors Blair and Stout to build their legal theory.⁷² The Team Production Theory provides an explanation of the tendency for people to form a corporation to conduct business as follows:

[A] number of individuals come together to undertake a team production project that requires all to make some form of enterprise – specific investment. Perhaps one individual brings critical technical skills to the table, while another has a talent for management, and a third provides marketing insights. They may lack financial capital, however, so they seek out wealthy friends or family members to put up initial funding. Thus, a team is born. Undertaking team production, however, requires each of the members to make irrevocable investments that leave them vulnerable to opportunistic exploitation by other team members Despite their mutual vulnerabilities, the team members expect for the most part to be able to get along with each other and figure out how to allocate tasks and divide up rewards as they go. When disputes arise, however, they want a decision making procedure in place that all believe will be fair. The solution? They form a public corporation.⁷³

According to this theory, a “public corporation is a team of people who enter into a complex agreement to work together for their mutual gain. Participants – including shareholders,

⁷⁰ BAINBRIDGE, *supra* note 4, at 8.

⁷¹ Blair & Stout, *supra* note 16, at 247.

⁷² See Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 779–81 (1972).

⁷³ Blair & Stout, *supra* note 16, at 276.

employees, and perhaps other stakeholders such as creditors or the local community – enter into a ‘*pactum subjectionis*’.”⁷⁴ Therefore, a corporation is not just a “bundle of assets” owned in aggregate by shareholders⁷⁵ but a bundle of efforts presented by a group of persons for their mutual benefit. Accordingly, the Team Production Theory negates ownership of the corporation for one member of the team: the shareholders. Thus, the wealth of the corporation is the property of the firm.⁷⁶

Professors Margaret M. Blair and Lynn A. Stout argue that “public corporation law can be best explained in terms of the mediating hierarchy model.”⁷⁷ Under this model, “team members relinquish important rights (including property rights over the team’s joint output and over team inputs such as financial capital and firm-specific human capital) to a legal entity created by the act of incorporation.”⁷⁸ Under this model, the board of directors is not an “agent” of the stockholders but rather “[l]ike trustees ... once [directors] elected, become the ultimate decision-making authority within the firm, constrained primarily by their fiduciary duties.”⁷⁹

In addition, this unique model “eliminates the role of the principal, imposing in its place an internal governance structure – the mediating hierarchy – designed to respond to the problem of horizontal coordination inherent in certain forms of team production.”⁸⁰ Thus, the idea of principal – agent is not part of this model because no stakeholders – including shareholders and

⁷⁴ *Id.* at 247, 279. *But see* BAINBRIDGE, *supra* note 53, at 61 (arguing “firm-specific investments are not the defining characteristic of team production. Rather, the critical feature of team production is task nonseparability”).

⁷⁵ Blair & Stout, *supra* note 16, at 279.

⁷⁶ *Id.* at 250–51.

⁷⁷ *Id.* at 287.

⁷⁸ *Id.* at 250.

⁷⁹ *Id.* at 291.

⁸⁰ Blair & Stout, *supra* note 16, at 265.

the board of directors – have the power to exert “control” over the other “team” members (stakeholders).⁸¹ Therefore, the model conceives of shareholders voting and the right to initiate derivative litigation merely means that the corporation grants this right to shareholders “because they often are in the best position to represent the interests of the coalition that comprises the firm.”⁸²

However, Professor David Millon disagrees with justification of granting shareholders voting rights under the Team Production Theory when he says

In any of these cases, the shareholders’ monopoly over the franchise cannot be justified in terms of nonshareholder interests; if corporate law were committed equally to all the members of the team, either all affected parties would have a right of approval or no one would. At the very least, under a TPM-based conception of the board’s role, one might expect the board to have the power and the duty to veto shareholders’ decisions that harm nonshareholder constituencies.⁸³

Another criticism of the theory is that the idea of the board of directors as an “independent hierarchy” is not compatible with the legal entitlement of shareholders to have voting rights, a mechanism which affects the alleged independence of the board (the hierarchy).⁸⁴

In addition, opponents of the Team Production Theory criticized the theory’s description of the publicly traded corporations as one “team” where in fact it is “a hierarchy of teams.”⁸⁵ For example, worker, executive, and directors are different teams working inside and for the corporation.

⁸¹ *Id.* at 277.

⁸² *Id.* at 289.

⁸³ David Millon, *New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001, 1019 (2000).

⁸⁴ *See id.* at 1001, 1020.

⁸⁵ BAINBRIDGE, *supra* note 53, at 61.

In sum, four main theories shape the debate over the nature of interests in the publicly traded corporation. The first one is the traditional theory which regards the company as a property of the shareholders and the directors as agents of the principals (shareholders). The second theory, the contract theory, views the company as a web of contracts between different stakeholders. The third theory is the entity or the concession theory where the corporation is regarded as a fiction created by a government act. The last theory is the Team Production Theory which visualizes the corporation as aggregate inputs from all stakeholders. Not one of the aforementioned theories provides a full account of the true nature of the publicly traded corporation but each of them articulates a valid stance that might be taken into consideration when trying to answer the question “What is a public corporation?”

4.3 THE OBJECTIVE OF THE PUBLICLY TRADED CORPORATION

4.3.1 Shareholders Wealth Maximization

From a normative perspective, the American Law Institute’s Principles of Corporate Governance provides that “a corporation ... should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.”⁸⁶ “Most” corporate law scholars support the shareholders wealth maximization thesis.⁸⁷

In contrast, Principles of Corporate Governance states:

⁸⁶ PRINCIPLES OF CORPORATE GOVERNANCE § 2.01(a) (1994).

⁸⁷ See Millon, *supra* note 83, at 1003.

[T]hat the objective of the corporation is to conduct business activities with a view to enhancing corporate profit and shareholder gain – does not mean that the objective of the corporation must be realize corporate profit and shareholder gain in short run. Indeed, the contrary is true: long-run profitability and shareholder gain are at the core of the economic objective. An orientation toward lawful, ethical and public-spirited activity will normally fall within this description. The modern corporation by its nature creates interdependencies with a variety of groups with whom the corporation has a legitimate concern, such as employees, customers, suppliers, and members of the communities in which the corporation operates. The long-term profitability of the corporation generally depends on meeting the fair expectations of such groups. Short-term profits may properly be subordinated to recognition that responsible maintenance of these interdependencies is likely to contribute to long-term corporate profit and shareholder gain.⁸⁸

Shareholder wealth maximization proponents base their argument on the fact that “shareholders are the residual claimants to the firm’s income.”⁸⁹ That means the shareholders “invest for the life of the firm and their claims are located at the end of queue should liquidation occur.”⁹⁰ They indeed lack bargaining power to defend their interests in the corporation. In defending shareholders wealth maximization, Professor Roberta Romano notes that “the board of directors ... principal purpose is to safeguard those who face a diffuse but significant risk of expropriation because the assets in question are numerous and ill defined, and cannot be protected in a well-focused, transaction-specific way. Thus regarded, the board of directors should be seen as a governance instrument of the stockholders.”⁹¹ Thus, the stockholders’ position is the weaker position in the corporation, which entitles them to special protection.⁹² The form of protection that is offered to them (shareholders) is the fiduciary duty which

⁸⁸ PRINCIPLES OF CORPORATE GOVERNANCE 55 (1994).

⁸⁹ EASTERBROOK & FISCHER, *supra* note 26, at 67.

⁹⁰ Oliver E. Williamson, *Corporate Governance*, FOUNDATION OF CORPORATE LAW 148, 159 (Roberta Romano ed., 1993).

⁹¹ *Id.*

⁹² Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 44 (1991).

Professor Romano described as a “device uniquely crafted to fill in the massive gap in this open-ended bargain between shareholders and corporate officers and directors.”⁹³

Besides the aforementioned basis for control purposes, efficiency militates toward having one ultimate beneficiary. In support of this claim, Professor Clark remarked that

A single objective goal like profit maximization is more easily monitored than a multiple, vaguely defined goal like the fair and reasonable accommodation of all affected interests. It is easier, for example, to tell if a corporate manager is doing what she is supposed to do than to tell if a university president is doing what she supposed to do. Assuming shareholders have some control mechanisms, better monitoring means that corporate managers will be kept more accountable. They are more likely to do what they are supposed to do and do it efficiently. Better accountability thus encourages people to participate in large corporations....⁹⁴

On the other hand, workers, creditors and other stakeholders have fixed claims⁹⁵ on the corporation by which they have the ability to “draft contracts that protect them against the consequences of future, unforeseen contingencies.”⁹⁶ In addition, they could “renegotiate terms when contracts are renewed”⁹⁷ whenever they think more protection is needed or better treatment is justified.

Therefore, nonshareholder constituencies should remain fixed claimants instead of being residual claimants (shareholders).⁹⁸ Protection should be provided to only shareholders who are willing to pay for those non-shareholder constituencies who are “unwilling to pay for such

⁹³ *Id.* at 41.

⁹⁴ ROBERT CHARLES CLARK, CORPORATE LAW 20 (1986).

⁹⁵ See EASTERBROOK & FISCHER, *supra* note 26, at 67.

⁹⁶ Macey, *supra* note 92, at 40.

⁹⁷ Williamson, *supra* note 90.

⁹⁸ Macey, *supra* note 92, at 36.

protection in the form of lower wages or lower interest rates on debt” as Professor Macey argued.⁹⁹

Moreover, the extension of the fiduciary duty to non-shareholder constituencies beyond the existing legal scope is contradictory to the intended function of “fiduciary duties,”¹⁰⁰ which mainly aim “to fill in the massive gap in this open-ended bargain between shareholders and corporate officers and directors.”¹⁰¹

In the end, fiduciary duty is a gap-filling device that should only be available to the parties of an incomplete contract, which usually are the shareholders. If in the future other non-shareholder constituencies are willing to become non-fixed claimants like shareholders, they will have at that time valid grounds to be included within the scope of protection of the fiduciary duty of shareholder wealth maximization. Other than that, this fiduciary duty as it is should be upheld and be kept as an integral part of the corporate structure. If not, the board of directors could “easily pursue their own agenda, one that might maximize neither shareholder, employee, consumer, nor national wealth, but only their own,”¹⁰² as Professor Mark Roe asserts.

⁹⁹ *Id.*

¹⁰⁰ *Id.* at 41.

¹⁰¹ *Id.*

¹⁰² Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065 (2001).

4.3.2 Stakeholders welfare maximization

Although the shareholder wealth maximization principle dominates American legal practice,¹⁰³ there are serious efforts to challenge this principle by making corporate management more concerned about non-shareholder constituencies of the publicly traded corporation . In its modern form, this effort has developed into a debate between two law professors (Adolf Berle and Merrick Dodd) who mainly focused on defining the real function of the publicly traded corporation . From one side Professor Adolf Berle argued that the corporation is a wealth generating machine for its shareholders.¹⁰⁴ On the other side of the debate, Professor Merrick Dodd, asserted other functions of the publicly traded corporation besides making profits for its shareholder: serving the non-shareholder constituencies.¹⁰⁵

This 1930's debate became heated again in the wake of the massive takeover trend of the "1980's"¹⁰⁶ by jurists called "communitarians."¹⁰⁷ The communitarians'¹⁰⁸ main goal was to

¹⁰³ See Cynthia A. Williams, *Corporate Social Responsibility in an Era of Economic Globalization*, in CORPORATE GOVERNANCE LAW, THEORY AND POLICY 30, 30 (Thomas W. Joo ed., 2004), where she noted that "consensus suggests that corporations have no specific social responsibilities beyond profit maximizing for the benefit of shareholders, but that such profit maximizing must occur within the confines of the law, without deception or collusion."

¹⁰⁴ See Adolf Berle, *For Whom Corporate Managers Are Trustees*, 45 HARV. L. REV. 1365 (1932).

¹⁰⁵ See E. Merrick Dodd, Jr., *For Whom Are Corporate Mangers Trustees?*, 45 HARV. L. REV. 1145 (1932).

¹⁰⁶ David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, in PROGRESSIVE CORPORATE LAW 1, 2 (Lawrence E. Mitchell ed., 1995).

¹⁰⁷ *Id.* at 1 (Professor Millon says that "[t]hose scholars who challenged the shareholder primacy principle may be referred to as communitarians, because ... their work focuses on the sociological and moral phenomenon of the corporation as community, in contrast academic discourse in corporate law"). *Id.*

¹⁰⁸ This theory also called progressive theory.

challenge the shareholder wealth maximization principle¹⁰⁹ because they believed adhering to this principle leads to a negative impact on stakeholders.¹¹⁰

Professor David Millon argues that stakeholders have made “nontransferable investments of human and financial capital in the reasonable expectation of a continued, long term corporate relationship.”¹¹¹ Not only do the shareholders contribute to the corporation and are the beneficiaries from corporate “success,” but also other stakeholders share the same goal¹¹² and provide similar contributions. In many cases, the success of a corporation matters more to non-constituency shareholders than it does to the shareholders.¹¹³ For example, creditors furnish money to needed firms.¹¹⁴ This money in many cases is the real financial cornerstone that makes a business succeed. Workers also provide “human capital.”¹¹⁵ Workers, contribution is valuable due to the unique talents and skills of the workers which enable the corporation to operate and to compete in the open markets. The society as a whole, in some ways, has also contributed to the corporation.¹¹⁶ Many societies bear the harmful consequences of accepting certain types of

¹⁰⁹ Millon, *supra* note 106, at 1.

¹¹⁰ *Id.*

¹¹¹ *Id.* at 2.

¹¹² Blair & Stout, *supra* note 16, at 250. Also, Professor Karmel says that “[t]he stakeholder model is premised on the theory that groups in addition to shareholders have claims on a corporation’s assets and earnings because those groups contribute to a corporation’s capital.” Roberta Karmel, *Implications of the Stakeholder Model*, 61 GEO. WASH. L. REV. 1156, 1172 (1993).

¹¹³ Shareholders in publicly held corporations usually diversify their investments in order to reduce their risk. Therefore, the failing of the corporation is just going to cause a relatively smaller effect on shareholders; however, this not so for other non-shareholder constituencies such as employees who could not diversify due to the nature of their input in the firm.

¹¹⁴ Karmel, *supra* note 112, at 1171.

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 1172.

corporations operating within their borders. For instance, the harmful emissions that a steel plant produces, negatively affect the health of the people living in the surrounding community.¹¹⁷

Based on the above, the fiduciary duty of a board of directors should accommodate all stakeholders, not just the shareholders.¹¹⁸ Clearly, such expansion will lead to a “rich foundation of mutual trust and interdependence” between all stakeholders including shareholders.¹¹⁹ In addition, a board of directors should reconcile all stakeholders “interests,” including the stockholders if a contradiction arises between stakeholder groups.¹²⁰ Directors should choose a “solution” that completely “compensates non-shareholders for their losses.”¹²¹ The only proper way to achieve this goal is to modify the existing laws to grant the stakeholders a protection.¹²²

However, many scholars take issue with the communitarian point of view. They advocate the shareholder wealth maximization principle, either under the traditional view or, the law and economics view (contractarian). They do not countenance communitarian ideas because traditionalists as well as contractarians are afraid that the adopting stakeholder’s welfare maximization principle, as communitarians propose it, may lead to the reduction of the “profitability” of the corporation.¹²³

¹¹⁷ Economists called this negative effect “external cost” or “externality.” For detailed discussion of the external cost, see Ronald Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1–44 (1960).

¹¹⁸ Millon, *supra* note 106, at 12.

¹¹⁹ *Id.* at 4.

¹²⁰ *Id.* at 12.

¹²¹ *Id.*

¹²² *Id.* at 11.

¹²³ PINTO & BRANSON, *supra* note 14, at 19.

Professor Milton Friedman is opponent of the stakeholder welfare maximization principle in that he asserts that stakeholder wealth maximization is a form of “socialism.”¹²⁴ He argues:

In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desire, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.¹²⁵

Therefore, allowing a board of directors to maximize the welfare of a stakeholder is regarded in his point of view as a “spending [of] someone else’s money for a general social interest.”¹²⁶

In addition, contractarians philosophically disagree with the expansion of the fiduciary duty to non-shareholder constituencies because this expansion contradicts their view of the nature of a publicly traded corporation, which consists of a web of explicit and implicit contracts by which the only right of non-shareholder constituencies is that for which they contracted.¹²⁷

In fact, the real problem with the expansion of fiduciary duty, as the communitarians approach it, that is expanded duties will place non-shareholder constituencies in a much better position over shareholders because they will have both what they contracted for and the protection of fiduciary duty. This communitarian thesis might have appeal but only in situations in which most of non-shareholder constituencies’ compensation is not based on a fixed contractual return but rather depends on the corporation’s performance and profitability.

¹²⁴ Friedman, *supra* note 9.

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ EASTERBROOK & FISCHER, *supra* note 26, at 36.

4.4 THE CONTROL OF THE PUBLICLY TRADED CORPORATION ¹²⁸

4.4.1 Separation of Ownership and Control

4.4.1.1 Introduction

Two centuries ago, only a few partners or shareholders held control of enterprises and those people directly or indirectly directed the enterprise's business affairs.¹²⁹ However, development led to an accumulation of great wealth and labor which "combined through the corporate mechanism into a single producing organization under unified control and management."¹³⁰

In their famous work,¹³¹ "The Modern Corporation and Private Property," Adolf Berle and Gardner Means noted that "in the corporate system, the "owner" of industrial wealth is left

¹²⁸ Part IV discusses control in the traditional vertical structure of publicly held corporations that follow traditional firm theory; whereas Professor Ronald Coase said in his seminal work that the firm exists to reduce costs by accumulating all production required inputs in one device which is the firm. R.H. COASE, THE NATURE OF THE FIRM, *ECONOMICA*, New Series, vol. 4, No. 16, 387–405 (Nov. 1937). But, the advancement of communication led recently to the possibility that more reductions of cost may happen by the desegregation of a firm's inputs into several firms in order to retain the core function of control to the main corporation. This new model of a horizontal structure of a corporation which is not based on Coase's master-servant model is called a virtual corporation. See Clair Moore Dickerson, *Spinning Out of Control: The Virtual Organization and Conflicting Governance Vectors*, 59 U. PITT. L. REV. 759, 762 (1998) (author claims a virtual corporation which reduces "costs simultaneously" and "makes the virtual organization difficult and cumbersome to govern").

¹²⁹ ADOLF A. BERLE JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 2 (1933).

¹³⁰ *Id.*

¹³¹ Although Berle and Means were not the first to recognize the separation of ownership and control in publicly held corporations; however, they did shed light on this matter. Historically, Adam Smith noted this problem in his seminal work:

The directors of such companies, however, being the manager rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. It is upon this account that joint stock companies ... have seldom been able to maintain the competition against private adventurers.

with a mere symbol of ownership while the power, the responsibility and the substance which have been an integral part of ownership in the past are being transferred to a separate group in whose hands lies control.”¹³² This pattern is known as the “separation of ownership and control” in publicly traded corporations that has caused the “diffusion” of ownership among so many stockholders.¹³³ In other words, the persons who own property, stockholders, no longer control that property but the board of directors and managers they (shareholders) appoint, do. In fact, separation of ownership and control is an important factor for the ability of a corporation to gather a huge amount of wealth.¹³⁴

Also, it has been asserted that “as the ownership of corporate wealth has become more widely dispersed, ownership of that wealth and control over it have come to lie less and less in the same hands.”¹³⁵ Berle and Means noted that “[t]he separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge.”¹³⁶

ADAM SMITH, *THE WEALTH OF NATIONS* 941 (Bantam Classic ed. 2003).

¹³² BERLE & MEANS, *supra* note 129, at 68.

¹³³ *Id.* at 52.

¹³⁴ *Id.* at 5. An independent board of directors is an important feature of every publicly held corporation. For as Professors Blair and Stout said:

[a]n independent board is one of the most important characteristics distinguishing public corporations from other forms enterprise. Limited partnerships, limited liability companies (“LLCs”), and closely held corporations all limit investors’ liability without requiring them to do business through a board; partnerships, LLCs and private firm provide vehicles for collective investment, sometimes with free transferability of shares; private corporate and some limited partnerships enjoy perpetual ability existence; and virtually all forms of enterprise permit their owners to delegate the day-to-day management of the firm to hired professional.

Blair & Stout, *supra* note 16, at 253 n.9.

¹³⁵ BERLE & MEANS, *supra* note 129, at 69.

¹³⁶ *Id.* at 5.

4.4.1.2 Patterns of Control

Berle and Means categorize corporations based on their pattern of separation of ownership and control as follows:

- **Control through almost complete ownership** whereby one person or a few persons own the shares of the corporation, meaning that this person or those few people are the owners and the controllers of the business.¹³⁷ In this case, there is no separation of ownership and control.¹³⁸
- **Majority control** is when a majority of the shares are held by one person or a few persons, and these shares entitle this person or persons to control the affairs of the corporation, for instance, electing a board of directors, changing bylaws, and approving of any other task corporate law has mandated for shareholders. In this case, the majority has at least 50% of the corporation's shares. In fact, although the decision still rests in the hands of the majority controlling shareholders, there is a separation of ownership and control due to lack of complete control of the business affairs."¹³⁹
- **Control through a legal device without majority ownership** is an old pattern of ownership in which a control exists though a voting trust or a pooling agreement. Thus, the control is a result of a legal mechanism not due to economic ownership pattern.
- **Minority control** is a situation in which one or a few persons own shares that do not entitle them to the majority control of the corporation. In fact, this group has control due to a coalition that has been created among themselves, on the one hand, and diffusion of

¹³⁷ *Id.* at 70.

¹³⁸ State owned corporations are prominent examples of this pattern where no separation and control exists.

¹³⁹ BERLE & MEANS, *supra* note 129, at 17.

the majority of other shares, on the other hand.¹⁴⁰ In large corporations, such minority coalitions controlling the corporation are fragile due to the communication difficulties between large numbers of shareholders.”¹⁴¹

- **Management control** is the situation in which shares are widely dispersed among so many shareholders that neither a majority nor a minority control exists. In this case, the board of directors is in the position of directing the corporation while the shareholders hands are tied completely from practicing their limited role in corporate governance.¹⁴²

4.4.1.3 Agency Problem

The divergence problem that stems from the separation of ownership from control is called the agency cost problem.¹⁴³ Agency cost is “the sum of ... monitoring expenditures by the principal ... [,] the bonding expenditures by the agent,[and] ... residual loss.”¹⁴⁴ For example, a hotdog seller in the corner of a street does not have agency costs because he prepares and sells the hotdogs alone. If this person decides to open his own hotdog shop and hires three people, for instance, to help him, he will have a slight agency cost. The agency costs will increase if he (the hotdog seller) decides to form a corporation to open three other hotdog shops. Moreover, he will

¹⁴⁰ *Id.* at 80.

¹⁴¹ *Id.* Often referred to this patten as “working control.”

¹⁴² *Id.* at 84.

¹⁴³ Some economists see the relation between shareholders and board of directors as an agency relationship. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Cost and Ownership Structure*, 3 J. FIN. ECON. 305, 5 (1976). However, corporate law does not regard the relationship between shareholders and directors as an agency relation but a fiduciary one. Also, it is worth noting that many scholars argued to the contrary of Berle and Means’ thesis that separation of ownership and control is not an issue but a virtue: “diffusion and separation of decision management and control have survival value in complex organizations both because they allow valuable specific knowledge to used at the points in the decision process where it is most relevant and because they help control the agency problems of diffuse residual claims.” Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 323 (1983).

¹⁴⁴ Jensen & Meckling, *supra* note 143, at 5–6.

bear more agency costs if he goes public with his hotdogs corporation where the diverse owners elect a board of directors to manage the corporate affairs. In other words, the more the owner delegates or loses control of his corporation, the more the agency costs become.

Thus, stockholders, as risk bearer, should play the final monitoring role of the corporation because the reduction of agency costs is combined with their benefits. However, the problem with this solution is that stockholders are usually not willing to assume such roles and – even if they wanted to – corporate law and their lack of knowledge will prevent them.¹⁴⁵ In other words, they are “rationally apathetic.”¹⁴⁶

However, modern corporate governance literature has revealed that the dispersed ownership model of ownership is an exception to the norm (the concentrated ownership model).¹⁴⁷ The concentrated ownership model exists in all developing countries and many developed countries as well, such as France, Germany, and Italy.¹⁴⁸ In the concentrated model, agency costs are not caused by the independence of the corporate directors and key executives for shareholders supervision but rather by the controlling shareholders and their appointed board of directors.¹⁴⁹ Truly, constitutional design of the corporation decision making system normally confined shareholders’ decision making power to just extraordinary matters. However, shareholders’ *de facto* economic power in the concentrated model shifted this paradigm for

¹⁴⁵ Bainbridge, *supra* note 4, at 37.

¹⁴⁶ See CLARK, *supra* note 94, at 390–92.

¹⁴⁷ See Florencio Lopez de Silanes, Rafael La Porta & Andrei Shleifer, *Corporate Ownership Around the World*, 54:2 J. FINANCE 471–517 (1999).

¹⁴⁸ For empirical evidence that indicates concentrated ownership pattern is the dominant ownership pattern around the world, see de Silanes et al., *supra* note 147.

¹⁴⁹ See generally Julian Franks & Colin Mayer, *Corporate Ownership and Control in the U.K., Germany, and France*, vol. 9.4 J. OF APPLIED CORPORATE FINANCE (1997).

directors to their benefits.¹⁵⁰ Accordingly, (majority) shareholders direct the company's affairs from behind the scenes through dummy directors whom they appoint and remove at any time. This scenario opens a wide door for controlling shareholders to seize most of the company benefits for themselves, at the expense of minority shareholders who are entitled to share some financial benefits of the company based on their investment.¹⁵¹ Thus, and in contrast to the dispersed ownership model, the concentrated model of ownership agency problem is between the shareholders themselves: the controlling majority shareholders v. minority shareholders.¹⁵²

4.5 CONCLUSION

The first part of this chapter summarized and commented upon various theories of the publicly traded corporation : the traditional theory, the nexus of contract theory, the entity theory and the team production theory. Clearly, each theory has advantages and disadvantages; however, the claim of the traditional theory that shareholders are the owners of the corporation is no longer plausible under the law and practice. The nexus of contract theory, which describes shareholders as residual claimants, is closer to reality. The last part was devoted for the discussion of

¹⁵⁰ In other words, I believe that a joint stock company drafter historically drafted the provision of such a company with one idea in mind: that is no shareholder(s) may have a controlling share of any public company due to the huge amount of capital required to be established when such company operations were limited public interest mega projects. Also, the drafter may have thought that the small investors of public companies would work together diligently to achieve their mutual interests.

¹⁵¹ See generally Debra A. DeMott, *Agency Principles and Large Block Shareholders*, 19 CARDOZO L. REV. 321 (1997–1998).

¹⁵² CORPORATE GOVERNANCE: A FRAMEWORK FOR IMPLEMENTATION VI, at 33 (Magdi R. Iskander & Nadereh Chamlou eds., World Bank Group 2000).

ownership and control and agency problem in dispersed ownership system and concentrated system.

5.0 ISLAM AND CORPORATE GOVERNANCE

5.1 INTRODUCTION

Modern corporate governance is about managing the corporation efficiently by increasing its beneficiaries' value and reducing agency costs. The corporate governance culture of any society reflects the ideological foundation of that society. In modern states, corporate governance principles would be found in legislation (binding rules) or in ethical codes observed by that society (non-binding norms). This categorization of sources fits perfectly with corporate governance principles in secular states.¹ In such systems, ethics are generally considered to be non-binding standards, merely containing a moral obligation recognized by the society. In other words, ethics have no legal obligation that could be enforced directly in the court of law.²

Conversely, Islam is a holistic system that does not differentiate between law and ethical non-binding morals.³ Mervyn Lewis noted:

The New Testament injunction to render unto Caesar the things which are Caesar's, and unto God the things that are God's, has led to a divergence in the

¹ A secular state refers to the state that separates religious affairs from the public sphere. The degree of separation varies from one country to the other. For different patterns of secularisms, see generally CHARLES TAYLOR, *MODELS OF SECULARISMS*, IN *SECULARISM AND ITS CRITICS* 32, 32–53 (Rajeev Bhargava eds., 1998).

² The word "ethics" comes from the Greek word "ethos," which means in western literature "what is appropriate and rational." Ataulloh Siddiqui, *Ethics in Islam: Key Concept and Contemporary Challenges*, 26 *J. MORAL EDUC.* 423, 423 (1997) (quotation omitted).

³ See Mervyn K. Lewis, *Islamic Corporate Governance*, 9 *REV. ISLAMIC ECON.* 5, 14 (2005).

West between sacred and secular that is anathema to Islam. In Islam, the realms of God and Caesar are not separate jurisdictions.⁴

Moreover, ethics in secular systems are extracted from “human reason” and practice, and disregarding “the role of faith,” while “religious ethics draw its resources from revelation.”⁵ Therefore, Muslims are obligated to integrate Islam into their all their life’s endeavors.⁶ Hence, Islam, as a holistic nature, “contain[s] a number of basic principles that may be applicable to the conduct of corporate affairs,”⁷ and interacts with modern corporate governance.

5.2 PRINCIPLES OF CORPORATE GOVERNANCE IN ISLAM

5.2.1 Social Responsibility

5.2.1.1 Islamic Perspective on Social Responsibility

Muslims believe in the unity of God under which “there is no God but Allah.”⁸ Allah created the universe including our planet and all living creatures.⁹ Allah is the true owner of everything in

⁴ *Id.*

⁵ Siddiqui, *supra* note 2.

⁶ *See* Lewis, *supra* note 3.

⁷ Abdul Rahim Abdul Rahman, *An Islamic Perspective of Corporate Accountability and Morality*, 4 GADJAH MADA INT’L J. BUS. vol. 1, 121 (2002).

⁸ See the Koran which provides that: “Say: He is Allah, the One! (1) Allah, the eternally Besought of all! (2) He begetteth not nor was begotten. (3) And there is none comparable unto Him. (4)” (Koran: Surat Al-Ikhlās, verses 1–4).

⁹ The Koran provides that:

Lo! your Lord is Allah Who created the heavens and the earth in six Days, then He established Himself upon the Throne, directing all things. There is no intercessor (with Him) save after His permission. That is Allah, your Lord, so worship Him. Oh, will ye not remind?

this world as the Koran notes: “Say: Unto whom belongeth whatsoever is in the heavens and the earth? Say: Unto Allah.”¹⁰ Allah has full control over this universe:

Say (unto them, O Muhammad): Who provideth for you from the sky and the earth, or Who owneth hearing and sight; and Who bringeth forth the living from the dead and bringeth forth the dead from the living; and Who directeth the course? They will say: Allah. Then say: Will ye not then keep your duty (unto Him)?¹¹

At the end of the world, Allah will be the final inheritor of everything on this planet as noted in the Koran: “Lo! We Only, We inherit the earth and all who are thereon, and unto Us they are returned.”¹² Human beings are created by Allah and put on the earth as His “viceregents,” as the Koran reveals:

And when thy Lord said unto the angels: Lo! I am about to place a viceroy in the earth, they said: Wilt thou place therein one who will do harm therein and will shed blood, while we, we hymn Thy praise and sanctify Thee? He said: Surely I know that which ye know not.¹³

As viceroys, people are entrusted with the stewardship of the earth.¹⁴ People as stewards are not only entitled to the natural resources of the earth but also obliged to develop them.¹⁵ Also, people are expected to utilize earth’s resources efficiently:

“O Children of Adam! Look to your adornment at every place of worship, and eat and drink, but be not prodigal. Lo! He loveth not the prodigals.”¹⁶

(Koran: Surat Yunus, Verse number 3).

¹⁰ (Koran: Surat Al-Anaam, Verse number 12).

¹¹ (Koran: Surat Yunus, Verse number 31).

¹² (Koran: Surat Maryam, Verse number 40).

¹³ (Koran: Surat Al-Baqara, Verse number 30).

¹⁴ See Rahman, *supra* note 7, at 122.

¹⁵ The main mandate is to worship Allah as the Koran states: “I created the jinn and humankind only that they might worship Me.” (Koran: Surat Ada-Dhariyat, Verse number 56).

¹⁶ (Koran: Surat Al-Araf, Verse number 31).

Availability of a natural resource in great quantity does not justify wasteful consumption of that resource. In this regard, Prophet Mohammad ordered his companions to economize when using water for ablution by saying preserve the water “even if [they] are on the bank of a flowing river.”¹⁷

Islam adores a working and wealthy generation and recognizes its impact on people and the society. The Prophet Mohammad said, “Work for your worldly life as if you were going to live forever, but work for the life to come as if you were going to die tomorrow.”¹⁸ Businesses thus should not be driven simply by profit or gains, but act also for societal benefit,¹⁹ such as the conservation of natural resources and sustainability.

Islam also recognizes two mechanisms for redistribution of wealth.²⁰ The first one, *zakat* (alms), is a mandatory imposed taxation on every Muslim.²¹ *Zakat* spending channels are strictly prescribed in the Koran, which reflects a strong advocacy of social welfare promotion in Islam:

The alms are only for the poor and the needy, and those who collect them, and those whose hearts are to be reconciled, and to free the captives and the debtors, and for the cause of Allah, and (for) the wayfarer; a duty imposed by Allah. Allah is Knower, Wise.²²

The second mechanism is *sadagah* which refers to voluntarily charitable contributions. Islamic texts are full of encouragement for Muslims to contribute to others. The Koran reminds

¹⁷ Narrated by Ibn Majah (“The Prophet Mohammad went along one of his companions (Saad) “when he was performing ablution, and he [Prophet] said: ‘What is this extravagance?’ He [Saad] said: ‘Can there be any extravagance in ablution?’ He [Prophet] said: ‘Yes, even if you are on the bank of a flowing river.’”). *Id.*

¹⁸ Gillian Rice, *Islamic Ethics and Implications for Business*, 18 No. 4 J. BUS. ETHICS 345–58 (Feb. 1999).

¹⁹ See Rahman, *supra* note 7, at 122–24.

²⁰ See RODNEY J. WILSON, ECONOMY, IN A COMPANION TO MUSLIM ETHICS 131, 132 (Amin B. Sajoo eds., 2010).

²¹ See Rice, *supra* note 18, at 348.

²² (Koran: Surat Al-Tawba, Verse number 60).

people of their stewardship function over the wealth of God which He has deposited under their custody. Hence, people shall not hesitate to give part of Allah's money to the less advantaged persons in society:

- Believe in Allah and His messenger, and spend of that whereof He hath made you trustees; and such of you as believe and spend (aright), theirs will be a great reward."²³
- Those who spend their wealth by night and day, by stealth and openly, verily their reward is with their Lord, and there shall no fear come upon them neither shall they grieve."²⁴

Allah condemns greedy people who are excessively attached to wealth accumulation and spare nothing for needy persons in the society:

They who hoard up gold and silver and spend it not in the way of Allah, unto them give tidings (O Muhammad) of a painful doom, On the day when it will (all) be heated in the fire of hell, and their foreheads and their flanks and their backs will be branded therewith (and it will be said unto them): Here is that which ye hoarded for yourselves. Now taste of what ye used to hoard."²⁵

Islamic scope of charitable contribution is very progressive as it includes all living creatures. Regarding this, the Prophet noted: "[a] reward is giving in connection with every living creature."²⁶

²³ (Koran: Surat Al-Hadid, Verse number 7).

²⁴ (Koran: Surat Al-Baqara, Verse number 274).

²⁵ (Koran: Surat Al-Tawba, Verses number 34-35).

²⁶ The Prophet Mohammad's statement came in the context of an interesting story narrated by the Prophet:

While a man was walking on his way he became extremely thirsty. He found a well, he went down into it to drink water. Upon leaving it, he saw a dog which was panting out of thirst. His tongue was lolling out and he was eating moist earth from extreme thirst. The man thought to himself: 'This dog is extremely thirsty as I was.' So he descended into the well, filled up his leather sock with water, and holding it in his teeth, climbed up and quenched the thirst of the dog. Allah appreciated his action and forgave his sins." The Companions asked: "Shall we be rewarded for showing kindness to the animals also?" He (PBUH) said, "A reward is given in connection with every living creature." Narrated by Muslim.

However, one should bear in mind that Islam encourages moderate behavior in every aspect of life.²⁷ A Muslim has to pursue balanced behavior that neither greedily runs after wealth accumulation nor is excessively extravagant, even if such profligacy is for charitable reasons. This idea model is depicted in the Koran: “[a]nd let not thy hand be chained to thy neck nor open it with a complete opening, lest thou sit down rebuked, denuded.”²⁸

5.2.1.2 The Socially Responsible Company

As illustrated, Islam strongly supports a modern corporate notion of social responsibility which advocates the implementation of sustainable and charitable practices by corporations. Linking modern social responsibility principles to their Islamic counterparts will promote incorporation of social responsibility principles into corporate governance systems in Islamic states on one hand, and persuade Islamically-aware corporations to implement socially responsible governance policies on the other. A well-governed Islamic corporation should have balanced policies that may ensure financial gains to the corporation and socially benefit the society.²⁹ A socially responsible corporation has to implement environmentally-friendly policies and assign segments of its financial and non-financial resources to increase social welfare of the community.

²⁷ See the Koran which provides: “Thus We have appointed you a middle nation, that ye may be witnesses against mankind, and that the messenger may be a witness against you.” (Koran: Surat Al-Baqara, Verse number 243).

²⁸ (Koran: Surat Al-Isra, Verse number 29).

²⁹ See Rice, *supra* note 18, at 349. Also see Abdul Rahim Abdul Rahman, *Issues in Corporate Accountability and Governance: An Islamic Perspective*, AM. J. ISLAMIC SCI. 55, 62 (1998) (“[T]he right to use and benefit from one’s wealth and property must not be exercised as the expense of the interest of the community.”). *Id.*

5.2.2 *Adel*

The Arabic word “*Adel*” conveys two interlinked meanings: fairness and justice. *Adel* is one of the pillars of the Islamic legal and ethical system. All Muslims are under obligation to adhere to this principle when dealing with other people, as noted by Allah:

O ye who believe! Be steadfast witnesses for Allah in equity, and let not hatred of any people seduce you that ye deal not justly. Deal justly, that is nearer to your duty. Observe your duty to Allah. Lo! Allah is informed of what ye do.³⁰

The Islamic economic system is one of the key sectors of society that has been heavily influenced by the *adel* principle. *Adel* defines Islamic economic theory, which has coincided greatly with modern market economy (e.g., prohibition of government pricing of goods)³¹ and free movement of goods crossing borders (e.g., custom duties prohibition).³² Islam’s pro- “free economy” principles might be justified under the principle of *adel* because, for instance, mandatory pricing of commodities by the state or custom duties levying would constitute prejudicial action against merchants. At the same time, *adel* has played a crucial role in justifying some limitations imposed on the Islamic economic model. For instance, Islam rejects

³⁰ (Koran: Surat Al-Maeda, Verse number 8).

³¹ One of the companions (Anas) of the Prophet Mohammad reported the following discussion between the Prophet and his companions:

Prices became excessive during the time of the Messenger of Allah (saws), so they said: ‘O Messenger of Allah! Set prices for us!’ So he said: ‘Indeed Allah is Al-Musa’ir, Al-Qabid, Al-Basir, Ar-Razzaq. And I am hopeful that I meet my Lord and none of you are seeking (recompense from) me for an injustice involving blood or wealth.’ (Narrated by al-Tirmidhi.)

³² The Prophet Mohammad said about a repented adulterous woman that: “Khalid, be gentle. By Him in Whose Hand is my life, she has made such a repentance that even if a wrongful tax-collector [*muks*] were to repent, he would have been forgiven.” Narrated by Muslim. The majority of Islamic jurists interpret the aforementioned word [*muks*] as one of its meaning refer to custom duties imposed by states on traders. Islam’s prohibition of custom duties fourteen centuries ago reflect a crucial aspect of Islamic economic foundations which were recently intertwined with modern free trade principles encompassed in the World Trade organization (WTO) framework, namely the GATT agreement.

unfair trade practices such as monopolies,³³ selling below market prices,³⁴ uncertain contracts,³⁵ and usury (interest).³⁶ Hence, the *adel* principle has played an influential role in framing the Islamic economic system.

The concept of *Adel* in Islam interacts with modern corporate governance principles and promotes the corporate governance thesis on several fronts. Firstly, a corporate governance system has to guarantee fair and just treatment of the company's stakeholders. For instance, the company's employees have to receive "fair" compensation for their contribution to the company.³⁷ Also, shareholders have to receive a fair return for their investment in the firm (i.e., dividends or capital gains). Secondly, the board of directors and executive officers have to implement a fair decision-making framework in running the company's affairs. For example, monetary compensation for the company management has to be reasonable and determined by a fair process, like a well-structured and governed compensation committee. Thirdly, majority

³³ The Prophet Mohammad said: "[n]o one withholds goods till their price rises but a sinner." Narrated by Abi Dawud.

³⁴ The second successor caliph (ruler) of the Islamic state (634–44), *Umar ibn al-khattab*, forbid merchants to sell below market price as depicted in the following incident:

Umar ibn al-Khattab passed by Hatab ibn Abi Baltaa who was underselling some of his raisins in the market. Umar ibn al-Khattab said to him, "Either increase the price or leave our market."

Narrated in the Imam Malik (*al-Muwatta*: sales chapter).

³⁵ See WILSON, *supra* note 20. A prominent example in Islamic *fiqh* (jurisprudence) is the illegality of the contemporary insurance contracts (commercial insurance but not cooperative form) due to the uncertainty which makes one party pay for something he might not receive anything in return for it. However, there are some jurists like Mustafa Ahmad Al-Zarqa who have opined that an insurance contract is permissible in Islam. See MUSTAFA AHMAD AL-ZARQA, *AL-MADKHAL AL-FIQHI AL-AAM*, vol. 1, 624 (1998). Other eminent scholars such as Sheik Yusuf al-Garadawi proposed some modifications to the existing insurance contractual structure to fit within Islamic standards. See YUSUF AL-GARADAWI, *AL-HALAL WA AL-HARAM FI AL-ISLAM* 252 (14th ed. 1985).

³⁶ See WILSON, *supra* note 20. In debt financing contracts, one party does all the effort and assumes the risk, while the other party is indifferent about the business financed by his money because he will receive his money back with interest regardless of what had happened to the project. See *generally id.* at 131, 145. For theory of Islamic finance, see FRANK E. VOGEL & SAMUEL L. HAYES III, *ISLAMIC LAW AND FINANCE: RELIGION, RISK, AND RETURN* (1998).

³⁷ Mervyn K. Lewis, *Islam and Accounting*, 25 ACCOUNTING FORUM 103, 110 (2001).

shareholders have an obligation towards the minority shareholders, especially during the time of fundamental changes in the company's structure, such as buy-out acquisitions. In this event, the majority shareholders are obliged to refrain from approving any unjust transactions against minority shareholders or other stakeholders.

5.2.3 Trustworthiness and Honesty

5.2.3.1 Introduction

In the pre-Islamic era, Arabic culture prized the values of honesty and trustworthiness.³⁸ In addition, the people of Mecca used to call the Prophet Mohammad before his prophecy “*al-ameen*” (the trustworthy).³⁹ Later, the Prophet Mohammad indicated that Islam recognized the good pre-Islamic values being observed in the Arab peninsula, noting: “I was sent to perfect good character.”⁴⁰ In fact, these two values “are universal among the three religions [Judaism, Christianity and Islam], and indeed, among most moral codes.”⁴¹ Such long-standing Arabian and Islamic heritages of recognition and admiration of these values would greatly promote modern corporate governance ideology and practice.

³⁸ See, e.g., Akthum bin Saifi Speech in front of the Sassanid Emperor, quoted in Jamhart kutab alarab fi al usur alwosta, at 21–22 (1923).

³⁹ SAFI AL-RAHAMAN AL-MUBARAKFURI, AL-RAHEEQ AL-MAKTUM 62 (2007).

⁴⁰ Narrated by Imam Malik (Muwatta: chapter of Good Character).

⁴¹ Rice, *supra* note 18, at 349.

5.2.3.2 Trustworthiness

Muslims have to maintain their integrity by not violating trust placed on them by others, as the Koran provides:

- O ye who believe! Betray not Allah and His messenger, nor knowingly betray your trusts.⁴²
- **Lo! Allah commandeth you that ye restore deposits to their owners.**⁴³

The Prophet Mohammad also ordered Muslims to be trustworthy.⁴⁴ A trustworthy person should respect his contractual relations, as the Koran provides: “O ye who believe! Fulfill your undertakings.”⁴⁵ Moreover, an entrusted person has to conserve and develop the assets positioned in his control for the benefit of the asset’s beneficiary. For instance, the custodian of orphans’ affluence has to perform his duties with extraordinary integrity and care in accordance with Allah’s command: “Come not near the wealth of the orphan save with that which is better till he come to strength; and keep the covenant. Lo! of the covenant it will be asked.”⁴⁶ Also, Islam has obligated every Muslim to uphold a trust placed upon him even if the other parties fail to keep their obligation towards him, as the Prophet instructed: “[p]ay the deposit to him who deposited it with you, and do not betray him who betrays you.”⁴⁷

⁴² (Koran: Surat Al-Anfal, Verse number 27).

⁴³ (Koran: Surat An-Nisa, Verse number 58).

⁴⁴ The Prophet Mohammad said: “There are three signs of hypocrites: When he speaks, he lies; when he makes a promise, he breaks it; and when he is trusted, he betrays his trust.” Narrated by al-Bukari and Muslim.

⁴⁵ (Koran: Surat Al-Maeda, Verse number 1). In other part of the Koran, Allah commands Muslims to keep their promise by saying: “and keep the covenant. Lo! of the covenant it will be asked. (34).” (Koran: Surat Al-Isra, Verse number 34).

⁴⁶ (Korran: Surat Al-Isra, Verse number 34).

⁴⁷ As the Prophet Mohammad said: “[p]ay the deposit to him who deposited it with you, and do not betray him who betrays you.” Narrated by Abi Dawud.

Trustworthiness is regarded a prerequisite of recruiting employees. Two practical incidents reported in the Koran show a link between trustworthiness and suitability for employment. In the first one, the Prophet Joseph emphasizes his notorious trustworthiness to the King of Egypt when Joseph petitioned to be appointed by the king: “[h]e said: Set me over the storehouses of the land. Lo! I am a skilled custodian.”⁴⁸ In another incident, some young women urge their father to hire the Prophet Moses due to his famed trustworthiness by saying: “O my father! Hire him! For the best (man) that thou canst hire is the strong, the trustworthy.”⁴⁹

Clearly, the value of being trustworthy in Islam overlaps with modern corporate governance principles, contributing to achieving governance’s goals in different ways. First, the corporation’s board of directors and other officers have to preserve the corporation’s assets and spend such assets efficiently for the benefit of the corporation and its shareholders. Also, they have to maintain their loyalty to the corporation by avoiding any conflict of interest transactions. Accordingly, the members of the board of directors and executive officers should not use the corporation’s assets for their own interests or to the contrary of the best interests of the corporation. Secondly, every member of the corporation has to look after the corporation’s assets placed under his trust. This duty of care is so wide that it includes every person working for the company. Preserving the company’s assets requires that the board of directors’ members and top executive officers receive reasonable compensation. Wasting the company’s resources on unnecessary matters violates the duty of trust imposed on these entrusted persons. Thirdly, the board of directors and other high-ranking management officers are obligated to hire the most qualified persons in the company. Fourthly, the company has to respect all contractual

⁴⁸ (Korran: Surat Yusuf, Verse number 55).

⁴⁹ (Korran: Surat Al-Qasas, Verse number 26).

agreements with its stakeholders. Finally, the company has to observe trust placed in it by workers: they must pay workers' salaries on time, protect their retirement plan, take into account their position whenever fundamental change in the company's legal structure arises (e.g., restructuring or dissolution). However, the corporation's employees have no right to violate their duty of trust to the company even if the company has not fulfilled its promises to them. The same applies to the corporation if there is betrayal by an employee. For these events, pursuing a legal remedy is the only available option to the injured party.

5.2.3.3 Honesty

Honesty is another pivotal principle in Islamic ethical system. Honesty commonly goes hand in hand with trustworthiness.⁵⁰ In the Koran, Allah commanded Muslims to be endowed with honesty, saying: "O ye who believe! Be careful of your duty to Allah, and be with the truthful."⁵¹ Prophet Mohammad encourages this good behavior by advising his companions to be honest to attain Allah's satisfaction.⁵²

Transparency represents an integral component of honesty's value in Islam. A merchant has to allow a buyer to accurately determine the condition of goods he presents for sale:

- Happened to pass [the Prophet Mohammad] by a heap of eatable (corn). He thrust his hand in that (heap) and his finger were moistened. He said to the owner of that heap of eatable (corn): What is this? He replied ... these have been drenched by rainfall. He ... prophet remarked: Why you did not place

⁵⁰ Honesty refers to telling the truth and trustworthiness refers to keeping the promise.

⁵¹ (Koran: Surat Al-Tawba, Verse number 119).

⁵² The Prophet Mohammad said: "it is obligatory for you to tell the truth, for truth leads to virtue and virtue leads to paradise...." Narrated by Muslim.

this (the drenched part of the heap) over other eatables so that the people could see it? He who deceives is not of me (is not my follower).⁵³

- Allah's Messenger (PBUH) forbade the selling by Munabadha, i.e. to sell one's garment by casting it to the buyer not allowing him to examine or see it. Similarly he forbade the selling by Mulamasa. Mulamasa is to buy a garment, for example, by merely touching it, not looking at it.⁵⁴

In addition, a disclosure system in Islam imposes an obligation on the seller to reveal all information related to the goods, especially if there is any defect in them:

Both parties of a business transaction have the right to annul it so long as they have not separated; and if they speak the truth and make everything clear they will be blessed in their transaction; but if they tell a lie and conceal anything the blessing on their transaction will be blotted out.⁵⁵

The sellers are prohibited from employing deceptive marketing and advertising strategies:

The Prophet (PBUH) said: Don't keep camels and sheep un milked for a long time, for whoever buys such an animal has the option to milk it and then either to keep it or return it to the owner along with one Sa of dates.⁵⁶

Trade has to be conducted based on market prices that are known by both parties. Neither seller nor buyer is entitled to take advantage of the other one; thus they must disclose the fair market value of the goods. In this vein, the Prophet Mohammad "forbade the meeting (of caravans) on the way and the selling of goods by an inhabitant of the town on behalf of a desert dweller."⁵⁷

Islam's strong support of honesty and transparency promotes sound corporate governance objectives, especially with regard to a disclosure framework. Publicly traded corporations are

⁵³ Narrated by Muslim.

⁵⁴ Narrated by al-Bukhari.

⁵⁵ Narrated by Muslim.

⁵⁶ Narrated by al-Bukhari. The Arabic word "Sa" refers to measure of weight in Arab countries which is a proximately equal to two and half kilograms.

⁵⁷ Narrated by al-Bukhari.

obliged to disclose all material information to investors. Disclosures compatible with Islamic values should “include[] the attribute of ‘truth’-fair and accurate disclosure of the matters at hand.”⁵⁸ Merely disclosing all information does not satisfy the Islamic disclosure requirements under which the corporation is obliged to signal important information and risk factors to investors. As illustrated in the wet heap of corn incident, all material information has to be communicated effectively to the investor rather than merely enabling him to search for such information “like looking for a needle in haystack.” Dumping a great deal of unnecessary information on investors in hopes of burying material information does not fulfill Islamic disclosure requirements.

Disclosed information ought to include all information investors would deem necessary to determine compatibility of the corporation operations and finance structure with Islamic teachings.⁵⁹ For instance, any interest-based finance has to be disclosed to investors.⁶⁰ The corporation’s line of business should also be disclosed to investors to enable them to make accountable investment decisions, especially with regard to investment in corporations that

⁵⁸ Lewis, *supra* note 37, at 103, 114.

⁵⁹ See Lewis, *supra* note 3, at 23.

⁶⁰ See, e.g., Fatwa No. 3134, the Permanent Committee in the General Presidency of Scholarly Research and Ifta, vol. 13, P. 505, n.d., available in English at <http://www.alifta.net/fatawa/fatawaDetails.aspx?BookID=3&View=Page&PageNo=10&PageID=5032> (accessed on Dec. 20, 2012) (The fatwa (ruling) of the committee indicated that shareholding in interest based banks is not permitted in Islam.). *Id. Cf. see, e.g.*, Fatwa No. 4512, the Permanent Committee in the General Presidency of Scholarly Research and Ifta, vol. 13, 508, n.d., available in English at <http://www.alifta.net/Fatawa/FatawaDetails.aspx?View=Page&PageID=5026&PageNo=1&BookID=7#P508> (accessed on Dec. 20, 2012) (the committee with regard of shareholding in non-interest based banks ruled:

[i]t is permissible to buy shares in the banks which do not deal in Riba. Profits earned from shareholdings in the bank and which are the result of dealings that do not involve anything *Haram* [prohibited]; are *Halal* [lawful].

Id. (italics added).

engage in a prohibited business such as intoxicant production or selling,⁶¹ selling predatory animals⁶² and tobacco.⁶³ Moreover, the disclosure framework ought to communicate to investors the corporation's social responsibilities such as its policies towards the environment, charitable contributions, and *zakat* (alms) payment and calculations.⁶⁴ The external auditor of the corporation is under an obligation to signal any violation of Islamic corporate governance principles.⁶⁵ The corporation's accountant and internal auditor have to ensure a sound recording of the corporation's financial statements, especially with regard to the corporation's liabilities, as instructed by the Koran.⁶⁶ A sound transparency model should indicate the way a corporation

⁶¹ The Prophet Mohammad said, "The trade of alcohol has become illegal." Narrated by al-Bukhari.

⁶² See Fatwa No. 18807, The Permanent Committee in the General Presidency of Scholarly Research and Ifta, vol. 13, 41, n.d., available in English at <http://www.alifta.net/Fatawa/FatawaDetails.aspx?View=Page&PageID=4581&PageNo=1&BookID=7#P41> (accessed on Dec. 20, 2012).

⁶³ See Fatwa No. 4947, the Permanent Committee in the General Presidency of Scholarly Research and Ifta, vol. 13, 32, n.d., available in English at <http://www.alifta.net/Fatawa/FatawaDetails.aspx?View=Page&PageID=4572&PageNo=1&BookID=7#P32> (accessed on Dec. 20, 2012).

⁶⁴ See Lewis, *supra* note 37, at 103, 114.

⁶⁵ For religious auditing, see generally Rahman, *supra* note 29, at 55, 64–65.

⁶⁶ The Koran provides:

O ye who believe! When ye contract a debt for a fixed term, record it in writing. Let a scribe record it in writing between you in (terms of) equity. No scribe should refuse to write as Allah hath taught him, so let him write, and let him who incurreth the debt dictate, and let him observe his duty to Allah his Lord, and diminish naught thereof. But if he who oweth the debt is of low understanding, or weak, or unable himself to dictate, then let the guardian of his interests dictate in (terms of) equity. And call to witness, from among your men, two witnesses. And if two men be not (at hand) then a man and two women, of such as ye approve as witnesses, so that if one of the two erreth (through forgetfulness) the one of them will remind. And the witnesses must not refuse when they are summoned. Be not averse to writing down (the contract) whether it be small or great, with (record of) the term thereof. That is more equitable in the sight of Allah and more sure for testimony, and the best way of avoiding doubt between you; save only in the case when it is actual merchandise which ye transfer among yourselves from hand to hand. In that case it is no sin for you if ye write it not. And have witnesses when ye sell one to another, and let no harm be done to scribe or witness. If ye do (harm to them) lo! it is a sin in you. Observe your duty to Allah. Allah is teaching you. And Allah is knower of all things.

(Koran: Surat Al-Baqara, Verse number 282).

acquires its assets and the lawfulness of the means of acquisition.⁶⁷ Accordingly, Muslim investors are required to avoid investing in a corporation which acquires its assets unlawfully (e.g. intellectual property infringements). In this vein, the Prophet Mohammad noted: “[h]e who buys something stolen, while being aware that it is stolen, shares in the sin and shame of stealing.”⁶⁸ The Islamic perception of disclosure and scope of transparency seem wider than the modern disclosure framework.

5.2.4 Shura (Consultation)

5.2.4.1 Shuratic Decision-making Process in Islam

Arabian Peninsula tribes observed the process of consultation in their decision-making even before the advent of Islam.⁶⁹ Generally speaking, in such a decision-making model, the “tribe’s” seniors form an “informal” congress for discussing and advising the tribe leader.⁷⁰ *Quraysh*, the Prophet Mohammad’s tribe, for instance, had a designated council house, *Dar al-Nadwa*, for deliberating and deciding on the tribe’s affairs.⁷¹ Later, Islam appraised the value of consultation and formally incorporated it in the new religion. The Koran provides:

⁶⁷ The Koran provides that: “And eat not up your property among yourselves in vanity, nor seek by it to gain the hearing of the judges that ye may knowingly devour a portion of the property of others wrongfully.” (Koran: Surat Al-Baqara, Verse number 188).

⁶⁸ Reported by al-Bayhaqi, cited in YUSUF AL-QARADAWI, *THE LAWFUL AND THE PROHIBITED IN ISLAM* 261 (2d ed. al-Falah Foundation for Translation, Publication, and Distribution 2001)

⁶⁹ See PHILIP K. HITT, *HISTORY OF THE ARABS* 28 (revised 10th ed. 2002).

⁷⁰ See Lewis, *supra* note 3, at 15.

⁷¹ See Ibrahim A. Al-Marzouqi, *Political Rights and Democracy in Islamic Law*, in *DEMOCRACY, THE RULE OF LAW AND ISLAM* 455, 456 (Eugene Cortan & Adel Omar Sherif eds., 1999).

- And those who answer the call of their Lord and establish worship, and whose affairs are a matter of counsel.⁷²
- So pardon them and ask forgiveness for them and consult with them upon the conduct of affairs.⁷³

Unequivocally, Islam encourages people to consult before commencing any project or making important decisions in every matter. In this regard, Shaik al-Mawdudi said:

Islamic way of life requires that the principle of consultation should be used in every collective affair, big or small. If it is a domestic affair, the husband and the wife should act by mutual consultation, and when the children have grown up, they should also be consulted. If it is a matter concerning the whole family, the opinion of every adult member should be solicited. If it concerns a tribe or a fraternity or the population of a city, [they have to be consulted, as well].⁷⁴

Nonetheless, the need of consultation seems more crucial when the subject matter is related to a group of people's affairs.⁷⁵ For centuries Islamic scholars have not yet concurred on whether performing consultation by the leader is a mandatory or optional matter.⁷⁶ Although the merit of the debate emerged in a constitutional context with regard to ruler-subject relation, nothing in the literature suggests excluding other organizational models from that debate perspective or insights.⁷⁷

Whether *shura* is obligatory or optional does not matter: what really matters is that a form of *shuratic* decision-making process framework is implemented in both cases. Disregarding *shura* value at any decision-making level represents "a grave immorality which Islam does not

⁷² (Koran: Surat Ash-Shura: verse number 38).

⁷³ (Koran: Surat Al-Imran, Verse number 159).

⁷⁴ Shaik al-Mawdudi, *Towards Understanding the Quran*, surah ash-Sura, n.61, available at <http://www.islamicstudies.info/tafheem.php?sura=42&verse=30&to=53> (accessed on Feb. 15, 2013).

⁷⁵ *See id.*

⁷⁶ *See generally* TAWFIK AL-SHAWI, *FIGH AL-SHURA WA AL-ISTISHARAH* 101–57 (2d ed. 1992).

⁷⁷ *See id.* at 8, 21.

permit.”⁷⁸ The leader has to furnish a suitable ambient for consultees to provide their insight.⁷⁹ The leader needs not to be opinionated and he has to concede to the best advice offered, as the Prophet Mohammad’s tradition teaches us that even the prophet admitted to his followers some recommendations “that contradicted his opinion.”⁸⁰

The minority’s voice has to be heard and taken into account because “[j]ustice demands that all those whose interests are involved in a matter be consulted.”⁸¹ The interests of the whole group are the ultimate goal of the Islamic *shuristic* decision-making model; therefore, the leader initially has to devote immense exertion to form a consensus over the decision and not resort to a majority opinion unless forming a consensus is impossible. For instance, Indonesian people – who are a Muslim majority – disregarded the country’s formal constitutional setting which adopted the western model of majority ruling⁸² and upheld their long-standing consultation and consensus seeking decision-making model.⁸³ An anthropologist describes the decision-making process in Indonesian villages by saying:

[U]nanimous decision can be reached by a process in which the majority and minorities approach each other by making the necessary readjustments in their respective viewpoints, or by an integration of the contrasting standpoint into a

⁷⁸ al-Mawdudi, *supra* note 74.

⁷⁹ See MAHMOUD SHALTUT, *AL-ISLAM AKIDA WA SHARIA* 440 (18th ed. Dar Elshorouk 2001).

⁸⁰ Rahman, *supra* note 29, at 55, 62.

⁸¹ al-Mawdudi, *supra* note 74.

⁸² See Kiochi Kawamura, Consensus and Democracy in Indonesia: *Musyawaharah-Mufakat* Revisited, Institute of Developing Economies Discussion Paper No. 308, 5–7 (cited pages) (Sept. 2011), available at <http://www.ide.go.jp/English/Publish/Download/Dp/pdf/308.pdf> (accessed on Feb. 20, 2013). Also, Soetardjo commented on the limitations of western majority decision-making structure in Indonesia by saying: “a majority vote system like that employed in western democracies ... is not familiar to the Indonesian people.” *Id.* at 4 (quoting Soetardo Kartohadikoesoemo, *Desa*, 102 (1953)).

⁸³ See Martha G. Lonsdon, *Traditional Decision Making in Urban Neighborhoods*, 26 *INDONESIA* 95, 96 (Oct. 1978) (she said that “[f]or many of the peoples of Indonesia unanimous consent is the indigenous decision-making rule”). *Id.*

new conceptual synthesis ... [Consultation and unanimity] thus exclude the possibility that the majority will impose its view on the minority.⁸⁴

One the other hand, consultation about special or technical matters (an expert opinion) should be directed to the most qualified person for advice. For instance, the eminent Islamic ruler and close companion of the Prophet Mohammad, Umar ibn al-Khattab,⁸⁵ consulted a woman⁸⁶ about the amount of time soldiers' wives could wait for their husbands to come back from the front lines of a war. In another event, Umar referred an alleged satirical poem to a famous poet to determine the true nature of that artistic work.⁸⁷ Needless to say, a consultant in Islam is obliged to deliver advice based on his best knowledge and judgment,⁸⁸ as noted by Prophet Mohammad: "One who is consulted is entrusted."⁸⁹

5.2.4.2 *Shura* and Corporate Governance

The Islamic compatible corporate governance model has to observe a *shuratic* decision-making process in corporations. The Islamic framework suggests that all members of the organization

⁸⁴ KOENTJARANINGRAT, THE VILLAGE IN INDONESIA TODAY, IN VILLAGES IN INDONESIA 386, 397 (Koentjaraningrat eds., 1967).

⁸⁵ For short biography of Umar ibn al-Khattab, see "Umar ibn, al-Khattab" 2009, in *Britannica Concise Encyclopedia*, ENCYCLOPEDIA BRITANNICA (Chicago, IL, USA) (viewed 15 Feb. 2013), from http://www.credoreference.com/entry/ebconcise/umar_ibn_al_kha%E1%B9%AD%E1%B9%AD%C4%81b.

⁸⁶ ABDUL RAZIQ AL-SANANI, AL-MUSANAF, vol. 7, 157 (1st ed., Dar al-Kotob al-Ilmiyah 2000). The woman that Omar consulted was his daughter, Hafsa, and the Prophet Mohammad's wife. Consultation of women about their affairs or matters they have more expertise and insight on was a common practice by Omar. See ABI BAKER A. AL-BAYHAGI, AL-SUNAN AL-KUBRA, vol. 10, 193 (3d ed., Dar al-Kotob al-Ilamiyagh: 2003); ABBAS AL-AKKAD, ABKARIAT OMAR 193 (Dar Nahdat Mesir: 1998). However, that does not mean women's opinion is not sought for in other matters. Since the early days of Islam, women have represented a respected constituent of Muslim society in which their voice was taken into account with regard to the Islamic society affairs, on the same footing as the men's voice. For instance, women were consulted on electing the third ruler of the first Islamic state, Othman bin Affan. See ISMAIL IBN KATHEIR, AL-BIYDAYAH WA AL-NIHAYAH, vol. 10, 211 (1st ed., Hajir publishing 1998).

⁸⁷ See AL-AKKAD, *supra* note 86, at 165–66.

⁸⁸ al-Mawdudi, *supra* note 74.

⁸⁹ Narrated by Ibn Majah.

should be allowed to “participate in the decision-making” process.⁹⁰ Therefore, the corporation has to set policies and procedures to guarantee that no decision would be taken in absence of preliminary consultations and consensus-seeking over that decision. For example, the board of director’s members and shareholders should not make any decisions within their realm of authority without conducting extensive deliberation and devoting a great deal of effort to build consensus over the pending matter. Besides conducting the mentioned horizontal consultations, a vertical consultation has to be observed between the board of director’s members and the company’s top executive officers, and those top officers with the rest of the employees. Allowing all employees to participate in the decision-making process will increase their loyalty to the company and improve their productivity.⁹¹ Any minority group – whether on the board of directors or at shareholders meetings – has to be consulted and allowed to participate in the decision-making process of the corporation. The opinion of the majority shall not be imposed before a candid, consensus- seeking effort is conducted. The company has to support its decisions with the best available expert’s opinion. For instance, the financial administrative structure and marketing strategies of the company have to be formed and evaluated by experts.

The division among Islamic scholars over the obligatory nature of *shura* would allow for the emergence of several varieties of *shuratic* decision-making models. For instance, informal incorporations of *shura* in a company’s decision-making process as in the Indonesian example would satisfy the Islamic requirement of a *shuratic* model. Or, a formal form of a *shuratic* decision-making process might be imposed mandatorily on companies in a way similar to the German corporate governance model which requires labor participation in a company’s decision-

⁹⁰ See SHALTUT, *supra* note 79, at 158, 440.

⁹¹ See KHALID KHALIL AL-DAHIR, *AL-NIDAM AL-IDARI* 184 (2009).

making process.⁹² Implementing any form of a *shuratic* decision-making process reflects an inclination to the stakeholder model of corporate governance which strongly advocates the stakeholder's, especially the employees, involvement in the company's decision-making process.⁹³

5.2.5 Accountability

5.2.5.1 Fear of Allah

As in Judaism and Christianity,⁹⁴ Islam holds that every person will be held accountable on the Day of Judgment for his actions in this life.⁹⁵ People's actions, whether veiled or concealed, are known to Allah, as the Koran provides: “[s]ay, (O Muhammad): Whether ye hide that which is in your breasts or reveal it, Allah knoweth it.”⁹⁶ A wrongdoer may escape accountability in this life but, ultimately, they will be held accountable by Allah.⁹⁷ Therefore, abidance to Islamic rules

⁹² For the German labor participatory model of corporate governance see, e.g., MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT 71–82 (2003).

⁹³ Several scholars have categorized Islamic corporate governance a stakeholder model. See, e.g., ZAMIR IQBAL & ABBAS MIRAKHOR, AN INTRODUCTION TO ISLAMIC FINANCE: THEORY AND PRACTICE 283–85 (2007).

⁹⁴ This connection is illustrated by a western scholar:

[T]he God of Muslims is the same God of the Jews and the Christians, although without what perhaps might be seen as the racial exclusiveness attributed to Him by Judaism, or the intricate theology woven around Him by Christianity in the form of the Trinity ... Many of the familiar stories and names of the Bible are to be found in the Holy Qur'an In fact, Islam is the only non-Christian religion that makes it an article of faith to believe in Jesus as a prophet.”

Lewis, *supra* note 37, at 103, 105.

⁹⁵ Allah said: “And whoso doeth good an atom's weight will see it then, And whoso doeth ill an atom's weight will see it then.” (Koran: Surat al-Zalzala, Verses number 7-8).

⁹⁶ (Koran: Surat Al-Imran, Verse number 29).

⁹⁷ See Rahman, *supra* note 7, at 122.

and guidance exceeds complying with the rules enacted by legislature.⁹⁸ In a secular system, for instance, taking advantage of a loophole in the legal system would not matter, but it would matter greatly in a religion-based system which considers such an action a violation of God's will (i.e., a sin). In addition, permissibility of a specific activity or action by positive laws does not confer automatic legitimacy to that activity or action in Islam. For instance, national bank operations in Saudi Arabia encompass interest (usury), which is strongly forbidden by Islam.⁹⁹ Hence, many well-qualified Saudis tend to refuse to work in the banking sector.¹⁰⁰ Not only that, but many of them have quit their respectable jobs in that sector for inferior-status jobs or those which pay less.¹⁰¹ Until recently, the insurance sector had faced the same negative attitude from Saudis.¹⁰² Thus, the belief of the inescapable destiny of accountability may enhance Muslims' internal surveillance system and encourage every Muslim to self-enforce Islamic principles beyond the limits of a secular system.

⁹⁸ See Lewis, *supra* note 3, at 5–29 (cited page 16).

⁹⁹ The Koran provides that: O ye who believe! Devour not usury, doubling and quadrupling (the sum lent). Observe your duty to Allah, that ye may be successful." (Koran: Surat Al-Imran, Verse number 130).

¹⁰⁰ See, e.g., Fatwa No. 5714, the Permanent Committee in the General Presidency of Scholarly Research and Ifta, vol. 15, 55, n.d., available in English at, <http://www.alifta.net/Fatawa/FatawaDetails.aspx?View=Page&PageID=5486&PageNo=1&BookID=7#P55> (accessed on Dec. 20, 2012).

¹⁰¹ See, e.g., Fatwa No. 20068, the Permanent Committee in the General Presidency of Scholarly Research and Ifta, vol. 8, 371, n.d., available in English at <http://www.alifta.net/Fatawa/FatawaDetails.aspx?View=Page&PageID=13448&PageNo=1&BookID=7#P371> (accessed on Feb. 6, 2013) (a person ask the Permanent Committee if he could give *zakat* (alms) to a person (his brother) who voluntarily quit working for a bank because the bank deal in impermissible usury and had not find a job since then nor had any source of income).

¹⁰² The dominant opinion of most Islamic jurists in Saudi Arabia is that an insurance contract is forbidden under Islamic law because of that contract's uncertainty and unfairness. See, e.g., Fatwa No. 14839, the Permanent Committee in the General Presidency of Scholarly Research and Ifta, vol. 15, P. 9, n.d., available in English at <http://www.alifta.net/Fatawa/FatawaDetails.aspx?View=Page&PageID=5454&PageNo=1&BookID=7#P9> (accessed on Dec. 20, 2012) (the Committee ruled on working in non-Islamic compatible insurance (commercial insurance companies) by saying: "[w]orking for this company is impermissible for this is assisting in sin and transgression."). *Id.*

5.2.5.2 “Encouraging Good and Discouraging Evil”

The Islamic accountability framework is not limited to the hereafter under which every member of a Muslim society must stand against any non-Islamic actions that occur in the society. Not only that, but a true believer must also try to persuade other fellow Muslims to observe Islamic values. This obligation is called “encouraging good and discouraging evil,” which is noted in the Koran:

- And the believers, men and women, are protecting friends one of another; they enjoin the right and forbid the wrong, and they establish worship and they pay the poor-due, and they obey Allah and His messenger.¹⁰³
- Ye are the best community that hath been raised up for mankind. Ye enjoin right conduct and forbid indecency; and ye believe in Allah.¹⁰⁴

In addition, the Prophet Mohammad said that:

Whoever amongst you sees an evil, he must rectify it by his hand; if he is unable to do so, then by his tongue (speaking against it); if he unable to do so, then by his heart (rejecting it), and the latter is the weakest form of *iman* (faith).¹⁰⁵

“Encouraging good and discouraging evil” obligation is, also, known as *hisbba*.¹⁰⁶ The *hisbba* obligation in Islam is a “communal obligation.”¹⁰⁷ The fulfillment of such an obligation by enough members of the society would release the rest of their obligation to perform *hisbba*.¹⁰⁸ However, the whole of society will be held accountable if all of them ignore performing

¹⁰³ (Koran: Surat Al-Tawba, Verse number 71).

¹⁰⁴ (Koran: Surat Al-Imran, Verse number 110).

¹⁰⁵ Narrated by Muslim.

¹⁰⁶ See ABDULAZIZ BIN MOHAMMAD BIN MARSHID, *NIDAM AL-HISBA FI AL ISLAM* 10 (1972–1973).

¹⁰⁷ See IBN TAYMIYA, *PUBLIC DUTIES IN ISLAM: INSTITUTION OF HISBA* 23 (Muthar Holland translated from Arabic to English) (the Islamic foundation: 1985).

¹⁰⁸ For the nature of the communal obligation in Islam, see generally IMRAN AHSAN KHAN NYAZEE, *ISLAMIC JURISPRUDENCE* 64 (2000).

hisbba.¹⁰⁹ In the eighth century, the Islamic state institutionalized *hisbba*.¹¹⁰ Since that time, most of *hisbba* functions were assigned to public officers (singular-*muhtasab*, plural *muhtasabun*), especially with regard to matters requiring a forceful adherence to Islamic guidance.¹¹¹ Historically, the Islamic state had entrusted the *hisbba* institution with a wide range of functions related to judiciary, policing,¹¹² and religion. For instance, the *muhtasab* prosecutes and disciplines merchants and shoppers.¹¹³ Moreover, *hisbba* played a crucial role in preserving the integrity of markets by combating fraudulent acts,¹¹⁴ eliminating prohibited commodities (e.g., spirit beverages), and commanding shoppers and traders to conduct prayers.¹¹⁵

Currently, except for the Saudi Arabian “General Presidency of the Promotion of Virtue and Prevention of Vices,”¹¹⁶ all post-colonial Islamic states have abolished *hisbba* from their government structure and replaced it with a modern public administration structure of control and enforcement.¹¹⁷ Even in Saudi Arabia, the original functions of the *hisbba* have been reduced to

¹⁰⁹ See TAYMIYA, *supra* note 107.

¹¹⁰ Lewis, *supra* note 3, at 17.

¹¹¹ For the differences between voluntarily *hisbba* by non-authorized persons and government authorized persons (Muhtasabs), see ABUL-HASSAN ALI MOHAMMAD IBN HABIB AL-BASRI AL-BAGHDADI AL-MAWARDI, AL-AHKAM AS-SULTANIYYAH: THE LAWS OF ISLAMIC GOVERNANCE 338–37 (Asadullah Yate, PhD. Ta-Ha Publishers: n.d).

¹¹² The function of *hisbba* resides between that of judicial and police functions. See AL-MAWARDI, *supra* note 111, at 338–41.

¹¹³ See generally BIN MARSHID, *supra* note 106, at 151, 175.

¹¹⁴ See TAYMIYA, *supra* note 107, at 29–31.

¹¹⁵ For ordering people to perform prayers, see TAYMIYA, *supra* note 107, at 26.

¹¹⁶ For general information on “the General Presidency of the Promotion of Virtue and Prevention of Vices” see its homepage at <https://www.pv.gov.sa/Pages/default.aspx> (accessed on Dec. 18, 2012). For critical study of the *hisba* institution in modern Saudi Arabia, see MANSOUR AL-NUGAIDAN, AL-MULOUK AL-MIHTASBUN: ALAMIR BI ALMAROUF WA ALNAHI AN ALMUNKAR FI ALSAUDIAH (1927–2007) (4th ed. 2012).

¹¹⁷ Muhammad Akram Khan, Al-Hisba and the Islamic Economy, at 137, in appendix of Abul-Hassan Ali Mohammad ibn Habib al-Basri al-Baghdadi al-Mawardi, Al-Ahkam As-Sultaniyyah: the Laws of Islamic Governance, at 338, Translated by Asadullah Yate PhD (Ta-Ha Publishers: n.d). For historical aspect of hisba in Saudi Arabia, see Abdulaziz bin Mohammad bin Marshid, Nidam al-Hisba fi al Islam, at 189–215 (1972–1973).

moral policing, and most of original *hisbba* functions have been distributed to various government institutions.¹¹⁸ Nonetheless, distributing old *hisbba* functions to modern administrative institutions still does not release these institutions from performing any *hisbba* obligations. What really matters here is the substance of the responsibility and not the administrative structure of the government. Accordingly, institutions severing one of the *hisbba* functions has to observe the religious aspect of their mandate and remember the ultimate goal they are serving, which was eloquently articulated by Shaykh al-Islam Ibn Taymiya: “the aim of all authority in Islam is to ensure that all religion shall be God’s, and that the Word of God shall be all-high.”¹¹⁹ Failure of administrative institutions on fulfilling their assigned *hisbba* responsibilities will hold the entire society’s members accountable for not fulfilling their communal obligation of promoting good and discouraging evil.

5.2.5.3 Accountability and Corporate Governance

Accountability theory in Islam furnishes a solid foundation for a modern corporate governance premise. A belief of inevitable accountability on the Day of Judgment should encourage the companies’ stakeholders to observe Islamic principles that are intertwined with corporate governance principles, such as social responsibility, honesty, trustworthiness and fairness.¹²⁰ The ethical framework of these principles may fill any gap existing in the mandatory corporate governance structure, as God’s happiness and satisfaction is what matter in Islam. As the Koran

¹¹⁸ See Abdulaziz bin Mohammad bin Marshid, *Nidam al-Hisba fi al Islam*, at 208–14 (1972–1973).

¹¹⁹ Ibn Taymiya, *Public Duties in Islam: Institution of Hisba*, translated from Arabic to English by Muthar Holland, P. 19 (the Islamic foundation 1985).

¹²⁰ See Abdussalam Mahmoud Abu-Tapanjeh, *Corporate Governance from the Islamic Perspective: A Comparative Analysis with OECD Principles, Critical Perspective on Accounting 20*, at 556–67 (2009) (the cited page is 564).

articulates regarding the ultimate objective for every Muslim's action: "Say: Lo! my worship and my sacrifice and my living and my dying are for Allah, Lord of the Worlds."¹²¹ The fear of accountability and the desire of attaining Allah's satisfaction would impose a self-motivated behavior to implement Islamic guidance related to corporate governance.

The obligation of "commanding good and forbidding evil," may promote the enforcement of corporate governance.¹²² For instance, every stakeholder ought to stand against actions which are inconsistent with Islamic norms, including corporate governance violations.¹²³ Stakeholders are under an obligation to encourage the company to adopt sustainable and fair governance standards. In Islam there is no place for apathetic shareholders, because any shareholder – no matter how small his holding – will be held accountable for non-Islamic practices taking place in the corporation.¹²⁴ The idea of "an entity spate from its owners in no way removes th[e] obligation" of the shareholders in Islam.¹²⁵ Therefore, shareholders shall not stand passive about the activities taking place in the company. They could sell and leave for another investment opportunity, but putting sincere effort to correct the violating company's behaviors would be a better cause of attaining Allah's satisfaction. For instance, shareholders' proposals could represent an ideal mechanism to signal rejection of any non-Islamic practices taking place in the company. In addition, shareholder suits (direct and derivative) would actualize the *hisbba* objectives.

¹²¹ (Koran: Surat al-Anaam, Verse number 162).

¹²² See Lewis, *supra* note 3, at 17.

¹²³ See Abu-Tapanjeh, *supra* note 120.

¹²⁴ See Lewis, *supra* note 3, at 22.

¹²⁵ See *id.*

Members of the business society may also play a significant role in promoting and enforcing corporate governance principles. In the last few years, for example, periodical reviews on listed companies' compliance with Islamic guidance were issued by several Islamic scholars, especially with regard to the company's line of business and finance.¹²⁶ This practice forced several companies' managements to observe such concerns and impose pressure on their managements to lean towards more Islamically-accepted governance practice. For example, the Saudi giant oil company ARAMCO issued Islamically-compliant finance securities, *sukuk*, to finance one of its major projects to increase the marketability of *sukuk*.¹²⁷ Also, several public companies have established special committees to supervise the compatibility of those companies' operations with Islamic rules. For instance, the Islamic Supervisory Committee (Unit) in Al Rajhi Bank (a Saudi listed company) intends to: "ensure that the bank conducts its business in harmony with the precepts of Islamic *Sharia*."¹²⁸

Capital market authorities and other public companies regulators (i.e., the Ministry of Commerce and Industry and the Saudi Organization Certified Public Accountants, "SOCPA") represent a modern implementation of the Islamic concept of *hisbba*. Responsible members in such institutions have to realize the religious dimension of the job which requires a diligent effort on their institution's behalf to maintain capital market integrity and prevent harm to shareholders

¹²⁶ See, e.g., Islamic way website, <http://main.islammassage.com/newspage.aspx?id=9663> (accessed on Mar. 3, 2013).

¹²⁷ See Saudi Stock Exchange Tadawul website, http://www.tadawul.com.sa/wps/portal/!ut/p/c1/04_SB8K8xLLM9MSSzPy8xBz9CP0os3gX35DgIB9TQwMLY1dzA09nI79QCwsDIDACykeaxfsZOicFeZoYGRgEmxoYeJr4hIU4-7gbG3iYUqIbKE-KbveAMFOQ7mCj4AAvYwNPQrqDE4v0_Tzyc1P1C3JDQyPKHRUB0itEDw!!/dl2/d1/L3dDb1ZBQSEhL3dHa0FKREFOZ0EhIS9ZQkpKdzQ1dy83X0RNVFNSTDUxMDgzRTcwSUMyTIU4ODAwMDg0/?symbol=5014&tabOrder=9&bondsDetail=true (accessed on Feb. 10, 2013).

¹²⁸ See Al Rajhi Bank homepage, available at <http://www.alrajhibank.com.sa/en/about-us/pages/sharia-group.aspx> (accessed on Feb. 28, 2013).

and other stakeholders. For instance, those institutions are obliged to inspect and rectify actions that violate Islamic principles of equity (e.g., minority exploitation by controlling shareholders) and honesty (e.g., fraud or deception). The enforcement of the corporate governance principles has to be applied in a non-discriminatory basis. The Prophet Mohammad emphasized the importance of this norm by saying that:

The people before you were ruined because when a noble person amongst them committed theft, they would leave him, but if a weak person amongst them committed theft, they would execute the legal punishment on him. By Allah, were Fatimah, the daughter of Muhammad, to commit the theft, I would have cut off her hand.¹²⁹

All in all, application of the *hisbba* notion is very wide and not limited to the aforementioned examples and may accommodate countless existing and future commendable corporate governance inspection and enforcement mechanisms.

5.3 A BIRD'S EYE VIEW OF ISLAMIC CORPORATE GOVERNANCE SYSTEM

Modern corporate governance principles are mainly concerned with decision-making processes and control of publicly traded corporations.¹³⁰ Normally, any corporate governance model contains principles intended to reduce agency costs and promote fairness and transparency and furthermore to make the company and its management accountable to its stakeholders, including the society at large (social responsibility). In a holistic system like Islam, religious teachings regulate both the private and public lives of every person, which includes the social and

¹²⁹ Reported by al-Bukhari and Muslim.

¹³⁰ For corporate governance goals, see chapter III.

economic interactions in the community, such as corporate governance matters. This chapter shed light on the Islamic view of corporate governance by investigating the Islamic roots of modern corporate governance, and assessing its application and contribution to modern corporate governance framework. The Islamic principles of *adel* (fairness), honesty, trustworthiness, accountability, social responsibility, *shura* (consultation) are the cornerstone foundation of the Islamic corporate governance model. The substance Islamic principles are clearly reflected in the following subjects of modern corporate governance.

5.3.1 The Protection of Minority Shareholders

The Islamic model of corporate governance provides a solid foundation for the protection of shareholders. Islamic principles reject any form of oppression towards minority shareholders. Discriminatory treatment or exploitation by the controlling shareholders in relation to minority shareholders is prohibited. The minority shareholders have to be treated the same as majority shareholders, especially in the event of a buy-out or any other fundamental change of the company structure. Islamic principles also guarantee shareholders – especially the minority group – the right to express their voice effectively to the board of directors or at the shareholders meeting.

5.3.2 The Duty of Company's Management

The company's board of director members, top executives, and other management officers are obliged to observe Islamic governance principles. Islam imposes a trust duty on every custodian of the company's assets. That implies a wide scope of fiduciary duty of care in an Islamic

governance system, including every employee of the company. On the other hand, the decision-making structure of the company has to observe the Islamic *shuratic* decision-making process. Hence, a constructive environment of deliberation and consultation before undertaking decisions, or at least the important ones, within the organization has to be observed. The voices of all participants in the company should receive prompt attention from the decision makers, especially those weak parties such as minority shareholders and employees. Decision-making goals must focus on the company's interest, as reflected in the stakeholder primacy theory of governance.

5.3.3 Transparency and the Disclosure Framework

An Islamic model of governance encourages a transparent corporate governance framework. Generally, the disclosure system endorsed by modern corporate governance coincides greatly with Islamic principles. Nonetheless, the Islamic disclosure system has a wider scope than the modern disclosure system. The disclosure system in Islam has its own characteristics which require disclosing information that concerns Muslim investors and stakeholders, especially employees and consumers. Investors and the other stakeholders have the right to acquire detailed information about the company's financial structure and business activities. That is not to assess the company's financial position or future prospect but to instead ensure the company is not engaged in activities contradicting Islam, such as interest finance (usury), or the selling or provision of prohibited products or services (i.e. wine production or selling). Islamic discourse system obliges companies to be transparent with regard to their social responsibility obligations (zakat payment) and policies (sustainability).

5.3.4 Accountability

An Islamic perspective of accountability provides the foundation of two important corporate subjects. First, accountability is intertwined with Muslims' belief of the unity of the God (*Allah*), the day of judgment, and human stewardship (*kilafah* or vice-regency) over the earth. Such belief has two crucial implications to the corporate governance. First, corporations are required to peruse socially-responsible policies. A publicly traded corporation is not merely a wealth-generating engine for its shareholders as, for instance, Milton Freidman advocates,¹³¹ but rather a juridical person with social functions and responsibilities. Therefore, the Islamic view of socially responsibility coincides with modern corporate "socially- responsible" literature and standards, such as the conservation of natural resources and the charitable contribution to the community.

Secondly, the Islamic perspective of accountability furnishes the foundation of the enforcement framework of corporate governance principles. Generally, an Islamic enforcement framework consists of two main components. The first part is connected to afterlife accountability by *Allah* to all individuals. Every person will be held accountable on the Day of Judgment for his or her actions in life. A strong belief of such inescapable accountability may encourage Islamic corporate governance principles, namely the ones intertwined with Islamic teachings such as fairness, social responsibility, transparency, and trustworthiness. The second part is related to the enforcement of corporate governance principles in this life. The duty of *hisbba*, or "encouraging good and discouraging wrongs," offers the basis of today's enforcement model of corporate governance principles. This model consists of a tri-layer structure: self-

¹³¹ For Milton Friedman view, see *supra* note (9) chapter IV.

enforcement by individual believers; civil society's enforcement by a group of believers; and sanctioned enforcement by the government. The first two layers represent a self-enforcing mechanism of corporate governance principles. For instance, an individual stakeholder or a group of stakeholders are required to carry out the *hisbba* duty by encouraging the company to pursue good corporate governance and discouraging any violation of corporate governance principles. The last layer is related to enforcement of corporate governance by the government. Besides performing their legal responsibilities, government institutions are required to fulfill their *hisbba* role as a representative of society. Defaulting on the enforcement of laws and regulations assigned to government institutions will make the whole society sinful for not performing their duty of *hisbba*. Because the ultimate obligation of enforcement rests on society, self-enforcing *hisbba* may complement any weakness in the government's enforcement framework, especially in developing countries where an enforcement framework is normally not efficient. In this regard, Majid Khadduri said: "if the state failed to enforce the law ... , the believer still remained under the obligation to observe the law even in the absence of anyone to enforce it."¹³² The society and the government (as the people's representatives) have to ensure the application of corporate governance principles on an equal basis. Islam stands strongly against any selective application of its rules or standards.

On the other hand, the enforcement standard of corporate governance might be increased if a clear connection between modern corporate governance principles and their Islamic counterparts were emphasized. Such a move is expected to raise the degree of approval of corporate governance principles by Islamic societies, especially in countries consisting of

¹³² Majid Khadduri, *Nature and Source of Islamic Law*, 22 GEO. WASH. L. REV. 3, 7 (1953).

religiously conservative citizens such as Saudi Arabia. Unfortunately, Saudi Corporate Governance Rules “SCGRs” have ignored the significance of such a connection by not linking its rules with Islamic teachings. For instance, SCGRs do not incorporate the *shura* principle and do not emphasize the importance of disclosing material information to Muslim investors and stakeholders. Accordingly, the Saudi Capital Market Authority “SCMA” may need to rethink its current approach of implementing corporate governance in the country which merely focuses on complying with the international best standards toward a balanced approach that takes national factors into account. A step like that, if taken, would promote good corporate governance aims in Saudi Arabia and encourage people to uphold the corporate governance principles as part of their religious duties.

5.4 CONCLUSION

This Chapter highlights several Islamic principles that have a connection to corporate governance principles. The Islamic corporate governance model is founded mainly upon six principles: social responsibility, *adel*, trustworthiness, honesty, *shura*, and accountability. The analysis of the substance of these principles reveals a great overlap between the Islamic view of corporate governance and the modern corporate governance thesis. Both systems support efficiency, sustainability, fairness, transparency and accountability. Nonetheless, the Islamic corporate governance model contains a few exceptional principles that require the adoption of a *shuratic* decision-making process within the company and the expansion of the scope of a disclosure system to include matters concerning Muslim investors, especially regarding the company’s line of business, financial structure, and Zakat payment. There is an obvious disparity

between the Islamic corporate governance framework in theory as articulated in this chapter and the Muslims communities' actual respect of corporate governance value.¹³³ Islamic countries, regrettably, suffer from common third world governance problems, mainly corruption¹³⁴ and weak contract enforcement.¹³⁵ When the gap between business ethics standards and practice was slim several centuries ago, Muslim merchants astonished other, non-muslim business communities by their high moral standards and caused a huge number of those societies to convert to Islam.¹³⁶ A notable example is Indonesia, today's largest Islamic state, which became an Islamic country through the interaction of ethically-abiding Muslim merchants.¹³⁷ At the end, Islamic corporate governance leans toward the stakeholders' theory, which promotes the consideration of the interests of non-shareholder constituents when governing the company.

¹³³ See Rice, *supra* note 18, at 352.

¹³⁴ Most Islamic countries ranked at the rear of the corruption rankings. See Transparency International: Corruption Perception Index of 2012, available at http://issuu.com/transparencyinternational/docs/cpi_2012_report/1 (accessed on May 14, 2013).

¹³⁵ Many Islamic countries scored very low in the contract enforcement ranking conducted by the World Bank. See the World Bank: International Finance Corporation, Doing Business Index 2012, Economy Ranking, available at <http://www.doingbusiness.org/rankings> (accessed on May 14, 2013).

¹³⁶ See Rice, *supra* note 18, at 347.

¹³⁷ See WILSON, *supra* note 20, at 31, 137. Indonesia population is over 250 millions, more than% 86 is Muslims. Central Intelligence Agency (CIA): the World Factbook, Indonesia, available at <https://www.cia.gov/library/publications/the-world-factbook/geos/id.html> (accessed on May 14, 2013).

6.0 CORPORATE GOVERNANCE IN SAUDI ARABIA: GENERAL FRAMEWORK

6.1 INTRODUCTION

This chapter is devoted to discussing the general framework of existing Saudi corporate governance. The external structure of corporate governance is crucial to corporate governance reform. The development of institutions complementing corporate governance and the ownership pattern of publically traded companies are decisive factors in determining the trajectory of corporate governance reform in all countries. Accordingly, this chapter provides an introduction to the Saudi capital market, including capital market authority functions. With this introduction as a foundation, the ownership structure of Saudi publicly traded companies is examined. From this point, the chapter moves into a discussion of the sources of corporate governance in Saudi Arabia. Furthermore, the disclosure system in publicly traded companies is investigated. Finally, this chapter assesses the capability of the Saudi judicial system in promoting good corporate governance in the country.

6.2 SAUDI CAPITAL MARKET

6.2.1 Historical Remarks

The Saudi capital market, arguably, emerged hand in hand with the formation of the first Saudi joint stock company, “Arab Automobile,” in 1935.¹ The trading volume developed and expanded with the increase of the number of joint stock companies.² In 1982, the Kuwaiti Capital Market collapsed in the *Souk Al-Manak* catastrophe, caused mainly by trading forward checks.³ In response, the Saudi authority decided to regulate its capital market to prevent the same disaster from happening in the Saudi capital market. 1984 witnessed the first set of financial regulations in the Saudi capital market, including the forbidding of trading stocks by forward checks.⁴ The reactive and precautionary regulations enacted by the Saudi authority to avoid such a problem from happening in Saudi Arabia had encompassed the premature statutory and institutional frameworks of the capital market.⁵ That implemented framework had assigned the stock market regulation and supervision to a ministerial committee consisting of three relevant ministries: the

¹ See the Saudi Stock Exchange (Tadawul) website, *available at* <http://www.tadawul.com.sa> (accessed on Oct. 17, 2011). Arabian Automobile wound up shortly after its creation in 1935.

² In the middle of 1975, there were 14 (JSCs). Saudi Stock Exchange (Tadawul) website, *available at* [http://www.tadawul.com.sa/wps/portal!/ut/p/c1/04_SB8K8xLLM9MSSzPy8xBz9CP0os3g_AewIE8TIwMLj2AXA0_vQGNzY18Q1wAoH4kk7x4QZmrgaeITbBQc4GVs4GIEQHdwYpG-n0d-bqpQW5EOQAsB49z/dl2/d1/L0IHSkovd0RNQUprQUVnQSEhL11CWncvZW4/!](http://www.tadawul.com.sa/wps/portal!/ut/p/c1/04_SB8K8xLLM9MSSzPy8xBz9CP0os3g_AewIE8TIwMLj2AXA0_vQGNzY18Q1wAoH4kk7x4QZmrgaeITbBQc4GVs4GIEQHdwYpG-n0d-bqpQW5EOQAsB49z/dl2/d1/L0IHSkovd0RNQUprQUVnQSEhL11CWncvZW4!/) (accessed on Oct. 17, 2011).

³ In 1982, Kuwaiti capital market experienced a precipitous drop. “*Souk Al-Manak*” was the first capital market disaster in the GCC countries. The official market lost about one quarter of its value and the unofficial market lost about 60% of its value. The main cause of the market collapse was the trading in forward checks in lieu of cash which created a bubble that imploded in 1982. As a result, the Kuwaiti government restructured the Kuwaiti capital market and enacted a new regulatory framework of the market to halt such a calamity from happening again. Kirt C. Butler & S.J. Malaikah, *Efficiency and Inefficiency in Thinly Traded Stock Markets: Kuwait and Saudi Arabia*, 16 J. BANKING & FIN. 197, 198–99 (1992).

⁴ ABDULAZIZ M. AL-DUKHEIL, *THE BANKING SYSTEM AND ITS PERFORMANCE IN SAUDI ARABIA* 57 (1995).

⁵ See Butler & Malaikah, *supra* note 3, 197, 199.

Ministry of Commerce and Industry, the Ministry of Finance and the Saudi Arabian Monetary Agency (SAMA).⁶ The Ministry of Commerce, according to Saudi Companies' Law (SCL), had – and still has – the authority to regulate and supervise Saudi joint stock companies (JSC) from a company's formation to its winding up, which includes the stock issuance, negotiation (transfer) of shares, and public offering.⁷ Also, the Ministry has the discretionary authority over the conversion companies to the joint stock company form.⁸ The Ministry of Finance has general authority to articulate the financial policy of the country, which includes capital market policies and goals.⁹ Most importantly, SAMA is entrusted with the “operational ... management of the Saudi stock market.”¹⁰ Similar enough to the German stock market structure, SAMA authorized national banks exclusively to serve as intermediaries (brokers) of the selling and purchasing stocks.¹¹ A Saudi official commented on that approach:

Because there are more than 1,000 bank branches across the Kingdom, it was thought the banks were in the best position to provide this service to all citizens,

⁶ Saudi Stock Exchange (Tadawul) website, *available at* http://www.tadawul.com.sa/wps/portal!/ut/p/c1/04_SB8K8xLLM9MSSzPy8xBz9CP0os3g_AewIE8TIwMLj2AXA0_vQGNzY18Q1wAoH4kk7x4QZmrgaeITbBQc4GVs4GIEQHdwYpG-n0d-bqpQW5EOQAsB49z/d12/d1/LOIHSkovd0RNQUprQUVnQSEhL1ICWncvZW4!/ (accessed on Oct. 17, 2011).

⁷ Saudi Companies Law (CL) enacted by Royal Decree No. (M/6) in (Rabi-Al-Awwal 22, 1385 H) correspondent to (July 22, 1965).

⁸ For the rules required by the Ministry of Commerce and Industry for conversion to joint stock company, see The Guidelines for Conversion to Joint Stock Companies issue by the Ministry of Commerce and Industry resolution number (495) dated in Rabia Al-Awal 25, 1418 H correspondent to July 29, 1997.

⁹ See RAMADY, *supra* note 88, at 148.

¹⁰ *Id.*

¹¹ Article 1 in “the Executive Rules to Regulate Dealings in Company's Shares Through Local Banks” which states that:

The duty of buying and selling shares of Saudi joint stock companies are restricted to Saudi banks which are licensed to do so. The banks perform the role of mediator on behalf of clients (directly) and no share dealings can take place without their mediation.

Cited in Awwad Saleh Awwad, *Legal Regulation of the Saudi Stock Market: Evaluation and Prospects for Reforms*, 393, Appendix A (PhD) (2000) (unpublished dissertation University of Warwick School of Law) (one file with author).

even if they are in remote locations. Most importantly, building the stock exchange within the banking system would provide the market with better settlement and clearing systems. It was rightly assumed that situating the stock market within the banking system would provide the market with the best and less risky settlement.¹²

Every licensed brokerage bank has to designate a special unit in Riyadh (the capital) to perform the newly assigned brokerage function. The banks are allowed to charge commissions for its services.¹³ However, the banks are prohibited from trading in the stock market for their own accounts.¹⁴ At that time, stock trading was settled and cleared manually (off-exchange).¹⁵

During the period from 1985 to 2001, several important steps were taken by SAMA to improve the performance and efficiency of capital markets. First, it formed a company to handle the registration of joint stock companies' shares.¹⁶ Second, trading was facilitated in the market by introducing a system that allows investors to buy and sell stocks through the Internet.¹⁷ The system was named Tadawul (2001).¹⁸ In 2003, Saudi government took steps to regulate capital markets by unifying the regulatory and supervision mandates into a single government agency (Capital Market Authority "CMA")¹⁹ and initiating a formal securities exchange, Tadawul.

¹² Interview with Mr. Mansoor Al-Mayman, Deputy Minister of Finance and Member of the supervisory committee, Riyadh, November 21, 1997, quoted in Awwad, *supra* note 11, at 182.

¹³ Banks are allowed to charge no more the 1% of the transaction as a settlement fee. *See* Butler & Malaikah, *supra* note 3, at 197, 199.

¹⁴ Article 1 in "the Executive Rules to Regulate Dealings in Company's Shares Through Local Banks, quoted in Awwad Saleh Awwad, *Legal Regulation of the Saudi Stock Market: Evaluation and Prospects for Reforms*, Appendix A (PhD) (unpublished dissertation University of Warwick School of Law 2000).

¹⁵ *See* Butler & Malaikah, *supra* note 3, at 197, 199.

¹⁶ The company name "the Saudi Shares Registration Company." *See id.*

¹⁷ *See* RAMADY, *supra* note 88, at 149. In fact, Tadawul has followed other technologically advanced system (of that time) called "the Electronic Securities Information System (ESIS)" which was launched in 1990. *See generally* Awwad, *supra* note 11, App. A, at 197–213.

¹⁸ *See id.* This internet based system, initiated in 2001, follows an electronic-based trading system that was launched six years before the TADAWUL initiation. *Id.* at 148–49.

¹⁹ SCML art. § (4)(a).

6.2.2 Modern Capital Market Structure

6.2.2.1 Regulatory Framework

i. Capital Market Authority (CMA)

The Capital Market Law (CML)²⁰ established an independent government entity entrusted with the supervision and regulation of the Saudi capital market, “The Capital Market Authority” (CMA).²¹ The CMA has the power to implement the CML provisions and passes all related rules and regulations.²² The CML sets the objectives of the CMA which encompasses, *inter alia*, the regulation of securities offering and trading,²³ disclosure,²⁴ public offering,²⁵ and proxy.²⁶ More importantly, the CML entrusts the CMA with the protection of capital market investors from any unfair or deceptive actions which may occur in the Saudi capital market.²⁷ The CML has granted

²⁰ The Capital Market Law (SCML) that the enacted by the royal decree number (M/30) in Jumada al-Ahkirah 2, 1424 correspondent to (July 31, 2003).

²¹ CML Article § (4)(a) which states that:

An Authority to be named “The Capital Market Authority” is hereby established in the Kingdom and shall directly report to the President of the Council of Ministers. It shall have a legal personality and financial and administrative autonomy. It shall be vested with all authorities as may be necessary to discharge its responsibilities and functions under this Law. The Authority shall enjoy exemptions and facilities enjoyed by public organizations. Its personnel shall be subject to the Labor Law.

However, this is a relative independence by which the (SCMA) has to coordinate its work with the Saudi Arabian Monetary Agency (SAMA) with regard any matter that might affect any the monetary conditions in Saudi Arabia. CML Article § (6)(b).

²² CML art. § (5) para. (a) and art. § (6) para. (a) subparagraph (1).

²³ CML art. § (5)(a)(2).

²⁴ *Id.* § (5)(a)(6).

²⁵ *Id.* § (5)(a)(7).

²⁶ *Id.*

²⁷ *Id.* art. § (5)(a)(4).

the CMA wide power, *inter alia*, to suspend the exchange for no more than one day,²⁸ specify the brokers' commissions,²⁹ prohibit and suspend trading of any share or issuance,³⁰ set standards and requirements of auditing listed companies and investment funds,³¹ license rating agencies,³² and prescribe conditions and standards of the company's financial statements and the board of director's report contents.³³

The CMA is managed by a board called "the Board of Capital Market Authority" (BCMA).³⁴ The BCMA has the power to:

[E]xercise all authorities entrusted to the [Capital Market] Authority in accordance with the provisions of ... [Capital Market] Law. The Board will specify how the Authority's functions, responsibilities and operations will be organized among its divisions and departments.³⁵

The BCMA consists of five full time members (commissioners) including the board chairmen.³⁶ All commissioners are appointed by Royal Order for a five year session that can be renewed one time.³⁷

²⁸ *Id.* § (6)(a)(5).

²⁹ *Id.* § (6)(a)(8).

³⁰ *Id.* § (6)(a)(7).

³¹ *Id.* § (6)(a)(9).

³² *Id.* § (6)(a)(18).

³³ *Id.* § (6)(a)(10).

³⁴ *Id.* § (7)(a).

³⁵ *Id.* § (7)(d).

³⁶ *Id.* § (7)(a). To secure the independent and impartiality of the SBCMA members, the SCML Article § (11) provides that:

The members of the Board and the employees of the Authority shall not engage in any other profession or job, including occupying a position or a post in any company, in the government, or public or private institutions. Furthermore, they shall not provide advice to companies and private institutions.

³⁷ *Id.* art. § (7)(b).

The chairman of the BCMA is the CMA chief executive officer, who is in charge of “implement[ing] the Authority’s policy and shall be responsible for the management of its affairs.”³⁸ CMA is entrusted with the supervision of four market players that are Saudi Stock Exchange (Tadawul), authorized persons, listed companies, and traders.³⁹

ii. Saudi Stock Exchange (Tadawul)

The CML provides that a formal capital market has to be established, under the name of “[s]audi stock exchange” (Tadawul).⁴⁰ In 2007, the Saudi Council of the Ministers established the new exchange company⁴¹ with a 1,200,000,000 SR cash capital,⁴² totally provided by the government.⁴³ The SCML prescribes that Tadawul opt to select a joint stock company form⁴⁴ and allows Tadawul to sell part of its shares to the public.⁴⁵ Tadawul is the exclusive securities’ exchange in Saudi Arabia.⁴⁶ Tadawul’s bylaws provides:

The purposes of ... [Tadawul] include the provision and management of securities trading services, providing settlement and clearing services of securities, depository and registration of securities ownership, and dissemination of securities information ... [Tadawul] may engage in other related activities in order to meet its objectives as specified in the Capital Market Law.⁴⁷

³⁸ *Id.* § (11).

³⁹ *Id.* § (6)

⁴⁰ A good step intends to separate regulatory functions from the operational one as illustrated by best practices.

⁴¹ Council of Ministers resolution No. (71) in Safar 29, 1428H correspondent to (Mar. 19, 2007).

⁴² Tadawul By-law Article § (6). The Capital in dollars is around \$320 billion.

⁴³ That capital was provided by the Saudi government investment medium called “the Public Investment Fund.” Tadawul By-law Article § (6).

⁴⁴ Tadawul By-Law Article (1).

⁴⁵ *Id.* art. (7).

⁴⁶ CML Article § (21)(b).

⁴⁷ Article § (3).

The CML delineates the chief objectives for Tadawul as follows:⁴⁸

- Insure fairness, efficiency, and transparency of the listing requirements and trading rules.
- Implement reliable and swift settlement and clearance system.
- Frame professional standards for brokers and enforce those standards.
- Insure the financial strength and soundness of brokers.
- Implement a proper framework for the protection of money and securities under the control of the brokerage companies.

The company is managed by a board of directors comprised of nine members⁴⁹ representing the relevant government authorities (Ministry of Finance, Ministry of Commerce and Industry, and Monetary Agency)⁵⁰ and various capital market players (four members representing brokerage companies, and two members representing listed joint stock companies).⁵¹ Both public and private sectors' board members are appointed by the Council of Ministers.⁵² The board has the authority to propose to the Board of CMA any regulations, rules, and directives that are related to the operation of the capital market exchange (Tadawul).⁵³ Tadawul are managed by an executive manager appointed by the Tadawul Board of Directors with approval of the Board of CMA.⁵⁴

iii. Securities Dispute Committees

The SCML has established a specialized (apart from the judicial branch) dispute settlement mechanism, “the Committee for Resolution of Securities Disputes” (CRSD) to adjudicate any

⁴⁸ CML Article § (20)(c)(1–4).

⁴⁹ CML Article § (20)(a).

⁵⁰ SCML Article § (22)(b)(1–3).

⁵¹ *Id.* § (22)(b)(4 & 5).

⁵² *Id.* § (22)(b).

⁵³ SCML Article § (23)(a) and SCML Article § (22)(e). According to this article, the Tadawul Board of Directors has the authority to propose requirements for listing and trading of securities.

⁵⁴ SCML art. § (22)(e).

dispute arising in connection to CML provisions, applications or regulations enacted within the realm and power of CML.⁵⁵ Moreover, the CRSD jurisdiction includes the review of any complaint over resolution or any other action taken by the CMA or Tadawul.⁵⁶ The CML dictates that committee members have to be legal experts specializing in “commercial ... , financial affairs and securities.”⁵⁷ The CRSD has wide authority “to investigate and settle complaints and suits, including the power to issue subpoenas, issue decisions, impose sanctions and order the production of evidence and document.”⁵⁸ In other words, the committee has jurisdiction over three legally recognized areas: civil law, administrative law, and criminal law. This wide authority has a positive impact on accelerating the process of justice by unifying jurisdictions of adjudicating matters related to capital markets in one dispute settlement mechanism. Otherwise, for instance, a judicial review of CMA actions including decisions, rulings, and resolutions as an administrative agency would be in front of the Board of Grievances (administrative court).⁵⁹

The decisions of the Committee for Resolution of Securities Disputes can be appealed in front of an appellate panel, “the Appeal Committee for the Resolution of Securities Conflicts” (ACRS).⁶⁰ According to the SCML, the ACRC has:

The discretion to refuse to review the decisions of the Committee for the resolution of Securities Disputes, to affirm such decisions, to undertake a *de novo* review of the complaint or suit based on the record developed at hearing before

⁵⁵ SCML art. § (25)(a) [hereinafter CRSD].

⁵⁶ *Id.* § (25)(c).

⁵⁷ *Id.* § (25)(b).

⁵⁸ *Id.* § (25)(a).

⁵⁹ The Board of the Grievances Law (*Diwan Al-mazalm*) (BGL) art. § (13)(b).

⁶⁰ SCML art. § (25)(f). According to this article, “the appeal has to be filed within from their notification date.”

the Committee and issue such decision as it deems appropriate in relation to the complaint or the suit.⁶¹

Clearly, allowing the ACRS the discretion of admitting cases for review reflects the influence of the American legal ideology on the CML.⁶² The appellant panel is comprised of three members representing three government bodies: the Bureau of Experts at the Council of Ministers, the Ministry of Finance, and the Ministry of Commerce and Industry, for a renewable three year session.⁶³ Final decisions issued by CRSD⁶⁴ or the decisions of ACRC have equal legal standings as the decisions issued by the ordinary courts.⁶⁵ Moreover, the decisions of both committees are enforced in the same manner of enforcing court decisions.⁶⁶ Obviously, the specialized dispute mechanism of solving securities disputes has the weight and respect as any other counterpart in the judiciary.

Most of the cases filed and appealed are in civil matters. In 2010, for instance, 93 (81.6%) cases were filed in civil matters out of a total of 114 cases filed in front of CRSD⁶⁷ and 57 appeals were filed in the same matter in front of ACRC out of 75 appeals.⁶⁸ In contrast, only

⁶¹ SCML art. § (25)(g).

⁶² In general, in the American legal system, the petition for review filed in the Supreme Court is not a right of the grievant but rather a discretionary power vested in the hands of the Supreme Court, which is called the writ of certiorari. See (Rule 10) in the Rules of the Supreme Court of the United States which states that: “[r]eview on a writ of certiorari is not a matter of right, but of judicial discretion. A petition for a writ of certiorari will be granted only for compelling reasons.”

⁶³ SCML art. § (25)(g).

⁶⁴ *See id.* The CRSD only become final if they are not appealed within a legally required period. *See id.* art. § (25)(f).

⁶⁵ SCML art. § (25)(g). The ACRC decisions are always final. But CRSD decisions only become final if they are not appealed within a legally required period. *See id.* art. § (25)(f & g).

⁶⁶ *See* SCML art. § (25)(h).

⁶⁷ Saudi Capital Market Authority, Annual report, tbl.58, p. 137 (2010).

⁶⁸ *Id.* at tbl.62, at 142.

11 criminal cases were filed before the CRSD (representing 9.6% out the total filed cases)⁶⁹ and 14 cases were appealed before the ACRC (representing 18.7% out of the total filed cases).⁷⁰ The administrative cases were the least number filed in front of both committees (CRSD and ACRC).⁷¹

Unfortunately, the CRSD has not risen yet to the level of expectation of its founder by delivering a fast track exceptional dispute settlement mechanism for the Saudi Capital Market. The CRSD is not delivering enough verdicts compatible with the amount of cases filed in front of it. In 2010, a mere 15 cases were decided upon by CRSD against 114 cases filed.⁷² To the contrary, ACRC seemed more productive as it issued verdicts on 108 appeals⁷³ against 75 cases appealed before it in the same year.⁷⁴ The inconsistency of production among these committees needs to be addressed and solved by the SCMA before cases accumulate in the CRSD; otherwise, the idea of the CML designer of securing an efficient dispute settlement mechanism for the Saudi nascent capital market apart from the ill-functioning judicial branch sooner or later will be compromised.⁷⁵

⁶⁹ *Id.* at tbl.58, at 137.

⁷⁰ *Id.* at tbl.62, at 142.

⁷¹ *See id.* at tbl.58, at 137. *See also id.* at tbl.58, at 137.

⁷² *See id.* at 136.

⁷³ *Id.* at tbl.63, at 144.

⁷⁴ *Id.* at tbl.62, at 142.

⁷⁵ *See* Joseph W. Beach, *The Saudi Arabian Capital Market Law: A Practical Study of the Creation of Law in Developing Markets*, 41 STAN. J. INT'L L. 307, 318–19 (2005).

6.2.2.2 The Economics of the Saudi Stock Market

In 2010, the capitalization of the capital market reached \$354 Billion.⁷⁶ Accordingly, the Saudi capital market is regarded the biggest market in Arab World⁷⁷ including the GCC countries' capital markets,⁷⁸ and the largest capital market in the Middle East capital markets.⁷⁹ Moreover, in 2009, the Saudi capital market was ranked 23rd worldwide.⁸⁰

⁷⁶ World Bank, World Development Indicators (2010), *available at* <http://data.worldbank.org/country/saudi-arabia> (accessed on Nov. 10, 2011).

⁷⁷ The Arab World, in this study, refers to the 22 member countries in the League of Arab States, including the Palestinian territory: Algeria, Bahrain, Comoros, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Somalia, Sudan, Syria Tunisia, United Arab Emirates, and Yemen. For more information, see the League of Arab States' website, *available at* http://www.arableagueonline.org/wps/portal/las_en/home_page!/ut/p/c5/04_SB8K8xLLM9MSSzPy8xBz9CP0os3gXy8CgMJMgYwOLYFdLA08jF09_X28jIwN_E6B8JG55C3MCuoNT8_TDQXbiNwMkb4ADOBro-3nk56bqF-RGVHjqOioCAKQoUKM!/d13/d3/L2dBISEvZ0FBIS9nQSEh/ (accessed on Nov. 10, 2011). The second largest Arab capital market is the Kuwaiti capital market with a capitalization of \$119,620,955,366. World Bank, World Development Indicators (2010), *available at* <http://data.worldbank.org/indicator/CM.MKT.LCAP.CD> (accessed on Nov. 10, 2011).

⁷⁸ Arabian Gulf countries are the member countries of "the Cooperation Council for the Arab States of the Gulf": Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates. See the Cooperation Council for the Arab States of the Gulf website, <http://www.gcc-sg.org/eng/indexc64c.html?action=GCC> (accessed on Nov. 10, 2011). In fact, the Saudi Capital Market capitalization is almost equivalent to the other five states' total capital markets' capitalization. The second largest capital market in the Middle East is the Turkish capital market with a capitalization of \$306,662, 330,597. World Bank, World Development Indicators (2010), *available at* <http://data.worldbank.org/indicator/CM.MKT.LCAP.CD> (accessed on Nov. 10, 2011).

⁷⁹ The second largest capital market in the Middle East is the Turkish capital market with a capitalization of \$306,662,330,597. See the World Bank, World Development Indicators (2010), *available at* <http://data.worldbank.org/indicator/CM.MKT.LCAP.CD> (accessed on Nov. 10, 2011).

⁸⁰ The Central Intelligence Agency (CIA), the World Factbook, *available at* <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2200rank.html> (accessed on Nov. 10, 2011).

Table 3. Arab Countries' Capital Markets Indicators

Capital Market	Number of Listed Companies	Market Capitalization	Traded Shares	Turn Over ratio (%)
Amman (Jordan)	247	27,209.900.000	618,800.000	2.6
Bahrain	29	16,590.000.000	95,900.000	0.6
Tunisia	57	9,647.800.000	72,000.000	3.73
Saudi Arabia	150	338,873.000.000	13,448.200.000	25,4
Muscat	130	26,209.700.000	506,900.000	1.8
Kuwait	216	86,295.000.000	11,975.000.000	8.1
Beirut (Lebanon)	25	10,285.000.000	13,700.000	0.7
Egypt	214	48,679.000.000	3,648.000.000	9.5
Casablanca	76	60,092.200.000	66,600.000	3.9
Abu Dhabi	67	71,329.000.000	2,883.740.000	1.60
Dubai	62	49,033.000.000	3,779.300.000	2.5
Qatar	42	125,598.000.000	668,600.000	4.7
Khartoum	56	2,695.000.000	16,200.000	8.6
Algiers	2	135,600.000	80,900	0,45
Damascus (Syria)	21	1,527.520.000	4,830.000	1.50

Source: Arab Countries Capital Markets, Arab Monetary Fund: (Fourth Quarter of 2011)

Saudi Market capitalization has risen immensely in a very short period of time, reaching its peak in 2007 at \$515 billion.⁸¹ However, the massive increase was no more than a bubble that imploded after a short period of time to return to almost the same level that was before the vast increase had taken place.⁸² The Saudi capital market drop is one of the most severe market

⁸¹ World Bank, World Development Indicators, available at <http://data.worldbank.org/indicator/CM.MKT.LCAP.CD> (accessed on Nov. 10, 2011). Accordingly, Saudi Capital market value exceeded the value of some developed economies such as Italy. *Id.*

⁸² Saudi Capital Market capitalization returned in 2010 to an approximate level preceding the 2006 massive increase. See The World Bank, World Development Indicators (2010), available at <http://data.worldbank.org/indicator/CM.MKT.LCAP.CD> (accessed on Nov. 10, 2011).

⁸² World Bank, World Development Indicators (2010), available at <http://data.worldbank.org/indicator/CM.MKT.LCAP.CD> (accessed on Nov. 10, 2011).

declines in the modern history of stock markets.⁸³ The collapse was a Saudi-caused and suffered crisis.⁸⁴ In other words, in the wake of 9/11 Saudi expatriate investments flooded back to Saudi Arabia due to the fear of unwanted legal actions that might be taken against Saudi citizen's investment, especially by the U.S. government.⁸⁵ Moreover, oil price boosts since the 2000's had injected enormous amounts of cash into the Saudi economy, which then leaked into the capital market through government spending.⁸⁶ During both periods of increase and decline, the capital market suffered from a great deal of speculation fueled by rumors, or recommendations – as called by Saudis – to soften its illegal implications.⁸⁷ In fact, most investors at that time (and to some degree still) are not aware of violating the law when buying and selling on inside information. Becoming worse off, many people spread rumors with good intentions and directed other people to the “El Dorado.”⁸⁸ However, most rumors were fabricated by a large number of speculators who intended to inflate the price of the targeted stocks and then sell those stocks at a higher price to the rumors' followers. Additionally, there was a lack of competent financial analysts who could offer impartial financial advice on the stock market and share trading on

⁸³ See FERNANDO DELGADO & MAHER HASAN, STOCK MARKET DEVELOPMENTS IN THE COUNTRIES OF THE GULF COOPERATION COUNCIL (Ahsan Mansur & Fernando Delgado eds., 2008). In fact, The Saudi Capital Market lost around 60% of its market value.

⁸⁴ The Saudi capital market was almost confined to Saudi citizens at the time of the crash.

⁸⁵ See Abdul Momen, Impact of 9/11 on the Saudi Economy, Arab News (posted July 29, 2002), *available at* <http://www.arabnews.com/node/222928> (accessed on June 10); Mohamed A. Ramady, 9/11 Changes the Face of Gulf Economies, Arab News (posted Sept. 25, 2006), *available at* <http://www.arabnews.com/node/289492> (accessed on June 11, 2012); Fahad Mohammad Almajid, A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective 221 (Ph.D.) (2008) (unpublished dissertation University of Manchester).

⁸⁶ See Jadwa Investment, Oil and the Saudi Stock Market, 2 (May 2011), *available at* <http://www.jadwa.com/en/researchsection/research/market-research?page=2> (accessed on Dec. 26, 2012).

⁸⁷ See RAMADY, *supra* note 148, at 166.

⁸⁸ “El Dorado” is a mythical story about a missing city full of gold. The current meaning refers to “any place where wealth can be quickly and easily gained.” Eldorado 2011, Encyclopedia Britannica Online, *available at* <http://www.britannica.com/EBchecked/topic/182231/Eldorado> (accessed on Nov. 10, 2011).

various media channels.⁸⁹ For example, in a very short period of time, before the market collapsed, analysts projected the market index would continue to boost swiftly,⁹⁰ but that was merely conjecture. The market started to decline on February 26, 2006 and eventually lost around 70% of its value in a short period of time.

Table 4. Saudi Stock Market Capitalization 2002–2011

Year	Market Capitalization (Billion SR)	Change %
2002	280.73	2.26%
2003	589.93	110.14%
2004	1,148.60	94.70%
2005	2,438.20	112.28%
2006	1,225.86	-49.72%
2007	1,946.35	58.77%
2008	924.53	-52.50%
2009	1,195.51	29.31%
2010	1,325.39	10.86%
2011	1,270.84	-4.12%

Source: Saudi Stock Exchange (Tadawul), Annual Statistical Report (2011). PP.42.

National banks played a major role in inflating that market bubble by providing small investors with outsized loans to be invested mainly in the stock market.⁹¹ The banks' advances were usually secured by the investor's portfolio, salary, or any other asset.⁹² As soon as the stock

⁸⁹ In the well-regarded (CNBC Arabia) T.V. channel, a Saudi financial analyst appeared a short time after the market collapse and forecasted an increase of the capital market.

⁹⁰ Abraheem Algirnas, *tawguat bi wosul al-muaasher ila ithnain wa ashreen alf nogta (alriyadh)*, Newspaper: Issue No. 13803 in April 11, 2006, *available at* <http://www.alriyadh.com/2006/04/11/article145404.html> (accessed on Dec. 23, 2012).

⁹¹ The banks' own finances increased massively from approximately 40 billion SR in early 2003 to around 188 billion SR on the day of crash. Abualhameed al-umari, *al-Thikra al-Kamisah Linhiyar al-souk al-Saudiah (2006–2011) [the Fifth Anniversary of Saudi Market Crash 2006–2011]*. Al-Riyadh Daily Newspaper, February 21, 2011 issue number 15587, *available at* <http://www.alriyadh.com/2011/02/26/article608219.html> (accessed on Nov. 12, 2011).

⁹² Many people sold their homes, cars, and whatever they could capitalize on to invest in the capital market.

market started to decline, banks rushed to liquidate investors' portfolios fearing (or more likely knowing) that most creditors would not pay back their debts.⁹³

The government took several steps to stop the crash or at least to revive the market and mitigate the crisis. For instance, it split the nominal value of all trading shares by five to increase market liquidity.⁹⁴ Saudi high-ranking officials spoke publicly to calm panicked investors and discourage them from liquidating their portfolios by attributing the market decline to psychological factors rather than to economic ones.⁹⁵ Moreover, the King himself was very displeased with the collective loss of middle class citizens due to the capital market crash. Hence, he expelled the commissioner of the CMA.⁹⁶ The King also promised the creation of a fund for middle class citizens.⁹⁷ The government would manage the fund for the benefit of the middle class citizens. In this intended fund the government would bear the risk of any loss while the investors would enjoy the full amount of the profit. Clearly, the fund's main idea was to

⁹³ In many cases, the liquidation process had no valid legal ground, a situation which led to the filing of a great deal of cases against the banks. In most cases the ruling was against the banks in favor of the harmed investors. See the statement of the Chairmen of the CRSD (Dr. Mohammad Al-Marsogi.), cited in the Asharq Al-Awsat News Paper issue 10224 on November 25, 2006, available at <http://www.aawsat.com/details.asp?section=6&article=393675&issueno=10224> (accessed on Nov. 12, 2011).

⁹⁴ See Capital Market Authority Board resolution No. (4-154-2006) in 27 Safar, 1427 H correspondent to 27 March 2006.

⁹⁵ Even before the crash, a public official was encouraging the stock market rise. See Abualhameed al-Umari, al-Thikra al-Kamisah Linhiyar al-souk al-Saudiah (2006–2011) [the Fifth Anniversary of Saudi Market Crash 2006–2011]. Riyadh newspaper, February 21, 2011 issue number 15587, available at <http://www.alriyadh.com/2011/02/26/article608219.html> (accessed on Nov. 12, 2011).

⁹⁶ See Royal Order (A/44) in Rabi Al-Awal 14, 1427 H correspondent to (May 12, 2006), available at <http://www.spa.gov.sa/awamer.php?pg=24&lite=> (accessed on Nov. 11, 2011).

⁹⁷ For King Abdullah's televised speech on the promise of the creation of a fund for the low income Saudi citizens. See al-Riyadh Newspaper issue 13840 on May 16, 2006 (the original source is the Saudi Press Agency 'SPA'), available at <http://www.alriyadh.com/2006/05/16/article154990.html> (accessed on Nov. 12, 2011).

shield amateur investors from loss by appointing a professorial manager to do the job for them. However, the promised “government managed and guaranteed fund” has not materialized.⁹⁸

Since the 2006 crisis, the Tadawul All-Share Index (TASI) is still hovering around 6,000 points.⁹⁹ Moreover, the Saudi capital market is still suffering from high volatility,¹⁰⁰ and speculation practices are still evident.¹⁰¹ This may be attributed to the small number of listed companies in the Saudi capital market and to the slim number of tradable stocks in the exchange (Tadawul).¹⁰²

Actually, a fear from losing their assets may be preventing Saudis from reinvesting in the capital market. However, current stagnancy on the Tadawul All-Share Index could provide CMA time to develop its capabilities and perfect the regulatory structure of the Saudi emerging capital market. Needless to say, elevating the restriction on foreign investors to invest¹⁰³ directly in the Saudi capital market, instead of the current “Swap Agreement”,¹⁰⁴ mechanism, is an important step in developing the Saudi capital market.¹⁰⁵ The necessity does not stem from the cash inflow

⁹⁸ It seems the Saudi government has changed its mind about creating such a fund because no information about it has mentioned by any Saudi after the King’s televised speech in 2006, which encompassed his idea of creating such fund. *See generally* Rashid M. Alfozan, Sundooq Thawi Al-Dakl Al-Mahdood Ain?, Where is the low income mutual fund?, Riyadh newspaper issue number 14637 in 21 July, 2008 (in Arabic).

⁹⁹ Based on the closing of Tadawul All-share Index of 2009, 2010, and 2011. *See* Saudi Stock Exchange Tadawul, Tadawul Annual statistics of 2011, *available at* <http://www.tadawul.com.sa> (accessed on June 11, 2012).

¹⁰⁰ *See* RAMADY, *supra* note 88, at 162.

¹⁰¹ *See id.* at 163-64.

¹⁰² For floating shares issued in the Saudi stock market, *see* RAMADY, *supra* note 88, at 161–62.

¹⁰³ On the wake of 2006 market crash, non-Saudi residents were allowed to invest directly in the Saudi Stock Market with some restrictions.

¹⁰⁴ Under the SWAP agreement, foreign investors enjoy the economic rights of the share, but not the political one (voting right).

¹⁰⁵ SCMA founded its decision of allowing non-resident foreigners in Saudi Arabia to have access to stock markets on two grounds: to “deepen the capital market and promote its efficiency ... [and] strengthen the Saudi capital market’s openness indicator for foreign direct investments.” Saudi Capital Market Authority, 2010 Annual Report, 46 (2010).

that might be injected into the Saudi capital market by foreign investors but more importantly from the financial expertise international institutional investors would add to the system. Accordingly, the economic value added, which more likely would come with the international institutional investors to the Saudi Stock Market, would outweigh the fear from the “hot money” effect on the Saudi capital market.

6.3 SOURCES OF SAUDI CORPORATE GOVERNANCE

6.3.1 Hard sources

6.3.1.1 The Companies Law of 1965

The Companies Law of 1965 (CL)¹⁰⁶ abrogated the companies’ old legal framework laid in the Commercial Court Law of 1932 (CCL).¹⁰⁷ The CL furnished rules for joint stock companies from incorporation to liquidation. Before the enactment of Capital Market Law 2003,¹⁰⁸ CL had been considered the most influential source of the corporate governance of joint stock companies.¹⁰⁹ Currently, CL contains key corporate governance rules which include the board of

¹⁰⁶ Issued by the Royal Decree (M/ 6) in (Rabi al-Awwal 22, 1385 H) correspondent to July 22, 1965.

¹⁰⁷ Issued by the Royal Decree (32) in (Muharram 15, 1350) correspondent to June 2, 1931. This Law has two names: the Commercial Court Law and the Commercial Law. But, the most frequently used one is the Commercial Court Law.

¹⁰⁸ Issued by the Royal Decree (M/30) in (Jumada al-Akirah 2, 1924 H) correspondent to July 31, 2003.

¹⁰⁹ The Companies Law had been the solo primary source of corporate governance in publicly held companies but enactment of the new capital market law divides this mandate among both laws and their implementing authorities. At the early stage of the implementation of CML, a confusion of mandates created a problem whereby the issue had been solved by a memorandum of understanding that clarifies the scope of each authority with regard to some important matters related to public companies.

director's functions and formation,¹¹⁰ shareholders' power and rights,¹¹¹ disclosure,¹¹² capital structure and capital change,¹¹³ and criminal sanctions.¹¹⁴ CL applies to publicly traded and close joint stock corporations by which any joint stock company has to comply with CL provisions. Most of the CL provisions applicable to the joint stock company are mandatory rules in nature.

Moreover, CL authorizes the Minister of Commerce and Industry to issue implementing regulations and resolutions to supplement CL provisions.¹¹⁵ For instance, the Minister issued a resolution requiring all JSCs to establish audit committees.¹¹⁶ Moreover, joint stock companies by a Ministerial decision are required to adopt the standardized form of joint stock company by-laws¹¹⁷ unless there is a compelling reason to deviate from the terms stated in the Ministry's form.¹¹⁸ A Ministerial resolution has set a mandatory framework for JSCs board of directors' compensations and benefits.¹¹⁹

¹¹⁰ *See* C.L. arts. §§ (66–82).

¹¹¹ *See id.* §§ (83–97). For auditing of the company accounts, see C.L. arts. §§ (129–33).

¹¹² *See id.* §§ (89 & 122).

¹¹³ *See id.* §§ (134–46).

¹¹⁴ *See id.* §§ (229–31).

¹¹⁵ For more details about implementing regulations, see chapter II

¹¹⁶ Ministerial Resolution by Ministry of Commerce and Industry No. (903) dated in (1414 H) corresponding to (1993).

¹¹⁷ C.L. art. § (51).

¹¹⁸ *Id.*

¹¹⁹ *See* chapter VII.

6.3.1.2 Capital Market Law and Regulations

i. Capital Market Law

Capital Market Law (CML) contains several corporate governance rules for listed joint stock companies. The CML is a concise piece of legislation which consists of 67 articles.¹²⁰ The CML is divided into several sections that govern, *inter alia*, disclosure,¹²¹ proxy solicitation,¹²² market manipulation and insider trading.¹²³ Moreover, the CML granted CMA a broad discretion to render implementing regulations for CML. Accordingly, CMA enacted several implementing regulations that encompass provisions related to corporate governance directly such as Corporate Governance principles,¹²⁴ or indirectly such as the Listing,¹²⁵ market conduct,¹²⁶ merger and acquisition,¹²⁷ and securities offering (public and private).¹²⁸

¹²⁰ Issued by the Royal Decree (M/30) in (Jumada al-Akirah 2, 1924 H) correspondent to July 31, 2003.

¹²¹ CML arts. §§ (40–48).

¹²² *Id.* § (41).

¹²³ *Id.* §§ (48 & 50).

¹²⁴ Corporate Governance Regulations Issued by the Board of Capital Market Authority pursuant to Resolution No. 1/212/2006 in Shawwal 21, 1427 H (corresponding to Nov. 12, 2006).

¹²⁵ Issued by the Board of Capital Market Authority pursuant to Resolution No. 1/11/2004 in Rajab 20, 1425 H (corresponding to Oct. 4, 2004).

¹²⁶ Market Conduct Regulations Issued by the Board of Capital Market Authority pursuant to Resolution No. 3/11/2004 in Rajab 20, 1425 H (corresponding to Oct. 4, 2004). This regulations comprise of 21 Articles that are intended to supplement the generally stated provisions in the capital market law: to maintain the market integrity, to set standard for proper action by market participants. Accordingly, the regulation has described in details the nature of the prohibited market manipulation, insider trading, and false statements.

¹²⁷ Merger and Acquisition Regulations Market Conduct Regulations Issued by the Board of Capital Market Authority pursuant to Resolution No. 1/50/2007 in Rajab 21, 1428 H (corresponding to Oct. 3, 2007).

¹²⁸ Offers of Securities Regulations Issued by the Board of Capital Market Authority pursuant to Resolution No. 2/11/2004 in Rajab 20, 1425 H (corresponding to Oct. 4, 2004).

6.3.1.3 Corporate Governance Regulations

CMA issued the Corporate Governance Regulations (SCGRs) in 2006.¹²⁹ The SCGRs is directed toward Saudi joint stock companies listed on the Saudi Securities Exchange (Tadawul).¹³⁰ The regulation is not binding but rather directive in nature, as the SCGRs states:

[The SCGRs] constitute the guiding principles for all companies listed in the Exchange unless any other regulations, rules or resolutions of the Board of the [CMA] provide for the binding effect of some of the provisions herein contained.¹³¹

The SCGRs consists of 19 articles which cover various corporate governance subjects including the rights of the shareholders,¹³² disclosure and transparency,¹³³ and board of directors.¹³⁴ Moreover, the SCGR furnishes definitions of key terms related to corporate governance such as the independent members of the board of directors, non-executive director, stakeholders, and minority shareholders.¹³⁵ Publicly traded companies, though, are not obligated to implement most of this regulation provisions, and have to provide in annual board of directors' reports a reason for the non-implementation. The board has to specify in its annual report the implementation of any article. Article (1) of SCGRs provides that:

[A] company must disclose in the Board of Directors' report, the provisions that have been implemented and the provisions that have not been implemented as well as the reasons for not implementing them.

¹²⁹ Corporate Governance Regulations Issued by the Board of Capital Market Authority pursuant to Resolution No. 1/212/2006 in Shawwal 21, 1427 H (corresponding to Nov. 12, 2006).

¹³⁰ Corporate Governance Regulations (SCGRs) art. § (1)(a).

¹³¹ *Id.* § (1)(b).

¹³² *Id.* § (5).

¹³³ *Id.* §§ (1) & (9).

¹³⁴ *Id.* §§ (10)-(18).

¹³⁵ *Id.* § (2)(b).

This approach is similar to the English “comply or explain” technique of the implementation of good corporate governance standards.¹³⁶ Nonetheless, the CMA has the power to mandate full implementation of some of the SCGRs provisions. For example, the CMA has required all listed companies to adhere to some SCGRs provisions such as the board of director’s formation¹³⁷ and to adhere to disclosure requirements as stated in Article 9 of the SCGRs.¹³⁸ In addition, CMA requires every listed company to have an audit committee¹³⁹ and to have an internal control system compatible with SCGRs.¹⁴⁰

6.3.1.4 Listing Rules

Public offerings of securities have to be in accordance with CML and its Implementing regulations, most notably LRs.¹⁴¹ LRs are comprised of 53 mandatory articles and 9 annexes. LRs have various provisions to regulate public offerings and listings on the Saudi Securities Exchange (Tadawul).¹⁴² Nearly all of the LRs are adopted from the London Stock exchange

¹³⁶ See chapter III.

¹³⁷ The Board of CMA resolution No. 1/36/2008 in Thul-Qadah 12, 1429 H (corresponding to Nov. 10, 2008), which provides that paragraph (c) and (e) of article 12 in SCGRs is mandatory.

¹³⁸ The Board of CMA resolution No. 1/36/2008 in Thul-Qadah 12, 1429 H (corresponding to Nov. 10, 2008).

¹³⁹ The Board of CMA resolution No. 1/36/2008 in Thul-Qadah 12, 1429 H (corresponding to Nov. 10, 2008), which provides that article 14 in SCGRs is mandatory.

¹⁴⁰ The Board of CMA resolution No. 1/33/2011 in Thul-Hijja 13, 1432 H (corresponding to Oct. 30, 20011).

¹⁴¹ LRs art. § (2)(b). See also Offers of Securities Regulation art. § (8). Offers of Securities Regulation (OSR) issued by the Board of the CMA by the resolution No. 2-11-2004 in Rajab 20, 1425 H (corresponding to Oct. 4, 2004) (OSR Amended by the Resolution of the Board of CMA No. 1-28-2008 in Rajab 17, 1429 H (corresponding to Aug. 18, 2008).

¹⁴² LRs art. § (2)(a).

Listing Rules.¹⁴³ LRs contain various rules regarding corporate governance best practices. For instance, the LRs oblige boards of directors and high management staff to perform their duties and function for the interests of the company.¹⁴⁴ LRs furnish rules which govern prelisting requirements, listing obligations, and delisting provisions.

To be listed on the Saudi Securities Exchange (Tadawul), an applicant has to be a Saudi joint stock company¹⁴⁵ with at least 200 shareholders.¹⁴⁶ Also, the company had to have been conducting business for three years before the submission of application.¹⁴⁷ The applicant has to have skilled and knowledgeable high managerial staff members¹⁴⁸ who have been directing the company for at least three financial years.¹⁴⁹ The company has to provide CMA with three consecutive years of financial results.¹⁵⁰ The applicant also has to publish a prospectus.¹⁵¹ In addition, thirty percent of the company shares have to be offered to public investors on the exchange.¹⁵² Recently, LRs have allowed foreign companies to list their securities (cross-listing) on the Saudi Securities Exchange (Tadawul).¹⁵³

¹⁴³ Abdulrahman Y. Baamir, *Issues of Transparency and Disclosure in the Saudi Stock Market*, 22 ARAB L.Q. 63, 66 (2008).

¹⁴⁴ LRs art. § (44).

¹⁴⁵ LRs art. § (11)(a). However, recently the LRs allow for cross-listing by foreign companies. *See* LRs art. § (14).

¹⁴⁶ LRs art. § (13)(a)(1).

¹⁴⁷ *Id.* § (11)(b).

¹⁴⁸ LRs art. § (11)(e) which provides that “[t]he senior executives of the issuer must have appropriate expertise and experience for the management of the issuer’s business.” *Id.*

¹⁴⁹ LRs art. § (11)(b).

¹⁵⁰ LRs art. § (11)(c). However, the CMA has the power to shorten the listing requirement under special circumstances. *Id.*

¹⁵¹ LRs art. § (21).

¹⁵² *Id.* § (13)(a)(2).

¹⁵³ *Id.* § (14).

Every listing applicant has to appoint financial and legal advisors.¹⁵⁴ Both advisors have to be licensed to practice in Saudi Arabia.¹⁵⁵ The financial advisor performs several functions according to LRs. Besides being a focal point of communication with CMA in regard to all listing requirements,¹⁵⁶ the advisor has to provide CMA with any needed information about the company.¹⁵⁷ Moreover, the financial advisor has to conduct due diligence on the company and ensure that it has complied with all listing prerequisites.¹⁵⁸ On the other hand, the legal advisor's main role is to confirm the application's conformity with LRs.¹⁵⁹

After gaining admission for a listing, the company has to comply with various rules, most importantly disclosures.¹⁶⁰ LRs require continuous disclosures by the company, the board of directors, and major shareholders. LRs provide that "all disclosures made by a [listed company] to the public and to the [CMA] must be clear, fair and not misleading."¹⁶¹ Moreover, the LRs reiterate to the board of directors and high management of listed companies duty to discharge their tasks for the interest of the company.¹⁶²

Not complying with LRs and CML or implementing its regulations allows CMA to suspend and cancel listings. Listing suspensions or cancelations may arise when the CMA decides that it is necessary for the protection of market investors or for retaining capital market

¹⁵⁴ *Id.* § (5)(a).

¹⁵⁵ *Id.* § (6)(a).

¹⁵⁶ *Id.* § (7)(a)(1).

¹⁵⁷ *Id.* § (7)(a)(3).

¹⁵⁸ *Id.* § (7)(a)(2).

¹⁵⁹ *Id.* § (9) and see LRs Annex (8).

¹⁶⁰ *See id.* arts. §§ (40–48).

¹⁶¹ *Id.* § (40)(a).

¹⁶² *Id.* § (44).

discipline.¹⁶³ Also, CMA may take either of the aforementioned actions if the financial or operational position of the listing is unstable.¹⁶⁴ Cross-listed companies will be suspended or canceled in the Saudi Securities Exchange (Tadawul) if the crossed stock exchange has taken one of those measures.¹⁶⁵

Listed companies have no right of withdrawing their shares voluntarily from listing on the Saudi exchange.¹⁶⁶ However, listed companies can apply for a temporary halt of a listing under specific conditions.¹⁶⁷ In the last few years, the CMA has suspended the listings of several non-complying companies, such as the first suspensions in 2007 against Bisha Agricultural Development Company (Bisha)¹⁶⁸ and Anaam International Holding Group Company (Annam) for not complying with CML and LRs.¹⁶⁹

6.3.2 Accounting Standards

Sound accounting and auditing statements not only help management of the company and board of directors to make informed decisions and assess the enterprise performance but also help investors and public authorities to determine the enterprise's financial position.¹⁷⁰ So, the implementation of a sound accounting and auditing systems is very important in a capital market

¹⁶³ *Id.* § (35)(a)(1).

¹⁶⁴ *Id.* § (35)(a), which states that: “[CMA] considers that the issuer does not have a sufficient level of operations or sufficient assets to warrant the continued trading of its securities on the exchange.” *Id.*

¹⁶⁵ *Id.* § (35)(a)(6). To date, there is no cross listing has occurred in Saudi Stock Exchange.

¹⁶⁶ LRs art. § (36).

¹⁶⁷ *See id.* § (37).

¹⁶⁸ Board of CMA resolution No. (1-3-2007) in Thul-Hijjah 23, 1427 (corresponding to Jan. 13, 2007).

¹⁶⁹ Board of CMA resolution No. (5-1-2007) in Thul-Hijjah 28, 1427 (corresponding to Jan. 18, 2007).

¹⁷⁰ *See* THE OECD CORPORATE GOVERNANCE PRINCIPLES 49 (2004).

and good corporate governance as well. In this context, the OECD Corporate Governance Principles (2004) suggests that the company’s “[i]nformation should be prepared and disclosed in accordance with high quality standards of accounting.”¹⁷¹ The reliability of financial data significantly “depends on the standards under which it is compiled and disclosed.”¹⁷² These international accounting standards have become the role model for the quality financial information preparation.¹⁷³ In addition, “best practice” suggests that auditing of the company records should be carried out by “an independent, competent and qualified auditor”¹⁷⁴ to insure of the reliability of the audited documents.¹⁷⁵ In addition, the auditor has to express his view on the “way” wherein the financial results of the company “have been prepared and presented.”¹⁷⁶

Saudi Arabia enacted the Law of Public Accountants (LPA) to enhance the regulatory framework of accountancy and auditing professions in the country.¹⁷⁷ Such an independent body complies with best practice standards which intend to ensure the independence of the accounting profession.¹⁷⁸ Independence of the regulatory and supervisory body promotes the reliability of financial results.¹⁷⁹ Therefore, LPA established a specialized professional organization, the Saud Organization of Public Accountants (SOCPA), supervised by the Ministry of Commerce and

¹⁷¹ *Id.* at Principle (v) paragraph (B).

¹⁷² THE OECD CORPORATE GOVERNANCE PRINCIPLES 49 (2004).

¹⁷³ *See id.*

¹⁷⁴ *Id.* at Principle (v) paragraph (c).

¹⁷⁵ THE OECD CORPORATE GOVERNANCE PRINCIPLES 54 (2004).

¹⁷⁶ *Id.*

¹⁷⁷ The Law of Public Accountant (LPA) issued by the Royal Decree No. (M/12) in Jumada-al-Awwal 13, 1412 H (corresponding to Nov. 20, 1991).

¹⁷⁸ *See* THE OECD CORPORATE GOVERNANCE PRINCIPLES 54 (2004).

¹⁷⁹ *See id.*

Industry, to regulate and supervise public accountancy and auditing profession in the country.¹⁸⁰ LPA grants SOCPA vast power to implement all measures for promoting and developing the accounting profession in Saudi Arabia, such as auditors' certification, continuous training, and, more importantly, setting accounting and auditing standards and supervising their implementations.¹⁸¹ Yet, SOCPA has succeeded in enhancing the accountancy profession in Saudi Arabia to a high degree in comparison to some countries in the region, as the International Federation of Accountants (IFAC) pronounced: "SOCPA is a well established professional accountancy body with highly skilled and experienced staff and members. SOCPA is keen to provide support, advice and assistance to other professional bodies in Arabic-speaking countries."¹⁸²

Accounting standards are mainly divided into two schools of thoughts: "rules-based" and "principles-based" accounting standards systems. The former is elaborate and designed to provide for "bright line" accounting standards as in the American (GAAP) accounting system, while the other one is broader and less detailed as in British and International Accounting Standards.¹⁸³ Both standards treat a wide range of areas similarly and fewer areas differently.¹⁸⁴ The standards' positions on property valuation are just one of the substantial inconsistent areas

¹⁸⁰ Public Accountants Law (PAL) Article § (19).

¹⁸¹ *Id.*

¹⁸² International Federation of Accountants (IFAC), *Tools and Resources to Support the development of the Accounting Profession*, N.Y., New York: IFAC., p. 100 (2007), available at http://www.ifac.org/sites/default/files/publications/files/tools-and-resources-to-supp_0.pdf (accessed on May 13, 2012).

¹⁸³ See, e.g., Frederick Gill, *Principles Accounting Standards*, 28 N.C.J. INT'L L. & COM. REG. 967, 972 (2002–2003).

¹⁸⁴ For comparison between principles-based accounting standards (IFRS) and rule accounting-based standards (GAAP) see generally Ernst & Young, US GAAP versus IFRS: basics (2011), available at [http://www.ey.com/Publication/vwLUAssets/US_GAAP_v_IFRS:_The_Basics/\\$FILE/US%20GAAP%20v%20IFRS%20Dec%202011.pdf](http://www.ey.com/Publication/vwLUAssets/US_GAAP_v_IFRS:_The_Basics/$FILE/US%20GAAP%20v%20IFRS%20Dec%202011.pdf) (accessed on Feb. 18, 2013).

between the two accounting schools.¹⁸⁵ The American standard prohibits the revaluation of assets, with only historical cost reported, while the international standards allow for such revaluation of assets.¹⁸⁶ A rule-based approach grants a slim space for “discretion” in contrast to the principle-based approach which authorizes a wide “discretionary” space.¹⁸⁷ Recently, the principle-based approach gained international popularity – especially in the wake of the financial scandals in the U.S., such as Enron, which are attributed in some part to the U.S. accounting rule-based approach ideology.¹⁸⁸ The rule-based approach shifts the burden from concentrating on the company’s financial “status as a going concern, [to] focusing on compliance with complex rules as an end in and of itself.”¹⁸⁹ Accordingly, Sarbanes-Oxley Reform Act requests the SEC to study the possible adoption of principles based accounting to the U.S. corporate governance system various principle-based standards.¹⁹⁰

Saudi accounting standards used to be heavily influenced by the U.S. rule-based “Generally Accepted Accounting Principles (GAAP).”¹⁹¹ However, in response to the G-20 recommendation to enhance the quality of financial reporting, SOCPA recently announced its

¹⁸⁵ Ernst & Young, US GAAP versus IFRS: basics, 15 (2011), *available at* [http://www.ey.com/Publication/vwLUAssets/US_GAAP_v_IFRS:_The_Basics/\\$FILE/US%20GAAP%20v%20IFRS%20Dec%202011.pdf](http://www.ey.com/Publication/vwLUAssets/US_GAAP_v_IFRS:_The_Basics/$FILE/US%20GAAP%20v%20IFRS%20Dec%202011.pdf) (accessed on Feb. 18, 2013).

¹⁸⁶ *See id.*

¹⁸⁷ *See* Amra Balic, *Transparency, Disclosure, and Audit*, in *GOVERNANCE AND RISK: AN ANALYTICAL HANDBOOK FOR INVESTORS, MANAGERS, DIRECTORS, AND STAKEHOLDERS* 86, 90 (George Dallas ed., 2004).

¹⁸⁸ *See id.*

¹⁸⁹ *Id.*

¹⁹⁰ Andrea Esposito et al., *United States*, in *GOVERNANCE AND RISK: AN ANALYTICAL HANDBOOK FOR INVESTORS, MANAGERS, DIRECTORS, AND STAKEHOLDERS* 300, 314 (George Dallas ed., 2004).

¹⁹¹ *See* the Secretary General of the Saudi Organization for Certified Public Accountants (SOCPA) circular No. (2/102) in Shaban 21, 1414 H (corresponding to Feb. 1, 1994), which provides that certified public accountants have to consult American standards if there is no Saudi standard governing the matter being audited by them. However, in 2003, SOCPA amended its circular by changing the gap fillers standards from the American standards to the International Accounting Standards. The General Director of the Companies General Directorate in the Ministry of Commerce and Industry No. (3944/9/400/222) in Thul Qadah 1, 1423 (corresponding to Jan. 4, 2003).

attention to shift towards principle-based, International Financial Reporting Standards (IFRS).¹⁹² Currently, only banks and insurance companies are required to adhere to International Accounting Standards,¹⁹³ while the rest of listed companies in the Saudi exchange (Tadawul) are required to prepare their financial documents in accordance with Saudi standards.¹⁹⁴ The only challenge SOCPA might face is the lack of adequate resources to conduct all the assigned functions assigned to it bylaws.¹⁹⁵

6.3.3 Other Sources of Corporate Governance

Some corporate governance rules are delineated in special statutes governing the economic activities of publicly traded companies conducting business within the realm of those statutes. For instance, banks and insurance companies have additional or various governance requirements in comparison to other listed joint stock companies.¹⁹⁶ Bankruptcy rules generally

¹⁹² See the resolution of SOCPA Board, 10th meeting, 6th session, in February 18, 2012, in regard to the endorsement of SOCPA project's adopting International accounting and auditing standards, *available at* http://www.socpa.org.sa/Pdf/international_standard.pdf (accessed on May 13, 2012). For the reasons behind the recent popularity of principle-based accounting, *see generally* Alnoor Bhimani, *The Role of a Crisis in Reshaping the Role of Accounting*, 27 J. ACCOUNT. PUBLIC POLICY 444–54 (2008).

¹⁹³ Although listed on the Saudi capital market and required to elect public joint stock company form, the Banking sectors are required to follow international accounting standards.

¹⁹⁴ *See* Listing Rules (LRs) arts. (26 & 27). Article 27 provides that

The [listed joint stock company] must provide the [Capital Market] Authority and announce to shareholders its annual accounts (which must be prepared and audited in accordance the accounting standards issued by SOCPA).

Otherwise, the company has to provide justification in the board of director's annual report for its deviation from the Saudi Accounting Standards. LR art. § (27)(b)(6).

¹⁹⁵ *See* THE WORLD BANK REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC): CORPORATE GOVERNANCE COUNTRY ASSESSMENT OF THE KINGDOM OF SAUDI ARABIA 5 (Feb. 2009).

¹⁹⁶ For example, the Cooperative Insurance Companies Law required endorsement from the Saudi Arabian Monetary Agency (SAMA) to insure the board of director's appointees. *See* art. § (6) of Cooperative Insurance Companies Law.

interact with corporate governance, especially with regard to the shift in the board of directors' role as guardian of the interests of creditors rather than those of shareholders. However, Saudi Arabia does not yet have complete bankruptcy statutes: only rules regarding the company's liquidation and the procedures for consolidation with the company creditor which may interact with corporate governance.¹⁹⁷ Criminal law provisions may also contain rules related to corporate governance. For example, "the Anti-Bribery Law" criminalized making bribes or receiving them by public company employees, including executives or board of director's members of joint stock companies.¹⁹⁸ Moreover, the Bureau of Public Auditing (BPA) has the authority to review all of the financial matters of any public company that is owned in part by the government or a company for which the government guarantees an annual minimum profit as with the Saudi Electricity Joint Stock Company.¹⁹⁹ Case law carries nearly no weight as a source of corporate governance rules in Saudi Arabia due to the underdevelopment of the Saudi judicial system and the non-publication of decided cases. Accordingly, the court's decisions provide neither binding authority as common law tradition nor are seen as authoritative in civil law systems.

¹⁹⁷ See art. § (14) in Bankruptcy Preventing Settlement Law which Issued by the Royal Decree No. (M/16) in Ramadan 4, 1416 H (corresponding to Jan. 25, 1996).

¹⁹⁸ See art. § (8)(4–5) in Anti-Bribery Law which Issued by the Royal Decree No. (M/36) in Thu-Hijja 29, 1412 H (corresponding to July 1, 1992).

¹⁹⁹ See arts. (9) & (10) in The Bureau of Public Auditing which was issued by the Royal Decree No. (M/9) in Safar 1, 1391 H (corresponding to Apr. 7, 1971).

6.4 DISCLOSURE IN THE SAUDI LEGAL SYSTEM

6.4.1 Introduction

Disclosure is one of the mechanisms to promote integrity in the capital market.²⁰⁰ A transparent capital market reduces agency costs²⁰¹ and creates a leveled playing field for all participants. It is well established that “[a] world ... without adequate truthful information is a world with too little investment, and in the wrong things to boot.”²⁰² Disclosure offers investors equal access to the company’s information. Such information allows investors to compare companies’ performances and make an informed decision about their investment allocation.²⁰³ Otherwise, investors would be forced to conduct their own research about every company in the market to find one in which they could invest.²⁰⁴ Investors will be responsible to verify the accuracy of provided information whereby fraudulent information may affect the allocation of investment in the market under which better performing firms may not be rewarded financially.²⁰⁵ Therefore, “[i]nvestors do not ... want to inspect; they seek to be passive recipient of an income stream, not to be private investigators.”²⁰⁶

²⁰⁰ THE OECD CORPORATE GOVERNANCE PRINCIPLES 49 (2004).

²⁰¹ For the agency cost problem, *see* chapter IV.

²⁰² Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673 (1984).

²⁰³ *See* THE OECD CORPORATE GOVERNANCE PRINCIPLES 49 (2004).

²⁰⁴ *See* Easterbrook & Fischel, *supra* note 202, at 674–75.

²⁰⁵ *Id.* at 669, 673–74.

²⁰⁶ *Id.* at 669, 675.

On the other hand, disclosure is considered to be one of the techniques used by policy makers to promote corporate governance ambience.²⁰⁷ For instance, shareholders' acquisition of the company's information through disclosure allows them to decide whether to reelect the existing board of directors' members or not.²⁰⁸ Also, disclosure of an underperforming board of directors may encourage a takeover by another company,²⁰⁹ which more likely would push the incumbent board to increase its performance to avoid such a possibility. In addition, knowing what is going on inside the company, especially with regard to interested parties' contracts, may help shareholders to enforce board of directors' members "fiduciary duties."²¹⁰ In this regard, Merritt Fox said, "without required disclosure, most suits, even the ones against managers who in fact did breach their duties, would inevitably, start out as 'fishing expeditions.'"²¹¹

Since companies may not disclose their crucial information, not necessarily to hide misconduct, although that is possible, but in many times for other reasons such as management's shame in underperformance,²¹² or hiding important business information from competitors,²¹³ a national legal system tends to implement a mandatory disclosure framework. Mandatory disclosure refers to "any kind of legal obligation that requires ... [a company's] management [or shareholders] to provide on regular basis information that otherwise might not be inclined to

²⁰⁷ See Merritt B. Fox, *Required Disclosure and Corporate Governance*, in *COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH* 701, 704 (Klaus J. Hopt et al. eds., 1998).

²⁰⁸ *Id.* at 705.

²⁰⁹ *Id.* at 710.

²¹⁰ *Id.* at 708.

²¹¹ *Id.*

²¹² *Id.* at 703 n.4.

²¹³ Easterbrook & Fischel, *supra* note 202, at 673.

provide.”²¹⁴ There is no single best disclosure model to be imported and implemented at the national level. National ownership structure has a key effect in shaping any national disclosure framework.²¹⁵ For instance, high disclosure standards are in the dispersed ownership model, as in the U.S.A and U.K, while the need for the same standards is less urgent in concentrated ownership models.²¹⁶ The OECD Corporate Governance Principles of 2004 suggest adopting a disclosure structure that at least guarantees the disclosing of the company’s “financial situation, performance, ownership, and governance of the company.”²¹⁷ In addition, an effective corporate governance model has to guarantee the accuracy of the disclosed information and its publication in a specified timeline.²¹⁸ However, underdevelopment of disclosure systems is not necessarily attributed to deficiency in the governing rules but rather may be a cause of ineffective enforcement measures by authorities, if not both.²¹⁹

6.4.2 Saudi Disclosure System

The Saudi disclosure system has evolved rapidly in the last thirty years from minimal disclosure requirements under the Companies Law (CL) to the sophisticated disclosure requirements encompassed in the CML and its implementing regulations.²²⁰ Currently, disclosure

²¹⁴ Fox, *supra* note 207, at 703.

²¹⁵ *Id.* at 716.

²¹⁶ *Id.*

²¹⁷ THE OECD CORPORATE GOVERNANCE PRINCIPLES OF 2004, Principle V.

²¹⁸ *Id.*

²¹⁹ *See supra* note 254, at 63, 72.

²²⁰ For historical background on disclosure in Saudi Arabia before the CMA assumed its role in this regard, *see generally* Awwad Saleh Awwad, Legal Regulation of the Saudi Stock Market: Evaluation, and Prospects for

requirements and conditions are scattered in various legal documents, most frequently Companies Law (CL), Capital Market Law (CML), Listing Rules (LRs), and Corporate Governance Regulation (CGR). Those sources represent the backbone of Saudi disclosure's system. LRs require that every listed company ought to present to the [CMA] "without delay all information, explanations, books, and records ... which must be clear, accurate and not misleading."²²¹ CGR encourages every listed company to "lay down in writing the policies, procedures and supervisory rules related to disclosure."²²²

Disclosure requirements take various forms, whereby some are directed to the company and other disclosure requirements are directed to shareholders, board of directors' members, and senior executive officers. A study on the Saudi disclosure framework pointed out that disclosure in Saudi Arabia is significantly influenced by developed countries' disclosure experiences and the recommendations of international financial institutions.²²³ In this context, Baamir remarked:

When looking at the disclosure provisions in CML and other disclosure provisions from any developed market, the first impression will be that the CMA rules are a direct translation of LSE [London Stock Exchange] or NYSE [New York Stock Exchange].²²⁴

Nonetheless, a study by the World Bank in 2009 indicated that the Saudi framework of disclosure is still not in full compliance with transparency and disclosure recommendations of the OECD Corporate governance Principles of 2004.²²⁵ At the enforcement level, the nascent CMA has devoted great effort to promote the disclosure system in Saudi Arabia. In the last few

Reforms, Appendix C, 218-50 (PhD) (2000) (unpublished dissertation at University of Warwick School of Law [on file with the author]).

²²¹ LRs art. § (34)(a).

²²² CGR art. § (8).

²²³ See Baamir, *supra* note 143, at 63, 78.

²²⁴ *Id.*

²²⁵ The World Bank Report on the Observance of Standards and Codes (ROSC), Corporate Governance Assessment: Kingdom of Saudi Arabia (Feb. 2009).

years, the CMA has implemented disclosure requirements more strictly. For instance, the CMA recently suspended the trading of several listed companies for not complying with disclosure requirements.²²⁶

6.4.2.1 Disclosure by the Company

i. The Prospectus

Whenever a company aims to list its securities on the securities exchange listing or a listed company intends to offer new securities to the market, the company is normally required to disclose its financial and non-financial information to capital market investors by issuing a “prospectus.”²²⁷ Issuance of a prospectus is considered to be a global best practice model.²²⁸ For instance, a European resolution was issued in this regard stating that “[m]ember states shall not allow any offer of securities to be made to the public within their territories without prior publication of a prospectus.”²²⁹ Saudi LR mandates every company by for offering shares to the public to issue a prospectus written in the Arabic language²³⁰ and:

²²⁶ In 2012, For example, CMA suspended the Allied Cooperative Insurance Group (ACIG) and Buruj Cooperative Insurance Company (Buruj). Saudi Stock Exchange (Tadawul) webpage, <http://www.tadawul.com.sa> (accessed on June 9, 2012).

²²⁷ CML art. § (40)(b).

²²⁸ See EILIS FERRAN, PRINCIPLES OF CORPORATE FINANCE LAW 429 (2008).

²²⁹ Art. § (3)(1) in the Directive 2003/71/EC of the European Parliament and of the council of 4 November 2003: on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC. Published in the Official Journal of the European Union in 31/2//2003. In compliance with this Directive the United Kingdom has required that: “[i]t is unlawful for transferable securities to which this subscription applies to be offered to the public in the United Kingdom unless an approved prospectus has been made available to the public before the offer is made.” Art. § (84)(1) in Financial Services and Market Act of 2000 (FSMA).

²³⁰ LR art. § (21)(d).

[C]ontain all information which is necessary to enable an investor to make an assessment of the activities, assets and liabilities, financial position, management and prospects of the issuer and its profits and losses and must include information in relation to the number and price of the securities and any obligations, rights, powers, and privileges attaching to them.²³¹

However, the company has to gain CMA approval before the promulgation of the prospectus.²³² The CMA has power to reject the prospectus if disclosure requirements not have been met or are not accurate.²³³ The approved prospectus has to be sent to buyers at the time specified by the CMA.²³⁴

ii. Financial Results and Board of Directors' Report

The OECD principles suggest that all listed companies have to disclose their “financial results.”²³⁵ Financial results generally refer to the “balance sheet, the profit and loss statements, the cash flow statement and notes to the financial statements.”²³⁶ Financial results disclosure has double objectives, which are “to enable appropriate monitoring to take place and to provide the basis to value securities.”²³⁷ To achieve the goals of disclosure standards, financial data has to be “prepared” properly.²³⁸ According to CML, every listed company is under periodic obligation to disclose its financial results and to issue a board of director’s report.²³⁹ First, the financial results

²³¹ *Id.* art. § (21)(a). For the content of Prospectus, *see also* CML art. § (42).

²³² CML art. § (43)(a).

²³³ CML art. § (44)(d).

²³⁴ CML art. § (41).

²³⁵ THE OECD CORPORATE GOVERNANCE PRINCIPLES OF 2004, Principle V.

²³⁶ ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, CORPORATE GOVERNANCE PRINCIPLES 50 (2004).

²³⁷ THE OECD CORPORATE GOVERNANCE PRINCIPLES 50 (2004).

²³⁸ *Id.*

²³⁹ CML art. § (45).

have to be disclosed quarterly and annually.²⁴⁰ Financial results consist mainly of the balance sheet, profit and loss statement, and cash flow statement.²⁴¹

The company's board of directors has to approve the results which then need to be signed by the chief executive officer (CEO) and chief financial officer (CFO) of the company.²⁴² However, the information in those financial documents should be public before the approval for disclosure is granted from the CMA.²⁴³ The CML prohibits trading of shares based on information that has not yet become public.²⁴⁴

Second, best practice suggests that various nonfinancial information should be attached with the financial results, such as the operational results of the company, its future objectives and projected risk factors, board members and top management compensation, curriculum vitas of the board members, and related parties transactions.²⁴⁵ In addition, the attached report has to encompass the company's corporate governance framework and procedures.²⁴⁶ In fact, one of the disclosure's main goals is to allow the investor to comprehend the "whole picture" of the company.²⁴⁷

²⁴⁰ *Id.* § (45)(a). Originally, art. § (89) of the CL was the only legal source of disclosure of its financial information to its shareholders. This obligation was just for the annual financial results.

²⁴¹ *Id.* The company financial disclosure has to be prepared in accordance with Saudi Accounting Standards issued by SOCPA. LRs art. § (26)(d)

²⁴² LRs art. § (42)(a).

²⁴³ CML art. § (45)(c).

²⁴⁴ *Id.* art. § (50).

²⁴⁵ THE OECD CORPORATE GOVERNANCE PRINCIPLES OF 2004, Principle V paragraph (A) subparagraphs (1, 2, 4, and 5).

²⁴⁶ *Id.* at Principle V paragraph (A) subparagraphs (8).

²⁴⁷ THE OECD CORPORATE GOVERNANCE PRINCIPLES 50 (2004).

In the Saudi system, board of directors of the listed company has to attach to the company's annual financial results their annual report (the board of director's report "BDR").²⁴⁸ The BDR must contain disclosures of various financial and governance matters. For instance, the BDR should contain information about the listed company, such as its core business and activities.²⁴⁹ Moreover, the report has to divulge all relevant information regarding the company's board of directors, executive officers, and top managerial individuals.²⁵⁰ The report also has to provide information about major shareholders of the company.²⁵¹ The company management has to script their views on the report with regard to the company's existing business and their forecast on the business' expected future.²⁵²

The report has to disclose information about the company's board of directors such as the board's formation and classification of its members (executive, non-executive, or independent).²⁵³ The report has to illustrate the functions of the board of director's committees, information about the members of those committees and the number of the each committee meetings.²⁵⁴ In addition, compensation and remuneration of the board of director's members, including the board chairman,²⁵⁵ and the compensation and remuneration of highest paid managerial staff, including the chief executive officer (CEO) and chief financial officer (CFO)

²⁴⁸ See LRs art. § (43). Also see CGR art. § (9).

²⁴⁹ CML art. § (45)(b)(1) and LRs art. § (43)(1).

²⁵⁰ CML art. § (45)(b)(2).

²⁵¹ *Id.*

²⁵² *Id.* § (45)(b)(3).

²⁵³ CGR art. § (9)(c).

²⁵⁴ *Id.* art. § (9)(d).

²⁵⁵ *Id.* art. § (9)(e)(1).

must be reported.²⁵⁶ The internal control audit committee report has to be included in the board's report.²⁵⁷ The report should include the number of board of director's meetings and attendance sheet of the board members for the last financial year.²⁵⁸

The company obliges to disclose any contract entered into with interested parties.²⁵⁹ Thus, if any board of director's member, or chief executive officer (CEO) or chief financial officer (CFO) has an interest in any contract that the company may sign, the report must disclose that matter explicitly.²⁶⁰ Significant decisions of the company need to be included in the report, including the company's strategic plans.²⁶¹ Also, the company has to indicate in the board's report any sentence, penalty or measure implemented by the CMA against the company and the verdict rendered against the company by the judiciary.²⁶²

iii. Additional Forms of Disclosure by the Company

The company has to notify the CMA of any change in ownership of major shareholder who owns five percent or more of the company shares.²⁶³ Moreover, the company is obliged to notify the CMA and disclose to the public any decisions related to the company's capital change (increase or decrease),²⁶⁴ divided payment or nonpayment,²⁶⁵ repurchase or redemption of the company

²⁵⁶ CGR art. § (9)(e)(2).

²⁵⁷ *Id.* art. § (9)(g).

²⁵⁸ LRs art. § (43)(16).

²⁵⁹ *Id.* art. § (43)(17).

²⁶⁰ *Id.* art. § (43)(18).

²⁶¹ *Id.* art. § (43)(2).

²⁶² CGR art. § (9)(f).

²⁶³ LRs art. § (46)(a).

²⁶⁴ *Id.* § (46)(b)(1).

²⁶⁵ *Id.* § (46)(6)(2–3).

shares,²⁶⁶ amendment of the bylaws, changing headquarter locations,²⁶⁷ calling for general meeting including the meeting agenda,²⁶⁸ changing the external auditor,²⁶⁹ matters related to winding up and liquidation,²⁷⁰ or court or quasi-judicial decisions impeding the company from “utilizing” more than five percent of its assets.²⁷¹ In addition, the company has to use the Arabic language in all its communications and notifications²⁷² and send “copies to the authority of the circulars sent to shareholders and all documents relating to acquisitions, mergers and offers, notices of meetings, reports, announcements or other similar documents” swiftly upon their issuance.²⁷³

6.4.2.2 Disclosure Concerning Members of the Board of Director, Senior Executives, and Shareholders

Ownership of major shareholders has some implication on the corporate governance system, especially with regard to minority shareholders and small investors in the capital market. OECD Corporate Governance Principles (2004) suggests disclosure of “[m]ajor share ownership and voting rights.”²⁷⁴ Disclosure has to include direct ownership and indirect patterns to satisfy the

²⁶⁶ *Id.* § (46)(b)(4).

²⁶⁷ *Id.* § (47)(1).

²⁶⁸ *Id.* § (47)(6).

²⁶⁹ *Id.* § (47)(2).

²⁷⁰ *Id.* § (47)(3).

²⁷¹ *Id.* § (47)(5).

²⁷² *Id.* § (48)(1).

²⁷³ *Id.* § (50).

²⁷⁴ THE OECD CORPORATE GOVERNANCE PRINCIPLES OF 2004, Principle (V) paragraphs (A) subparagraph (3).

OECD disclosure standards.²⁷⁵ Saudi LRs regard ownership of 5% or more of listed company shares as a substantial shareholding.²⁷⁶ Accordingly, shareholders are obliged to promptly notify the company and CMA about such a holding whenever it reaches that level.²⁷⁷ Change in the substantial holding ownership by one percent or more (decrease or increase) also has to be reported.²⁷⁸ A board of directors' member and top management staff should notify the company and CMA about their acquisition of shares regardless of the amount.²⁷⁹ The CMA and the company have to be notified by a board of directors' member or top management staff if the value of the holding changes by fifty percent or more or if the change is equal to one percent (or more) of the company's outstanding shares.²⁸⁰ The share holding of the substantial shareholder, board of directors' member, top management staff members, including their dependent family members,²⁸¹ a company controlled by any one of those categories, shares,²⁸² and any person associated with any of the mentioned categories are "to act in concert to acquire interest in or exercise voting rights in the the ... [listed company]."²⁸³ In those cases, the shareholder has to

²⁷⁵ THE OECD CORPORATE GOVERNANCE PRINCIPLES 51 (2004).

²⁷⁶ LRs art. § (45)(a)(1).

²⁷⁷ Shareholder has to conduct the notification "at the end of the trading day of the occurrence of the relevant event." LRs art. § (45)(a). It has been proposed that shareholding notification should not be carried by the shareholder himself but rather by CMA to increase the efficacy of market surveillances and protect it from manipulative actions. *See* Baamir, *supra* note 143, at 79 (2008).

²⁷⁸ LRs art. § (45)(a)(2).

²⁷⁹ LRs art. § (45)(a)(3).

²⁸⁰ LRs art. § (45)(a)(4).

²⁸¹ LRs § (45)(b)(1). The scope of implementation of this article is too wide where it includes all of relatives of the substantial shareholder. Although this might increase the protection of investors, it seems that it went beyond the legal limits of fairness. Hence, the scope of this article needs to be revised to only direct family members such as spouse and children under 18 years old.

²⁸² LRs art. § (45)(b)(2).

²⁸³ *Id.* art. § (45)(d)(3).

complete a form and send it to the CMA²⁸⁴ with a clarification of his objective of the ownership.²⁸⁵

However, assertion of indirect ownership is very difficult in Saudi listed companies, due to the poor disclosure framework of unlisted companies in Saudi Arabia. Many major share holdings in listed companies are registered under the names of other business associations which are undoubtedly controlled by a concealed major shareholder. Therefore, cross ownership and pyramidal ownership structure are more likely to exist in Saudi companies whereby major holdings of unlisted companies in the listed companies might be only the tip of an iceberg of a conglomerate business association. All in all, the Saudi disclosure system has satisfied the best practice standards with regard to direct ownership. However, this disclosure framework needs to be improved with regard to indirect ownership. Otherwise, not providing full disclosure accounting to the public regarding who is the ultimate owner of the shares may forfeit the goals of ownership disclosure and diminish the accountability of the real owner to the public.

In the end, the disclosure system in Saudi Arabia disregards two crucial elements related to the corporate governance structure in this country. First, state owned and controlled publicly traded companies [SOEs] are not required to disclose information related to government ownership. Investors should be informed as to whether the government will act as a responsible shareholder that respects the independence of the SOE board²⁸⁶ and will not intervene in the daily administrative affairs of the SOE.²⁸⁷ Accordingly, the government needs to formulate a

²⁸⁴ *Id.* § 45(d).

²⁸⁵ *Id.* art. § (45)(d)(4). If the shareholder changed his ownership objective he must notify the CMA rapidly and refrain from selling his shares for the following ten days. *Id.* art. § (45)(e).

²⁸⁶ OECD Guidelines, Chapter (II) C.

²⁸⁷ OECD Guidelines, Chapter (II) B.

clear shareholding “policy,” which pinpoints “the overall objectives of state ownership, the state’s role in corporate governance of the SOE, and the method of implement[ing] its ownership policy.”²⁸⁸ For example, the government should disclose its intention to utilize its holdings for either the provision of public utility to its citizens, national development purposes to its citizens at a reasonable price, or business reasons.²⁸⁹ Secondly, under the current disclosure system, publicly traded companies are not required to disclose matters connected to *shariah*. Saudi investors, for example, should know if the company is engaged in prohibitive economic activity like selling musical instruments or finance its operation through interests (both activities are permitted under the Saudi law but not *shariah*).²⁹⁰

6.5 OWNERSHIP AND CONTROL IN SAUDI PUBLICLY TRADED COMPANIES

6.5.1 Ownership Structure

The number of listed companies in Saudi Arabia has grown phenomenally since the inception of the Saudi Capital Market Authority (CMA) in 2003. In such a newly organized capital market, however, several big companies that are in “the Saudi Top 100 Companies List”²⁹¹ are still not

²⁸⁸ OECD Guidelines, Chapter (II) A. A clear definition of the policy of ownership will tell other shareholders the objective of government investment in the company. OECD Guidelines, page 24.

²⁸⁹ See OECD Guidelines, page 23.

²⁹⁰ For Islam and disclosure *see* chapter IV.

²⁹¹ For the complete, list see Aleqtisadiah on-line, issue No. 6795 for May 19, 2012. This list was issued by Aleqtisadiah newspaper and was designed to mimic other internationally recognized lists of large companies, such as the Forbes and the Financial Times lists. The 100 company club, Aleqtisadiah on line, issue No. 5348 for February 6, 2008.

listed on the Saudi Stock Exchange (Tadawul). For instance, Alahli Bank (NCB),²⁹² Arab Supply and Trading Company (ASTRA),²⁹³ Zahran holding Company,²⁹⁴ Manafea Holding Company, are not listed companies at present.²⁹⁵ Most significantly, the world biggest oil company, Saudi Aramco, is not a listed company.²⁹⁶

Table 5. Number of Saudi Publicly Traded Joint Stock Companies from 1990 to 2012

Year	Number of public joint stock companies
1992	60
1997	70
2002	68
2007	111
2012	155

Source: Capital Market Authority: annual reports of 2007 and Saudi Stock Exchange (Tadawul) homepage, <http://www.tadawul.com.sa> (accessed on Dec. 7, 2012).

Although the seminal study, “Corporate Ownership around the World,” excluded Saudi Arabia due to its lack of a “significant capital market” at the time of the study (1999),²⁹⁷ other

²⁹² Alhali Bank (NCB) is the first Saudi Bank for which the Saudi government controls most of its shares. The Bank is ranked 4th on the “Saudi Top 100 Companies List” of 2012 compiled by the Saudi newspaper Alqitsadiah.

²⁹³ ASTRA is ranked 30 on the “Saudi Top 100 Companies List” of 2012, as compiled by the Saudi newspaper Alqitsadiah.

²⁹⁴ Zaharan is ranked 36 on the “Saudi Top 100 Companies List” of 2012, as compiled by the Saudi newspaper Alqitsadiah.

²⁹⁵ Manafea is ranked 40 on the “Saudi Top 100 Companies List” of 2012, as compiled by the Saudi newspaper Alqitsadiah.

²⁹⁶ Christopher Helman, *Big Oil: The World’s Biggest Oil Companies*, FORBES (7.9.2010, 5:28 PM ET), available at <http://www.forbes.com/2010/07/09/worlds-biggest-oil-companies-business-energy-big-oil.html> (accessed on Mar. 27, 2012). Moreover, two other large construction companies, which have been entrusted with conducting mega projects in Saudi Arabia, namely SAUDI OGER (LTD) and SAUDI BINLADN GROUP are not listed companies. Aramco is a limited liability, state owned company with a market value estimated at seven hundred and eighty billion dollars. Financial Times, FT Non-Public 150—the full list (Dec. 14, 2006), available at <http://www.ft.com/intl/cms/s/2/5de6ef96-8b95-11db-a61f-0000779e2340.html#axzz2EPVkoKoy> (accessed on Dec. 7, 2012).

²⁹⁷ R.L. Porta, F. Lopez-De-Silanes & A. Shleifer, *Corporate Ownership Around the World*, 54 J. FINANCE 471–17, 474 (1999).

sources have indicated that the pattern of Saudi ownership is concentrated.²⁹⁸ Major holding are in the hands of government, semi government institutions, families, and major individual investors. This section will highlight the ownership structure in Saudi listed companies.

6.5.1.1 Government Ownership

The Saudi government invests in the Saudi capital market through various mediums, notably the Public Investment Bank (PIF). The Government has 22 block holdings in 21 listed companies, which represents only 14% of Saudi companies listed on (Tadawul). Although the number of government investments in the capital market seems insignificant, the value of these investments is enormous – 341 Billion SR.²⁹⁹ The market share of government investment in the capital market is around 27%.³⁰⁰ The distribution of government investments is focused on specific sectors, such as cement, banking, energy, and petrochemicals (see Table 2).³⁰¹

²⁹⁸ See, e.g., WALEED ALAJLAN, OWNERSHIP PATTERNS AND THE SAUDI MARKET IN ADVANCES IN FINANCIAL ECONOMICS: CORPORATE GOVERNANCE, vol. 9, 161–86, 184 (2004). See also Fahad Mohammad Almajid, A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective 207-30 (Ph.D.) (2008) (unpublished dissertation University of Manchester).

²⁹⁹ Based on Information concerning listed companies on the Tadawul homepage (Nov. 8, 2012) and Al-Joman Economic Research Center.

³⁰⁰ Based on major shareholder information on the Saudi Securities Exchange (Tadawul) website, May 30, 2012.

³⁰¹ Major shareholder information on the Saudi Securities Exchange (Tadawul) website, May 30, 2012.

Table 6. Major Shareholding in Listed Companies Owned by Saudi Government Institutions, According to the Saudi Securities Exchange (Tadawul) Fifteen Market Sectors

Sector	Number of Companies
Petrochemical Industries	2
Banking and Financial	3
Telecommunication and Information Technology	1
Agriculture and Food Industries	3
Industrial investment	1
Energy and Utilities	2
Cement	4
Building and construction	1
Real estate development	1
Transport	2
Hotel and tourism	1
Total	21

Sources: Major shareholders information on the Saudi Securities Exchange (Tadawul) (May 30, 2012).

6.5.1.2 Semi Government Ownership

Pension fund assets are managed by two agencies, the Public Pension Agency (PPA),³⁰² and the General Organization for Social Insurance (GOSI).³⁰³ The (PPA) is entrusted with managing the pensions of public sector employees, such as civil servants, army and national guard members, and Internal Security Forces (for example, Police and Fire Fighters),³⁰⁴ while the latter, the GOSI, is in charge of private sector employees' pensions.³⁰⁵ The two agencies have been

³⁰² See the Regulation of the Public Pension Agency, which issued by the Council of Ministers resolution No. 3 in Rabi Al-Awwal 3, 1425 H, corresponding to April 22, 2004.

³⁰³ Article § (9) Paragraph (1) of the Social Insurance Law, which was enacted by Royal Decree No. M/33 on Ramadan 3, 1421 H, or November 29, 2000 AD.

³⁰⁴ Article § (10) of the Regulation of the Public Pension Agency, which was issued by Council of Ministers resolution No. 3 on Rabi Al-Awwal 3, 1425 H, or April 22, 2004 AD.

³⁰⁵ Article § (9) Paragraph (1) in the Social Insurance Law, which was enacted by Royal Decree No. M/33 on Ramadan 3, 1421 H, or November 29, 2000 AD.

established by the government, which exerts a wide scope of authority over the agencies' supervision and operation, including the appointment of their governors.³⁰⁶

6.5.2 Public Pension Agency (PPA)

The Public Pension Agency (PPA) has major shareholdings in twenty Saudi listed companies out of the 155 companies listed on the Saudi Stock Exchange (Tadawul).³⁰⁷ The total market value of PPA ownership is around 27 billion (SR).³⁰⁸ PPA investment is concentrated mainly in three economic sectors, including financial services, telecommunication, and industry including petrochemicals.

³⁰⁶ The king appoints the governors of both agencies. See Article § (13) of the Social insurance Law and Article (8) of the Regulation of the Public Pension Agency.

³⁰⁷ Saudi Stock Exchange (Tadawul), *available at* <http://www.tadawul.com.sa> (accessed Oct. 8, 2012).

³⁰⁸ The Value of Disclosed Institutions Ownership in the Saudi Listed Companies on October 31, 2012 by Aljoman Center of Economic Consultation, *available at* <http://www.aljoman.net/> (accessed on Nov. 14, 2012).

Table 7. Major Shareholding of the Public Pension Agency (PPA) in Saudi Listed Companies by Sector

Market Sector	Major shareholding
Petrochemical Industries	4
Banking and Financial	4
Telecommunication and Information Technology	2
Industrial Investment	2
Cement	6
Building and Construction	1
Insurance	1
Total	20

Source: Major shareholders information on the Saudi Securities Exchange (Tadawul) (Nov. 8, 2012.)

6.5.3 General Organization of Social Insurance (GOSI)

The GOSI is the second largest investor in the Saudi stock market. The GOSI possesses thirty one major shareholdings, which represents 90 billion (SR) of market value.³⁰⁹ Major shareholdings of the GOSI range between 5 and 22%. Around 64% of GOSI shareholdings are focused on three market sectors, namely banking, petrochemicals, and cement.

³⁰⁹ The Value of Disclosed Institutions Ownership in the Saudi Listed Companies on October 31, 2012 by Aljoman Center of Economic Consultation, *available at* <http://www.aljoman.net/> (accessed on Nov. 4, 2012).

Table 8. Major Shareholding of the General Organization of Social Insurance (GOSI) in Saudi Listed Companies by Sector

Sector	Major shareholding
Petrochemical Industries	6
Banking and Financial	8
Telecommunication and Information Technology	2
Agriculture and Food Industries	1
Industrial Investment	1
Energy and Utilities	1
Cement	6
Building and Construction	1
Real Estate Development	2
Insurance	1
Hotel and tourism	1
Media and Publishing	1
Total	31

Source: Major shareholders information on the Saudi Securities Exchange (Tadawul) (Nov. 8, 2012).

In total, semi-government agencies have major holdings in 39 listed companies. The market value of semi-government institutions is about 118 billion (SR), distributed between 50 or 51 companies. Semi-government agency ownership represents about 17% of institutional holdings' in the Saudi Capital Market.

Table 9. Major Shareholdings of Semi Government Institutions in Saudi Listed Companies by Sectors

Sector	Major Shareholding	Number of Companies	Companies with both Institutions
Petrochemical Industries	10	9	1
Banking and Financial	12	8	4
Telecommunication and Information Technology	4	3	1
Agriculture and Food Industries	1	1	0
Industrial Investment	3	2	1
Energy and Utilities	1	1	0
Cement	12	8	4
Building and Construction	2	2	0
Real Estate Development	2	2	0
Insurance	2	1	1
Hotel and tourism	1	1	0
Media and Publishing	1	1	0
Total	51	39	12

Source: Major shareholders information on the Saudi Securities Exchange (Tadawul) (Nov. 8, 2012).

6.5.3.1 Family Ownership

Apart from a few longstanding merchant families in the Arabian Peninsula, such as the Alireza³¹⁰ and al-Gosaibi families,³¹¹ nearly all of today's businesses families emerged after the foundation of the Kingdom of Saudi Arabia in 1932,³¹² mainly during the oil bonanza of the

³¹⁰ The Alireza family originally migrated from Iran to Jeddah, the western port city in the Arab Peninsula, in early nineteen century. For historical remarks on the Alireza business family, see MICHAEL FIELD, *THE MERCHANTS: THE BIG BUSINESS FAMILIES OF SAUDI ARABIA AND THE GULF STATES* 14–47 (1984).

³¹¹ The Algosaibi family started their business in Bahrain at the end of the nineteen century. For historical background on the Algosaibi family and commerce, see FIELD, *supra* note 310, at 217–46. The Algosaibi family business recently underwent an acute financial problem due to some mismanagement of one of the family affiliates. See Erik Larson, *Algosaibi Family Ordered by U.K. Court to Show Saudi Assets*, BLOOMBERG L.P. (July 7 2011), available at <http://www.bloomberg.com/news/2011-07-07/algosaibi-family-ordered-by-u-k-court-to-reveal-saudi-assets.html> (accessed on Nov. 30, 2012).

³¹² See *supra* chapter II.

1970s.³¹³ Currently, around 90 percent of business enterprises in Saudi Arabia are family owned.³¹⁴ Accordingly, family businesses play a significant role in the Saudi economy, contributing a quarter of the country's GDP.³¹⁵ Business families control 45 percent "of the top 100 Saudi companies."³¹⁶ Nonetheless, the size of family businesses is still not fully reflected in Saudi capital markets because the majority of families shy away from going public, as for example the Bin-Ladin family does.³¹⁷

Several listed companies carry controlling family names, such as Abdullah al-Khodari Sons Company, al-Rajhi Bank, and al-Zamil Industrial Investment, while the other companies have distinctive business names (for example, Jarrir Company and the Kingdom Holding Company).³¹⁸ For various reasons, numerous families' investments in listed companies are disguised under the name of private equity firms.³¹⁹ Thus, available data does not necessarily provide accurate information on the size of family ownership in the Saudi capital market. Saudi

³¹³ *See supra* chapter II.

³¹⁴ Council Saudi chamber of commerce and industry, <http://www.csc.org.sa/Arabic/OurServices/FamilyFacilities/Pages/AboutUS.aspx> (accessed on Nov. 30, 2012).

³¹⁵ *Id.*

³¹⁶ MOHAMED RAMADY, *THE SAUDI ECONOMY* 196 (2010).

³¹⁷ The Bin Ladin family structures its family business in a limited liability company form. For more information about the bin Ladin family company see Saudi Binladin Group, website, <http://www.sbg.com.sa/> (accessed on Dec. 17, 2012).

³¹⁸ See list of listed companies in Saudi Stock Exchange Tadawul, *available at* http://www.tadawul.com.sa/wps/portal/!ut/p/c1/04_SB8K8xLLM9MSSzPy8xBz9CP0os3g_A-ewIE8TIwP3gDBTA08Tn2Cj4AAvY_dQA_3gxCL9gmXHRQB0Zc_U/ (accessed on Nov. 4, 2013). *See also* Fahad Mohammad Almajid, *A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective* 218 (Ph.D.) (2008) (unpublished dissertation University of Manchester).

³¹⁹ Beside the economic and financial structure of the family business, there other various reasons for persons to hide their real identity from the public, mostly to avoid public scrutiny into the source of the business owner's money. Secondly, some business families have political connections, which cause them to prefer keeping their businesses unconnected to their real names. Finally, a number of rich business families avoid disclosing their wealth to the public due to fear of attracting what is believed to be the 'evil eye.' See Yasein Aljafri, 92 billion is the profit of the largest 100 Saudi companies, *Aleqtisadiah* on line, issue No. 6795 in May 19, 20012.

Stock Exchange data indicates that family ownership in the Saudi capital market is around 145 billion (SR).³²⁰ The Saudi Royal Family has the largest ownership share in family ownership which is followed by the Al-Rajhi family (see Table 7).³²¹

Table 10. Family Ownership in Saudi Arabia in the Saudi Capital Market (at the end of September 2012)

Family Name	Market value Billion SR	Percentage %
al-Saud*	62,134	43
al-Rajhi	49,289	34
al-Rashid	6,866	5
al-Eissa	6,728	5
al-Ageal	4,970	3.4
al-Hokair	4,483	3
al-Subaie	2,799	2
al-Shalash	1,614	1
al-Abdullatif	1,560	1
Other Families	4,371	3
Total	144,808	100%

Source: Family Ownership in the Saudi Capital Market, October 15, 2012.

*Al-Saud is the Royal Family of the Kingdom of Saudi Arabia. The investment registered under the Family name is owned by individual investors who are members of the Family in their personal capacity, and no formal legal privileges are provided for their investments. Furthermore, the Royal Family is an extended family that comprises several thousand members and its members' investments are not managed in concert with each other.

6.5.3.2 Individual Investors' Holdings

A notorious characteristic of the Saudi stock market is the high percentage of individuals (real persons) investing in the capital market in comparison with the available market share for this class. There are 79 major individual shareholders in the Saudi capital market, holding 94 major

³²⁰ Family Ownership in Saudi Capital Market on September 30, 2012 by AlJoman Center of Economic Consultations.

³²¹ *Id.*

block holdings in the various listed companies.³²² The value of stock held by major individuals is around 124 billion (SR). almost 99% of this amount (123 billion SR) is owned by just 54 people.³²³ The Saudi billionaire Alwaleed bin Talal al- Saud³²⁴ has the largest ownership share among this group of individual shareholders, with over 54 billion (SR) in block holdings, followed by the Saudi businessman Suleiman al-Rajhi, with stock holdings worth 21 billion (SR).³²⁵

Table 11. Top Four Major Individual Shareholders' Ownership in the Saudi Arabian Capital Market (at the end of September 2012)

Investor name	Market value of major shareholding (billion)	Percentage to the total major individual shareholding
Alwaleed al-Saud	54,569	46
Suleiman al-Rajhi	21,501	18.1
Sultan al-Saud	8,792	7.4
Abdullah al-Rajhi	7,350	6.2
Total	92,232	77

Source: Aljoman Center for Economic Consultations, 31/10/2012.

6.5.3.3 Foreign Ownership

Foreigners are not permitted to invest directly in the Saudi Capital Market; however, foreign investors may invest in the Saudi capital market indirectly through equity swap agreements.³²⁶

Swap agreement investors are not permitted to participate in the company governance, such as

³²² Classification of Disclosed Ownership in Saudi Capital Market on October 31, 2012, by Aljoman Center for Economic Consultation (Nov. 13, 2012).

³²³ Value of individuals disclosed ownership in Saudi listed companies as of August 9, 2012, by Aljoman center for economic consultations on September 8, 2012.

³²⁴ Forbes Magazine listed Alwaleed bin Talal as the 29th wealthiest person of the world. See The World's Billionaires, Forbes, <http://www.forbes.com/billionaires/list/#> (accessed on Oct. 28, 2012).

³²⁵ Value of individuals disclosed ownership in Saudi listed companies as of August 9, 2012, by Aljoman center for economic consultations on September 8, 2012.

³²⁶ See Capital Market Authority CMA: Swap Agreement, 20/8/2008, *available at* <http://www.cma.org.sa/ar/mediacenter/pr/Pages/swapagreement.aspx> (accessed Nov. 13, 2013).

voting in the shareholders' meetings.³²⁷ Shares owned in accordance with a swap agreement are not easily transferred.³²⁸ Despite these restrictions, swap agreements do provide foreign investors with limited access to the Saudi market, while maintaining a significant limit on foreign investment in that market. Thus, Morgan Stanley excludes the Saudi capital market from its Emerging Market Index (MSCI) because of the prohibition on foreign portfolio holders investing directly in the Saudi market.³²⁹ Currently, Saudi capital market is listed in Morgan Stanley frontier Markets Index alongside with Argentina and Ukraine.³³⁰

The national media reports that the Saudi Capital Market Authority (CMA) is currently considering opening the capital market to foreign investors.³³¹ Even if that happens, strict prerequisites will be imposed on nonresident foreign investors, under which only qualified institutional investors will have access to the Saudi Capital Market.³³² The Saudi government's ambivalent position toward foreign portfolio investment more likely is driven by the fear of the ramifications on the economy if "hot money" is allowed to flow into the market. As the Saudi

³²⁷ *See id.*

³²⁸ *See id.*

³²⁹ MSCI Press Release (June 20, 2012), MSCI Announces the results of the 2012 Annual Market Classification Review, *available at* http://www.msci.com/eqb/pressreleases/archive/Mkt_Class_2012.pdf (accessed on Dec. 5, 2012) (the press release provides that: "non-GCC based investors have indirect access to the Saudi equity market through the use of swaps which for institutional investors may cause compliance issues. The introduction of a new scheme allowing direct access for non-GCC based investors to the Saudi equity market may result in MSCI considering the inclusion of Saudi Arabia in Frontier Markets or Emerging Markets, depending on the level of market accessibility."). *Id.* at 5–6.

³³⁰ Morgan Stanley (MSCI) homepage, http://www.msci.com/products/indices/country_and_regional/tradable/frontier_markets_100/performance.html (accessed on Jan. 22, 2014).

³³¹ *See, e.g.,* Dania Saadi, *Saudi Market Opens Up, but Gradually*, N.Y. TIMES (Mar. 21, 2012), http://www.nytimes.com/2012/03/22/world/middleeast/22iht-m22-saudi-bourse.html?pagewanted=all&_r=0 (accessed on Dec. 5, 2012).

³³² *See* Abdulrahman Al-Tuajiri, The Chairmen of Saudi Capital Market Authority (CMA), Taking Stock in Saudi Arabia, Talks to CNBC (Mar. 23, 2010, 9:42 AM ET), *available at* <http://video.cnbc.com/gallery/?video=1448768833&play=1> (accessed on Dec. 5, 2012). *See also* Saadi, *supra* note 331.

Capital Market Chairmen, Abdulrahman al-Tuajiri, asserts, “It is not that I want to shield the Saudi [Capital] Market ... (but) we are more concerned about hot money and we want to see it in a very well organized way that are coming into our market.”³³³

The citizens of the Gulf Cooperation Council (GCC) member states have recently been allowed to invest in the Saudi capital market under the national treatment principle in accordance with GCC agreements.³³⁴ In addition, foreign residents in Saudi Arabia are allowed to invest in the Saudi stock market.³³⁵

Accordingly, the market share of foreign portfolio investment is small, specifically, it only accounts for around 6% of the Saudi capital market.³³⁶ The banking sector is the exception, in which the concentration of foreign ownership is high (see table 9). Having a strategic partnership with well known foreign bank was one of the obvious conditions to establish a bank in Saudi Arabia.

³³³ Abdulrahman Al-Tuajiri, Chairmen of the Saudi Capital Market Authority (CMA), quoted in Saudi Bourse Wants Foreigners but Fears “hot” money (Asma Alsharif and Ulf Laessing, Web, Reuter (Oct. 27, 2010), *available at* <http://uk.reuters.com/article/2010/10/27/uk-saudi-bourse-idUKLNE69Q01B20101027> (accessed on Dec. 5, 2012).

³³⁴ See Council of Ministers Resolution No. (267) in Shaban 14, 1428H corresponding to August 27, 2007.

³³⁵ See Capital Market Authority (CMA) Statement of March 20, 2006, *available at* http://www.cma.org.sa/Ar/News/Pages/CMA_N193.aspx (accessed on Dec. 5, 2012).

³³⁶ Gaweim kobar almullak takshif an miyat milyar riyal llajanj fi al soug alsaudeih, aleqtisadiyah newspaper online, Issue No. 5445, Sept. 9, 2008, *available at* http://www.aleqt.com/2008/09/07/article_153806.html (accessed on Dec. 6, 2012).

Table 12. Foreign Ownerships in Saudi Listed Banks

The Bank	Foreign Ownership %
SABB (British)	40
Saudi Faranci (France)	31.1
Arab National	40
Aljazira	5.8
Saudi Investment	7.4
Saudi Hollandi (Netherlands)	39.9

Source: Major shareholders information on the Saudi Securities Exchange (Tadawul) (May 30, 2012).

6.5.3.4 Ownership and Control Pattern

The concentration of ownership in Saudi listed companies is evident. Of these listed companies, 90% have major shareholders.³³⁷ Moreover, the level of concentration in Saudi listed companies is quite high: 56 of 155 companies have a concentration level above 50%.³³⁸

³³⁷ Al-Joman Center for Economic Consultations, February 29, 2012. Only 15 listed companies have no major shareholders. See Listed Companies with no Major shareholders, March 29, 2012, by Al-Joman Center of Economic Consultations.

³³⁸ List of Disclosed Shareholdings in the Saudi Bourse (from High to Low) on February 29, 2012 by Al-Joman Center of Economic Consultations.

Table 13. Concentration Level of Major Stock Holding (5% or more) in the 20 Largest Saudi Listed Companies

Number	The company	Concentration %	Major shareholders
1	SABIC	75.4	2
2	Al-Rajahi	35.7	3
3	STC	83.6	3
4	Saudi Electricity	81.2	2
5	SAFCO	59.6	2
6	SAMBO	49.3	3
7	Etihad Etisalat	38.8	2
8	Riyadh	69.5	5
9	Kingdom	95	1
10	SABB	74.4	4
11	Saudi Faranci	53.7	3
12	Saudi Kayan	35	1
13	YANSAB	62	2
14	Arab National	66.3	4
15	MA'ADEN	66.8	3
16	Almarai	70.8	3
17	Industrialization	46.6	7
18	Petro Rabigh	75	2
19	SAVOLA Group	40.1	4
20	Alinma	30.7	3

Source: Tadawul, major shareholders information on November 19, 2012.

The combined market value of the top 20 listed companies on the Saudi stock exchange is worth 960 billion (SR),³³⁹ which represents 75% of total market capitalization.³⁴⁰ Furthermore, major block holdings are under the control of a small number of investors (see Table 11). For instance, two major shareholders control 75% of the largest listed company, SAPIC (a giant petrochemicals conglomerate), while 95% of the Kingdom Company (a multi-investment

³³⁹ Source: Saudi Stock Exchange (Tadawul), Annual Statistical Report (2011): Market Capitalization as on 12/31/2011.

³⁴⁰ Market capitalization at the end of 2011 is 1, 270, 842, 630 billion (SR) which is equal to \$ 338, 891, 368.

holding company that, for example, holds 45% of the Four Seasons Hotels together with the Cascade Company of Bill Gates) shares are controlled by one investor, Alwaleed bin Talal al-Saud.³⁴¹

Table 14. Number of Major Shareholders in Saudi Listed Companies

Major Shareholders	Companies
One	28
Two	37
Three	32
Four	26
Five	7
Six	5
Seven	4

Source: Al-Joman Center for Economic Consultations, February 29, 2012.

Major shareholders' ownership is worth 800 billion (SR), which denotes over 60% of market capitalization of these companies. In fact, 85% (679 billion SR) of total major shareholding blocks are controlled by institutions: business organizations, government institutions, and semi-government institutions.³⁴² Public investment Funds (PIF) hold the largest number of shares among institutions with 43% of institutional investor ownership and is followed by the General Organization of Social Insurance (GOSI) with 13% of the institutional investors' share of the capital market.

³⁴¹ Major shareholders' information on the Saudi Securities Exchange (Tadawul) website, May 30, 2012 and the Kingdom Company homepage, <http://www.kingdom.com.sa/investments/hotels/management-companies/four-seasons-hotels-and-resorts> (accessed on Jan. 22, 2014).

³⁴² There are over 2000 institutions that are investing in the Saudi capital market. However, merely 200 institutions have major shareholdings. See Saudi Stock Exchange (Tadawul), Annual Statistical Report (2011): Market Capitalization as of 12/31/2011. Page 30 and Classification of Disclosed Ownership in Saudi Capital Market on October 31, 2012, by Al-Joman Center for Economic Consultation (Nov. 13, 2012).

Table 15. Institutional Major Holding Distribution in the Saudi Capital Market

Institution	Market Capitalization	Percentage %
Public Investment fund (PIF)	288,942,600	43
General Organization of Social Insurance	90,785,580	13
Saudi Government	40,245,130	6
SABIC	39,451,500	6
Public Pension Agency	27,283,960	4
Other Institutions	191,343,066	28
Total	678,051,836	100

Source: Al-Joman Center for Economic Consultations, September 30, 2012.

While there are four million individuals with investments in the capital market, few of them (79 persons) have major shareholdings.³⁴³ Ownership by the major individual investors represents 15% of the total major shareholdings.³⁴⁴

This chapter's examination of the structure of ownership in the Saudi capital market confirms that the Saudi pattern of ownership is still enormously concentrated. Such systems commonly encounter a principal (majority shareholders) - principal (minority shareholders) agency problem.³⁴⁵ In order to encourage increased diversity of ownership, the Saudi corporate governance system needs to devote special attention to addressing the protection of minority shareholders in Saudi listed companies. Systems with good protection of investors such as the U.S. system have more diversified investment and less investment risks accordingly.

³⁴³ Abridged Presentation and Analysis of Individuals' Disclosed Ownership in Saudi Listed Companies, August 16, 2012, by Al-Joman Center of Economic Consultations.

³⁴⁴ Classification of Disclosed Ownership in the Saudi Capital Market, October 31, 2012, by Al-Joman Center for Economic Consultation (Nov. 13, 2012).

³⁴⁵ See chapter IV.

6.6 SAUDI JUDICIAL SYSTEM AND CORPORATE GOVERNANCE

6.6.1 Introduction

The existence of an effective judicial system represents a key prerequisite for corporate governance.³⁴⁶ A judicial system that supports good corporate governance standards needs to be dependable and to move rapidly in handling cases.³⁴⁷ Within the system, judges should have proper training to confront the complex issues of corporate governance.³⁴⁸ The judges' ability to further the ideology of corporate governance is connected to the "remedies" available under a national system.³⁴⁹ Judges in common law countries have insightfully expanded the cause of good corporate governance by "filling gaps" in their legal systems.³⁵⁰ For instance, fiduciary duties represent a notable example of the judiciary's contribution to corporate governance standards.³⁵¹

Conversely, such positive contributions are not expected from developing countries, where the judiciary is typically made up of less capable judges.³⁵² Judges in developing countries

³⁴⁶ See Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 789–91 (2000–2001).

³⁴⁷ See *id.* at 781, 790 and 807.

³⁴⁸ See Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1926 (1995–1996).

³⁴⁹ See *id.*

³⁵⁰ See, e.g., John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. L. 1, 27 (1999–2000), and Bernard Black, *The Principal Fiduciary Duties of Board of Directors, Presentation at Third Asian Roundtable on Corporate Governance 1* (Singapore Apr. 4, 2001), available at <http://www.oecd.org/daf/ca/corporategovernanceprinciples/1872746.pdf> (accessed Nov. 27, 2013).

³⁵¹ See generally Black, *supra* note 350.

³⁵² This is more expected from countries with civil law tradition. Civil law system does not provide judges with a room to expand the statutory provisions as of their common law counterpart. See Coffee, *supra* note 350 ("the civil law judge may not have the same authority or the same expansive understanding of the judicial role. To the

are only equipped to deal with basic corporate governance issues. Accordingly, corporate governance principles in developed countries should be well crafted in order to facilitate their understanding and implementation. In relation to this issue, Professor Bernard Black said: “[E]nforcement will be easier if the court can often resolve disputes by applying bright-line rules rather than broad standards.”³⁵³

6.6.2 The Efficiency of the Saudi Judicial System

The Saudi legal system, as in most developing countries, suffers from a weak judicial system. Although analyzing the causes of this state of affairs is beyond of the scope of this study, it is crucial to highlight several factors that contribute to the issue, assessing their effects on the Saudi corporate governance system.

6.6.2.1 The Judicial Process and Enforcement

Judicial proceedings are very slow in Saudi Arabia; it may take years for the court to issue a judgment, putting an end to a particular dispute.³⁵⁴ The percentage of judges in Saudi Arabia is one of the lowest percentages in the world (see Table 1).

extent that the civil law distrusts judicial activism or views it as a usurpation of the legislature's role, the civil law judge is confined to the narrower role of interpreting what comprehensive civil codes have actually specified. Thus, at least at the margin, the common law encourages gap-filling, while the civil law tends to impede it.”). *Id.*

³⁵³ See Black & Kraakman, *supra* note 349, at 1911, 1926–27.

³⁵⁴ RIYADH ECONOMIC FORUM, FOURTH SESSION, ALANDIMA ALTIJARIAH WA MUTATLABAT ALTANMIYAH 144 (2009) [hereinafter RIYADH ECONOMIC FORUM]. See also See Fahad Mohammad Almajid, *A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective* (Ph.D.) 242 (2008) (unpublished dissertation University of Manchester).

Table 16. Number of Judges in Selected Countries

Country	Number of Judges (per 100 K inhabitants)
Saudi Arabia	4.0
Italy	10.2
U.S.A.	10.81
France	12.47
Switzerland	14.1
Portugal	18
Germany	24.5

Source: CEPEJ 2010 Report, Study on 16 Comparable Countries by Jean-Paul Jean and CEPEJ Expert (28 November 2010); J. Mark Ramseyer and Eric Rasmusen, Comparative Litigation Rates, Discussion Paper No. 681. Harvard Law School; Riyadh Economic Forum, first session, Albunyah altashriah wa alqdayah fi almamlakah alarabia alsaudiah 268 (2005).

The insufficient number of judges in the Saudi judicial system represents a key factor slowing down the dispute resolution process. At present, the Saudi judicial system would need more than five thousand judges in order to conform to best practice standards.³⁵⁵ The shortage of judges is not related to financial considerations; Saudi judges are compensated adequately.³⁵⁶ This shortage is related to the appointment process which has been selective and confined to groups or families that have a reputation for integrity.³⁵⁷ More importantly, many top Islamic law schools graduates refuse to accept judicial posts to avoid the perceived danger of punishment from God,³⁵⁸ as the Prophet Mohammad informed:

There are three types of judges: Two judges who are in the Fire, and a judge who is in Paradise. A man who judges without the truth, and knows that- this one is in

³⁵⁵ See RIYADH ECONOMIC FORUM, THIRD ANNUAL PERIOD, ALBIYAH ALADLIYAH WA MUTATALABAT ALTANMIYH 75 (2007).

³⁵⁶ For judges salaries see the Saudi Ministry of Civil Service webpage, <http://www.mcs.gov.sa/EmploymentRights/Pages/SalariesLadders.aspx#> (accessed Nov. 29, 2013).

³⁵⁷ This process unfortunately produced a bias in the selection process that excluded many qualified non Najidi (person from Najid region) persons from the judiciary. Recently, the selection process of judges has become less biased and includes person from regions and families that were excluded in the past. For more on the Najdi's dominance in jobs and positions connected to religion, see Mohmmad Nablil Mouline, *Ulma alislam*, 277 and after (2011).

³⁵⁸ See the former Saudi Minister of Justice, Abdullah al-Shaik, press release in *Al-Jazeera* newspaper issue No. 12577 dated 16 Safar 1428.

the Fire. One who judges while not knowing ruins the rights of the people. So he is in the Fire. A judge who judges with the truth, that is the one in Paradise.³⁵⁹

Exacerbating the problem, any enforcement of a regulation or decision requires pursuing justice through a lengthy and inefficient process.³⁶⁰ Moreover, the enforcement process is not always completed, nor is it always successful in its efforts.

Table 17. Two Enforcement Indicators for Selected Countries (2014)

Country	Contract Enforcement Ranking (world)	Time of Enforcement (days)
Korea (Rep)	2	230
Germany	5	394
France	7	395
U.S.A.	11	370
Singapore	12	150
Malaysia	30	425
Japan	36	360
Mexico	71	400
Saudi Arabia	127	635
Nigeria	136	447

Source: Doing Business 2014, the World Bank (2013).

6.6.2.2 Judges' Qualifications

The secondly problem of the Saudi judicial system is that judges do not receive the proper education and training they will need to resolve complex legal issues.³⁶¹ Generally speaking, judges in Saudi Arabia are trained in Islamic law having made no study of modern legal subjects,

³⁵⁹ Reported by Tirmithi. However, those groups forgot the more reliable tradition of the Prophet which states: "When a judge utilizes his skill of judgment and comes to a right decision, he will have a double reward, but when he uses his judgment and commits a mistake, he will have a single reward." Reported by Al-Bukhari and Muslim.

³⁶⁰ See generally RIYADH ECONOMIC FORUM, *supra* note 354, at 87–91.

³⁶¹ They are trained to deal with Islamic law issues but not statutory based issues. See generally Riyadh Economic Forum, third annual session, Albiyah aladliyah wa mutatalabat altanmiyh, 114–17 (2007).

such civil procedure and statutory law.³⁶² The curriculum in Islamic law schools consists exclusively of teaching classic Islamic treatises, authored several centuries ago.³⁶³ Such training is rigorous, but without a doubt, it is not sufficient to fulfill modern judiciary functions, for which judges are expected to follow and interpret a great number of statutes. Accordingly, judges must receive sufficient training in both Islamic and statutory based law in order to be effective in the modern Saudi judicial system.

6.6.2.3 Judicial System Segmentation

The Saudi judiciary is dispersed between its traditional court system and a variety of semi-judicial tribunals. This problem has its roots in the controversy that arose in the 1930s over the government's adoption of modern legislation, and codification.³⁶⁴ Religious scholars, the *ulama*, who have an absolute control over judicial branch, had strongly opposed all proposals for codifying Islamic jurisprudence.³⁶⁵ Ayoub Al-Jarbou ascribes the rejection of codification to the judges' desire to conserve their wide discretionary power over the judicial process and to the *ulama's* interest in maintaining their power in the society.³⁶⁶ That might be an accurate description of a number of *ulama* especially ones with high government positions. However, for

³⁶² See RIYADH ECONOMIC FORUM, *supra* note 354, at 115.

³⁶³ See Ayoub M. Al-Jarbou, *The Role of Traditionalists and Modernists in the Development of the Saudi Legal System*, 21 ARAB LAW Q. 191, 212–13 (2007).

³⁶⁴ See generally *id.* at 191, 200–01 (“[C]odifying Shariah simply means that there are different valid opinions on certain issues, and the authority chooses one of them to be binding among people and in courts.”). *Id.* at 195–96. For a comprehensive study of codification and Islamic rules, see ABDURRAHMAN A. AL-KASEM, *ALISLAM WA TAQNEIN ALAHKAM* (2d ed. 1977).

³⁶⁵ See Al-Jarbou, *supra* note 363, at 191, 201. See also See Fahad Mohammad Almajid, *A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective* (Ph.D.) 164 (2008) (unpublished dissertation University of Manchester).

³⁶⁶ *Id.* at 191, 197.

the majority of *ulama*, codification has a historical negative connotation because “[f]rom French Algeria to British India to Indonesia, codification of *Shariah*[sic] law was central to the colonial project to control the legal sphere and enable economic exploitation of colonies.”³⁶⁷

In contrast, proponents of codification argue that the Saudi Arabian judicial system grants judges the wide authority to select rules from various Islamic sources.³⁶⁸ Such a system is not predictable, in many cases producing contradictory verdicts.³⁶⁹ For instance, “[i]n 2006, a judge sentenced four men to between six to twelve years’ imprisonment each for sexually harassing women ... , while the same year three men convicted of raping a twelve-year-old boy received sentences of between one and two years in prison each and 300 lashes.”³⁷⁰

In the end, the *ulama* influence has halted the implementation of Islamic codified laws in Saudi Arabia. At the same time, however, the Saudi government has launched a western style legislative scheme to regulate numerous social and economic activities.³⁷¹ In this context, George Sfeir said:

Saudi Arabia’s approach to law reform has been cautious and piecemeal, the product of conflicting priorities. On the one hand there is the oil revenue fueled

³⁶⁷ ANDREW HAMMOND, *THE ISLAMIC UTOPIA: THE ILLUSION OF REFORM IN SAUDI ARABIA* 56 (2012).

³⁶⁸ Al-Jarbou, *supra* note 363, at 191, 199.

³⁶⁹ *See id.* at 191, 196.

³⁷⁰ HAMMOND, *supra* note 367, at 140.

³⁷¹ *See* Maren Hanson, *The Influence of French Law on the Legal Development of Saudi Arabia*, 2 ARAB L.Q. 272, 288–90 (1987), and Al-Jarbou, *supra* note 363, at 191, 201 (“regardless of the attitude of ... [the Ulma] towards these laws, and their interest in applying *Shariah*, which exists in the jurisprudence books to all aspect of life, many laws have been enacted in criminal, administrative, and commercial areas of the legal system. These laws correspond to the comprehensive development plans that the country is going to go through.”). *Id.* *See* also Fahad Mohammad Almajid, *A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective* (Ph.D.) 232 (2008) (unpublished dissertation University of Manchester).

drive for modernization and development, and, on the other, the perceived need to preserve traditional social values and religious mores.³⁷²

The problem is that many provisions of adopted statutes contradict Islamic law³⁷³ which, in turn, has inflamed the *ulama* and strengthened their disinclination toward legal modernization.

The Saudi government has overcome the issue of judges' reluctance to recognize enacted statutes by creating an informal judicial system, alongside the original judiciary.³⁷⁴ The new system comprises a number of specialized semi-judicial tribunals (administrative committees) that are exclusively entrusted with solving disputes that falls within the scope of a specific statute.³⁷⁵ The semi-judicial tribunals' practice falls quite short of judicial best practices, in areas such as independence, transparency, and professionalism.³⁷⁶

6.6.2.4 Transparency

The Saudi Judicial System is not transparent. For instance, the courts and semi-judicial tribunals' decisions are not published or available to the public, or even to lawyers.³⁷⁷ Such obscurity

³⁷² GEORGE N. SFEIR, MODERNIZATION OF THE LAW IN ARAB STATES: AN INVESTIGATION INTO CURRENT CIVIL CRIMINAL AND CONSTITUTIONAL LAW IN THE ARAB WORLD 45 (1998).

³⁷³ See Al-Jarbou, *supra* note 363, at 191, 203.

³⁷⁴ See *id.* at 191, 202. See also Fahad Mohammad Almajid, A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective (Ph.D.) 164 (2008) (unpublished dissertation University of Manchester).

³⁷⁵ See generally RIYADH ECONOMIC FORUM, *supra* note 354, at 72–73 & 78, 84–85.

³⁷⁶ For instance, the committees' members are mostly public servants working for the same ministry or government agency that in charge of enforcing the relevant statute. All commissioners serve in part time basis with minimal compensation for that extra work they deliver. No requirement to have training in law to be a member of such committees. The committees are not governed by binding civil procedures code and the verdicts are not published or available for public. See RIYADH ECONOMIC FORUM, *supra* note 354, at 72-73 & 78, 84-85. See also Fahad Mohammad Almajid, A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective (Ph.D.) 166 (2008) (unpublished dissertation University of Manchester).

³⁷⁷ See the Bureau of Experts Report No. 127 in (10 Rabi al-Awal 1422 H) corresponding to June 2, 2001. See also See Fahad Mohammad Almajid, A Conceptual Framework for Reforming the Corporate Governance of

hinders public supervision of the judicial process and prevents lawyers from predicting judicial policy towards a specific legal issue. The publishing of decisions plays a crucial role in understanding and improving the legal system.³⁷⁸ For instance, a decision to reform a specific area of the law would not be complete without the judge being informed about judicial implementation of relevant statutes. Compounding the problem, the absence of classification of court decisions deprive judges the opportunity to benefit from earlier decisions that were issued in similar disputes. This lack of access encourages inconsistency in judicial practice.

6.6.2.5 Law Profession

Lawyers play a minimal role in enhancing the Saudi justice system. This fact may be related to the underdevelopment in terms of organization of the Saudi legal profession country. For instance, there is no lawyers' association that organizes, supervises, and works to improve the legal profession.³⁷⁹ Currently, in part the Ministry of Justice fills this void by administering operations such as the licensing and disciplining of lawyers.³⁸⁰ Qualifications for practicing law in Saudi Arabia are very basic and easy to satisfy. For example, no qualifying or licensure exam is required; a few years of experience suffice.³⁸¹ Furthermore, the practice of law is not confined

Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective (Ph.D.) 162 (2008) (unpublished dissertation University of Manchester).

³⁷⁸ See Aleqtisadiah News Paper issue No. 4913 in March 25, 2007, *available at* http://www.aleqt.com/2007/03/25/article_83914.save (accessed Nov. 22, 2013).

³⁷⁹ See RIYADH ECONOMIC FORUM, *supra* note 354, at 80.

³⁸⁰ See Articles §§ (7, 29, 30, 31) and of Law Profession Law enacted by Royal Decree M/ 38, 28 Rajab 1422H corresponding to October 15, 2001.

³⁸¹ See Article § (3) of Law Profession Law enacted by Royal Decree M/ 38, 28 Rajab 1422H corresponding to October 15, 2001.

to licensed lawyers; any person with power of attorney may serve in the capacity of a lawyer.³⁸² Such non-trained "lawyers" tarnish the reputation of the legal profession and diminish its respect in the courts.³⁸³ For instance, judges may hunt for any excuse to expel lawyers from the court room.

6.6.3 Does the Saudi Judicial system support Corporate Governance effectively?

The forgoing analysis illustrates several issues in the Saudi judicial system, which suggest that such a system cannot be expected to play a supportive role in the ideology of corporate governance. In the area of corporate governance, effective enforcement requires a judicial system that responds swiftly to violations of rules and regulations in corporate governance and effectively redresses prejudiced stakeholders. Effective redresses require a creative, capable judiciary that is able to fill gaps in the national system of governance. The 'old fashioned' training of Saudi judges undermines their ability to adjudicate efficiently the complex corporate governance issues they encounter.³⁸⁴

In the last ten years, the government has issued a number of decisions in an attempt to reform the Saudi judicial system.³⁸⁵ Accession of Saudi Arabia to the WTO in 2005 presses the

³⁸² See Article § (18) of Law Profession Law enacted by Royal Decree M/ 38, 28 Rajab 1422H corresponding to October 15, 2001.

³⁸³ See RYADH ECONOMIC FORUM, *supra* note 354, at 80.

³⁸⁴ See Fahad Mohammad Almajid, A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective (Ph.D.) 167-168 (2008) (unpublished dissertation University of Manchester) (he argues for improving judges qualifications to meet the modern challenges.") *Id*

³⁸⁵ See Royal Order A/ 14 (23 Safar in 1426 H), corresponding to April 2, 2005, in re of organization of the Saudi judicial system.

Saudi government to pursue “legal and judicial reforms.”³⁸⁶ These reforms have the intent of abolishing the semi-judicial tribunals currently operating in the country, allocating their functions to the traditional judicial system.³⁸⁷ Moreover, an appellate level of adjudication has been created whereby Saudi court system for the first time has become a three tier judicial system.³⁸⁸

A series of specialized courts, which include first instance commercial courts and commercial appellate circuits, constitute the new court structure.³⁸⁹ The creation of a specialized commercial court represents a pivotal step in the right path which confirms with other civil law countries reform agenda.³⁹⁰ Professor John Coffee commented on this trend by saying: “[t]he inflexibility of civil law courts has already led to the creation of specialized courts in some civil law countries, which specialized courts have exclusive jurisdiction over some subject matters.”³⁹¹

The reform, also, had required courts to publish their decisions on a regular basis.³⁹² Furthermore, the government has issued a new law regulating the enforcement of judicial decisions.³⁹³ The new framework of enforcement is expected to lead to development of

³⁸⁶ HAMMOND, *supra* note 367, at 57.

³⁸⁷ See Section 9 of the Implementation Mechanism for Judicial and Board of Grievances Laws Royal Decree M/ 78 (19 Ramadan in 1428 H) corresponding to October 1, 2007.

³⁸⁸ See Article § (16) of the Judicial Law issued by Royal Decree M/ 78 (19 Ramadan in 1428 H) corresponding to October 1, 2007. For more information about Saudi judicial system see chapter (II).

³⁸⁹ See Article §§ (9 and 16) of the Judicial Law issued by Royal Decree M/78 (19 Ramadan in 1428 H).

³⁹⁰ See Coffee, *supra* note 305, at 1, 29–30.

³⁹¹ *Id.* at 1, 29 [footnote omitted].

³⁹² See Article § (71) Paragraph (3) of the Judicial Law issued by Royal Decree M/78 (19 Ramadan in 1428 H) corresponding to October 1, 2007 and Article § (21) of The Board of Grievances Law issued by royal decree No. (M/78) (19 Ramadan in 1428 H) corresponding to October 1, 2007.

³⁹³ See Enforcement Law issued by Royal Decree M/ 53 (13 Shaban in 1433 H) corresponding to July 3, 2012

enforcement mechanisms in the country. Furthermore, the new reform recognizes the importance of the codification of Islamic jurisprudence, for which a high level committee has been created to undertake this mission.³⁹⁴

Implementing the aforementioned reforms is expected to improve the Saudi judicial system. However, the attainment of full implementation of the reform agenda is a more complex and challenging task than it might seem, given that several religious problems have not been solved yet with the *Ulama*.³⁹⁵ For instance, judges of the new commercial courts will continue to refuse to recognize statutes that contradict Islamic teachings.³⁹⁶ In this juncture, Ayoub Al-Jarbou said:

The difference between the Shariah Courts' attitude toward enacted laws and their attitude toward unlawful ... [provisions included in these laws] is that their attitude towards the former might one day change and agree to judge cases and controversies according to them if these laws comply with Shariah, whereas their attitude toward the latter will remain the same, i.e. the refusal to entertain them.³⁹⁷

To avoid this problem, the new reform has maintained a number of semi-judicial tribunals that are related to the most problematic statutes, particularly banking, securities, and customs.³⁹⁸ However, disputes in the settlement of less problematic statutes, such as company law, are assigned to the new commercial courts.³⁹⁹ The problem is that the new commercial

³⁹⁴ See Royal Order A/ 14 (23 Safar in 1426 H), corresponding to April 2, 2005, in re of organization of the Saudi judicial system.

³⁹⁵ A former Saudi judge, Abdulaziz al-Gasim, views the judicial reform as an opportunity for "cleansing the judiciary of the conservatism that has dominated up to now," quoted HAMMOND, *supra* note 367, at 142.

³⁹⁶ The rejection of codification sentiments among Islamic scholars has decreased recently or at least moved from the rejection of codification per se to the rejection of provisions that contradict Islamic law.

³⁹⁷ Al-Jarbou, *supra* note 363, at 191, 205.

³⁹⁸ See Section 3.1 of the Implementation Mechanism for Judicial and Board of Grievances laws Royal Decree M/ 78 (19 Ramadan in 1428 H) corresponding to October 1, 2007.

³⁹⁹ See Article § (35) of the Law of Procedures before Sharaih Courts Procedures issued by Royal Decree M/ 1 (22 Muharram in 1435 H) corresponding to November 25, 2013.

courts will refuse to recognize interest-based contracts, including bonds and other forms of debt finance. Insurance contract legality under Islamic law is still a controversial issue, which may hinder the enforceability of such contracts depending on which judges adjudicate cases relating to them. Likewise, recognition of the limited liability of shareholders is still controversial among Islamic scholars because under the view of a number Islamic scholars that each person is fully responsible to pay his own debts.⁴⁰⁰ The enforcement of shareholders' rights in companies with objectives that contradict Islamic law is not guaranteed.⁴⁰¹ Furthermore, there is no enforcement of the rights associated with preferred stocks that confer priority over profits or assets upon liquidation.⁴⁰²

In short, the Saudi judicial system faces several issues, including those that involve ideological and theological controversies over the substance of reform. A large number of *ulama* still "views the reforms with suspicion."⁴⁰³ Such issues are more than likely to have negative effects on the judicial system and to undermine its function for the next few years. The recent reforms considered here will improve the judicial system, but probably not to a level that will enable the Saudi judicial system to offer an efficient external mechanism of enforcing corporate governance.

⁴⁰⁰ See *supra* chapter V.

⁴⁰¹ See *supra* chapter V.

⁴⁰² See *supra* chapter V.

⁴⁰³ HAMMOND, *supra* note 367, at 139.

6.7 CONCLUSION

The creation of a capital market authority and official securities exchange, Tadawul, in 2004 represents a pivotal step toward improving the regulatory environment for publicly held companies in the country. The Capital Market Authority has supplemented the Companies Law of 1965 with a set of regulations aimed at improving corporate governance directly and indirectly, through such measures as enacting the Listing Rules Regulation and the Corporate Governance Rules.

Ownership in the Saudi capital market is concentrated; families, semi-government and government funds control most of the publicly traded companies. Consequently, the agency cost problem in most Saudi companies is between controlling shareholder(s) and minority shareholders. Such an agency problem raises concerns over the protection of minority shareholders in Saudi Arabia.

The disclosure rules currently operating in Saudi Arabia comply with most internationally recognized best practice standards. The CMA is still not able to decrease insider trading and other conflict of interest transactions to an expected level. The disclosure system has failed to observe the importance of disclosing information related to the government as a unique investor in the Saudi capital market. The government, as a shareholder, should disclose its purpose of ownership in each publicly traded company. Investors need to know whether any government investment is for political or for purely business reasons. Moreover, the disclosure system has not taken into account the importance of disclosing financial information that potentially has religious implications for investors. Saudi investors need to know if the company is engaging in any activity that contradicts Islamic principles.

Given its current structure, the Saudi Judiciary cannot be expected to support the cause of corporate governance. The judicial system in Saudi Arabia is underdeveloped and defused among a system of formal (religiously based) courts and informal semi-judicial tribunals (shadow justice system).⁴⁰⁴ The slow adjudication process is neither transparent nor consistent. Recently, major steps toward reform have been taken to improve the Judiciary. However, improving the judicial system, if successful, will be a complex process and will require a lot of time.

⁴⁰⁴ See Fahad Mohammad Almajid, *A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective* (Ph.D.) (2008) (unpublished dissertation University of Manchester) (he noted: “one of the fundental problems cuaseing confusing for invesotrs and businesses, domestic or foreign, as well as instability in the system is related to the duality in the judiciary.”) *id*

7.0 INTERNAL CORPORATE GOVERNANCE IN SAUDI PUBLICLY TRADED COMPANIES: BOARD OF DIRECTORS

7.1 INTRODUCTION

In theory, shareholders are expected to govern the company's affairs and oversee the performance of the company's management. However, the enormous size of the group of shareholders makes this expectation impractical due to collective decision-making problems. To overcome this hurdle, an intermediary (between the shareholders and management) institution has been crafted: the board of directors, who govern the company in lieu of the shareholders.¹ Nonetheless, shareholders retain a few fundamental powers beyond the board of director's authority.²

The legal literature concerning corporations reflects a division among scholars over the nature of the board of directors. One group of scholars views the board as a subordinate body, comprised of agents of the company (or the shareholders' General Meeting "GM"),³ while other scholars categorize the board as an independent organ of the company, which represents the

¹ See chapter IV.

² See chapter VIII.

³ THARWAT ABDELRAHEIM, AL-GANOUN AL-TIJARI AL-MASRI 432 (1982); ALI HASSAN YOUNES, AL-SHAREIKAT AL-TJARIAH 274–75 (1956); the Legal Memo of the Ministry of Commerce and Industry No. 11/556 in 18/7/1400 [on file with the author].

company's will and acts on its behalf.⁴ The premise of these views is noticeable in scholarly discussion of the legal framework of boards of directors in joint stock companies, including the board's nature, powers, duties, as well as the liability of its members.

The board of directors is the cornerstone mechanism of internal corporate governance. In systems with weak external corporate governance mechanisms, such as the Saudi system, the board of directors is expected to play a crucial role in protecting the best interests of the company and its shareholders. This chapter is devoted to evaluating the structure of boards of directors in Saudi publicly held companies. This evaluation is conducted in light of OECD recommendations and comparative corporate governance, primarily in relation to the U.S. and French systems. The main goal of this chapter is to spur efforts to reform the governance of boards by directors in order further to improve the overall mechanisms of internal corporate governance in Saudi Arabia. A number of topics related to the board of directors are covered in this chapter, including its structure, functions, formation, duties, and remunerations.

7.2 BOARD STRUCTURE

Comparative corporate governance indicates that boards of publicly held companies may be single- or two-tiered board. No best practice preference is given to one board structure over the other. For instance, the *OECD Principles* recognizes both the single-tiered and two-tiered board

⁴ See MUSTAFA KAMAL TAHA, *AL-SHAREIKAT AL-TJARIAH* 240 (1997).

structures.⁵ Both board structures are expected to fulfill the same functions, namely the management and supervision of company affairs. However, the two-tiered board separates the supervisory role of the board from its managerial role,⁶ while the single-tiered, or unitary, board vests both functions in one body.⁷

The contemporary incorporation of independent directors into a one-tiered board, in fact, has brought the practice of the one-tiered board closer to that of the two-tiered board.⁸ For instance, independent directors are expected to play a supervisory role over their colleagues who are executive directors, in the same manner by which a supervisory board exerts formal oversight on a management board.

As in the U.S. system, the board of directors for Saudi listed companies consists of a single-tiered body.⁹ In contrast, the French corporate governance system provides publicly traded companies with the option to select either the single- or two-tiered model.¹⁰ In practice, the single-tiered board model is more popular among French publicly held companies.¹¹

⁵ No matter which board structure adopted, the “[t]he [OECD] Principles are intended to be sufficiently general to apply to whatever board structure is charged with the functions of governing the enterprise and monitoring management.” OECD Principles, at 58.

⁶ For the structure of the two-tiered board see the French Commercial Code [hereinafter FCC] articles §§ (L 225-57 – L225-90-1). The English version of FCC, which is the only version consulted in this study, is lastly updated on March 20, 2006. The FCC in English is available at <http://www.legifrance.gouv.fr/Traductions/en-English/Legifrance-translations> (accessed on Nov. 8, 2013).

⁷ For the structure of the single-tiered board see the French Commercial Code [hereinafter FCC] articles §§ (L 225-17 – L225-42-1).

⁸ See ADRIAN CADBURY, *THE CORPORATE GOVERNANCE AND CHAIRMANSHIP: A PERSONAL VIEW* 71 (2002).

⁹ See MODEL BUS. CORP. ACT § 8.03(a); and C.L. Article § (80).

¹⁰ See French Commercial Code (FCC) Articles §§ (L225-17) and (L225-57-59). Also see AFEB-MEDEF, *Corporate Governance Code of Listed Corporations*, Principle 3.1. (2013).

¹¹ CHRISTINE A. MALLIN, *CORPORATE GOVERNANCE* 225 (2010).

Conversely, a number of countries such Germany, Indonesia and China require a two-tiered board structure.¹²

Adopting a two-tiered board system is not a part of the current corporate governance reform agenda in Saudi Arabia.¹³ This could be due to the absence of labor unions in the country, organizations that might advocate shifting the existing one-tiered structure of the board to a two-tiered structure, a system which is better equipped to facilitate labor integration in governance.¹⁴ For instance, trade unions in post World War II Germany played a significant role in readopting the codetermination model of the board of directors in that country.¹⁵

The proliferation of co-determination in systems with mandatory two-tiered boards does not exclude this functionality of board structure in systems with no co-determination agenda.¹⁶ The two-tiered board originally was devised in the seventeenth century as a means of enhancing the control system in the company.¹⁷ Moreover, a two-tiered board is not a prerequisite for having a co-determinate board; co-determination can be implemented in both single-tiered and two-

¹² See MARTIN SCHULZ & OLIVER WASMEIER, *THE LAW OF BUSINESS ORGANIZATIONS: A CONCISE OVERVIEW OF GERMAN CORPORATE LAW* 41 (2012); THE INSTITUTE OF DIRECTORS, *THE HAND BOOK OF INTERNATIONAL CORPORATE GOVERNANCE: A DEFINITIVE GUIDE* 468–70 (2005); and GU MINKANG, *UNDERSTANDING CHINESE COMPANY LAW* 181–83 (2006).

¹³ See Fahad Mohammad Almajid, *A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective* 193 (Ph.D.) (2008) (unpublished dissertation University of Manchester). The only proposal for adopting the two-tiered board structure in Saudi Arabia was suggested by Mohammad al-Jabor. See *Mohammad al-Jabor, Musahama fi dirasht tashga'a kiyam sharikat musahamah fi almamlakah*, vol. 6, *JOURNAL OF THE COLLEGE OF ADMINISTRATIVE SCIENCES IN RIYADH UNIVERSITY* 105, 109–10 (1978).

¹⁴ See CADBURY, *supra* note 8, at 72.

¹⁵ For the role of the trade union in the adoption the codetermination in Germany, see generally Oscar Weigert, *Co-determination in Western Germany*, 73 *Monthly: The Provisions of the Law on Labor Participation in Management in the Steel and Mining Industries and the Inherent and Prospects*, *LAB. REV.* 649, 649–51 (1951).

¹⁶ See ADRIAN CADBURY, *THE COMPANY CHAIRMAN* 65 (1990).

¹⁷ *Id.* at 46. That does not mean a single-tiered board cannot realize that the French governance system has a codetermination in a single-tiered board. See French Commercial Code (FCC) Article § (L225-22).

tiered boards, both of which exist in the French corporate governance system.¹⁸ The Netherlands has a two-tiered board system with no (formal) participation by workers on either board.¹⁹

Nonetheless, the formal division of a board's managerial and supervisory functions is the real advantage of a two-tiered board over a one-tiered board.²⁰ Such formal division permits the board members at each level to focus on a specific mandate and to facilitate the allocation of liabilities. As Sir Adrian Cadbury remarks, "directors of supervisory and of management boards know precisely what their duties are and do not have to remember which of the two hats they are wearing."²¹ Otherwise, the collegial nature of a one-tiered board may "blur" the process of allocating mandates.²²

The British system has addressed this issue by suggesting that independent directors hold regular meetings in the absence of the executive directors.²³ Good supervision requires an open discussion among the supervisors (independent directors) without the supervised (the executive members) being present.

Accordingly, Saudi policy makers should consider the incorporation of the two-tiered board structure into the Saudi corporate governance system. However, the two-tiered board structure should not be imposed mandatorily as Mohammad al-Jabor had insisted on in the 1970s.²⁴ The adoption of an elective two-tiered board, such as French system has, may offer Saudi companies more options for governance. For instance, a two-tiered board structure may

¹⁸ See French Commercial Code (FCC) Article § (L225-27).

¹⁹ See CADBURY, *supra* note 16, at 66.

²⁰ See *id.* at 64.

²¹ See *id.* at 66.

²² See *id.*

²³ See MALLIN, *supra* note 11, at 168.

²⁴ See al-Jabor, *supra* note 13, at 105, 109.

suit companies with major government holdings. Accordingly, public officials (with no business experience) who normally represent the government on the board may be better positioned as part of a supervisory board.

7.3 DECISION MAKING FRAMEWORK

The Saudi governance system suggests that the board of directors ought to organize regular meetings, without specifying a minimum number of such meetings.²⁵ Empirical data gathered recently by the CMA has revealed that Saudi listed companies conducted 774 board meetings in 2011, with an average of over five meetings per year for each board.²⁶ By comparison, during the same period 58% of large U.S. companies held between 6-9 meetings per year.²⁷

The size of a corporation and the complexity of its business are the determining factors as to which role the board should play. In today's business world, most boards of directors in publicly held companies insulate themselves from the daily management of the company, devoting their attention to strategic, supervisory and advisory matters.²⁸ The U.S. system of corporate governance, for instance, observes this reality. To this end, the Model Business Corporate Act (MBCA) provides that, "[a]ll corporate powers shall be exercised by or under the authority of directors of the corporation, and the business and affairs of the corporation shall be

²⁵ SCGRs Article § (16) paragraph (1) and see C.L. Article § (80).

²⁶ The Saudi Capital Market Authority (CMA), the Annual Statistical Report on Corporate Governance of the listed companies (2011/2012) [on file with the author].

²⁷ Spencer Stuart Boards Index, 26 (2013).

²⁸ See generally STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 44-50 (2012).

managed by or under the direction, and subject to the oversight, of its board of directors.”²⁹ Based on this and similar statutory commands, a board of directors is the ultimate controller of the decision-making in a corporation.³⁰ The nature of ownership may affect the extent of *de facto* powers that the board has, but statutes always reserve *de jure* (statutory) powers for the board.³¹

Saudi corporate governance, however, does not observe the afore-mentioned shift with regard to the governance of large companies. For instance, Article (66) of the CL provides that, “the joint stock company shall be managed by a board of directors.”³² Furthermore, the CL lacks any provisions with regard to the role of executives in the company. Developed legal systems, such the U.S. and the French, recognize that the position of executives in the company, especially top executives, is a key source of agency cost problems.³³ Accordingly, the CL needs to fill this regulatory vacuum by regulating the role of executives in the company’s governance.

²⁹ MODEL BUS. CORP. ACT § 8.01(b); Del. § 141(a); Cal. § 300(a).

³⁰ A good summary of the board functions by Professors Cox and Hazen is as follows:

(1) setting the course of the enterprise by determining the company’s general objectives, goals, and philosophies; (2) selecting the chief executive and senior officers and seeing that able young executives are developed; (3) determining executive compensation, pension, and retirement policies; (4) delegating to the chief executive and subordinate executive authority for administrative action; (5) providing advice, counsel, and assistance to corporate officers; (6) fixing policies relating to such matters as pricing, labor relations, expansion, and new products; (7) determining the dividend payments financing, and capital changes; (8) monitoring the company’s progress, exercising vigilance for its welfare, and taking appropriate action in light of its progress; (9) submitting for shareholder action proposals requiring their approval; and (10) creating adequate machinery for conducting the board’s business.

JAMES D. COX & THOMAS LEE HAZEN, CORPORATION 149–50 (2d ed. 2003).

³¹ It is important to note that under corporate law the broad authority possessed by the board of directors is a default rule, able to be modified. MODEL BUS. CORP. ACT § 8.01(b); Del. § 141(a); Cal. § 300(a). Such limitations on board of directors’ power may occur either through amending the articles of incorporation or the bylaws.

³² The C.L. Article § (66).

³³ MODEL BUS. CORP. ACT § 8.42 and *see* Russian Law on Joint Stock Companies Article § (71).

The board of directors of Saudi publicly traded companies has “full powers in the administration of the company.”³⁴ As in France and other civil law countries, the board may make any decision that falls within the company’s objectives.³⁵ No approval from the shareholders’ GM is required, even if that decision is not in the ordinary course of business.³⁶ For instance, the board of a company with the objective of trading in real estate is not required to seek permission from the GM to sell real estate owned by the company because such a transaction falls within the objective of the company.³⁷ Conversely, U.S. company law utilizes the ordinary course-of-business criteria to evaluate board actions.³⁸ The wide scope of power granted to the Saudi board may decrease the power of shareholders and, accordingly, weaken checks and balances mechanisms within the company. The adoption of the U.S. model of ordinary and extraordinary criteria for board power may enhance the power of shareholders and enhance checks and balance in the Saudi companies.

³⁴ The C.L. Article § (73). The actions of the board of directors under the Saudi system are divided into actions of management and actions of disposable, which refer mainly to the transfer or pledge of the company’s assets. The board has full authority over the first kind of actions and has restricted power on the latter ones. *See* TAHA, *supra* note 4, at 268. Whenever an issue about the board of director’s power or liability arises, the trace of agency law is found in the answer of these issues. The board of director’s power is almost a copy of the agent obligations in Arab countries civil codes. *See, e.g.*, the agency contract under the Egyptian Civil Code Articles § (699-717). For instance, article describe the administrative (management) powers of the agent by saying: “[a]n agency which is mentioned in general wording, without particularization even of the type of the legal work for which the agency is granted, shall not vest the agent with a quality other than in acts of management.” the Egyptian Civil Code Article § (701) paragraph (1). Therefore, the act of administration are limited to the “preservation and maintenance works.” the Egyptian Civil Code Article § (701) paragraph (2). Conversely, the agent actions of disposable includes the action that is beyond the administrative actions scope which requires a special kind of authorization from the principal as the Egyptian Civil Code states:

A special proxy shall be provided for every work that is not an act of management particularly for an act of sale, mortgage, donation, composition, declaration, and arbitration, putting an oath, and pleading before the courts.

The Egyptian Civil Code Article § (702) paragraph (1).

³⁵ The C.L. article § (73).

³⁶ *Id.*

³⁷ *Id.*

³⁸ *See* ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 115 (2013).

Best practice asserts that the management of the company must be answerable to the board, given that the board will bear the ultimate responsibility for the company's success or failure.³⁹ This issue represents a high risk factor in Saudi publicly traded companies with significant government control, a potential problem that needs to be addressed by the Saudi corporate governance.

7.4 THE ISLAMIC PERSPECTIVE ON BOARD DECISION MAKING

The decision-making model of the boards of Saudi publicly traded companies conforms with decision-making structures adopted in various other countries. Shareholders of Saudi companies have sole access to the company decision-making process through appointing and removing directors, whereas no other stakeholders enjoy such privilege, most notably employees.⁴⁰ Furthermore, the boards' decision making structure is based on the majority decision making model.⁴¹

However, this decision-making structure disregards Islamic decision-making values, most importantly *shura* and consensus.⁴² *Shuratic* decision-making encourages the expansion of the decision making process to cover nearly all key elements connected to the decision. Accordingly, the Saudi corporate governance exclusion of key members of the production team in the

³⁹ See the OECD Guidelines, ch. (VI)A ("The boards of SOEs should be assigned a clear mandate and ultimate responsibility for the company's performance. Each board should be fully accountable to the owners.").

⁴⁰ See Fahad Mohammad Almajid, A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective (Ph.D.) 251 (2008) (unpublished dissertation University of Manchester).

⁴¹ C.L. Article § (80).

⁴² For *shura* and consensus, see chapter (V).

company undermines the value of *shura*. The formal incorporation of workers into the composition of the board of directors would bring board decision making closer to Islamic values. Alternatively, the installation of non-formal or binding mechanisms for consultation with employees and other major shareholders may comply with *shura*, as well. In this context, the Egyptian corporate governance permits direct participation of employees in the board of directors or indirect participation through forming an advisory committee to the board.⁴³

Saudi corporate governance should assert the importance of the value of *shura* as best practice for the boards of Saudi publicly held companies, providing companies with a default legal structure which would permit companies to incorporate workers into the boards of directors. A transplant of the Egyptian model of labor participation to Saudi corporate governance may satisfy *shura* requirements.

Beyond this measure, the value placed on consensus suggests that majority decision making should not be implemented if consensus over a board decision is achievable.⁴⁴ Accordingly, the view of the majority of directors should not be forced on minority directors before a sincere, consensus-seeking endeavor is undertaken. Such value carries great importance for minority representative on the board, who are elected through the cumulative method of voting. Saudi corporate governance should emphasize and promote consensus seeking as the first step in making any board decision.

⁴³ For labor participation under Egyptian corporate governance, see SAMIHA EL-KALIOUBY, AL-SHAREIKAT AL-TIJARIAH 952–60 (2008).

⁴⁴ The corporate governance structure of publicly held insurance companies recognizes consensus value. See article § (23) of the Mandatory Model Bylaws for Insurance Companies.

7.5 BOARD SIZE AND COMPOSITION

7.5.1 The Size of the Board

There is no agreed upon number for board members.⁴⁵ Sir Adrian Cadbury suggests that board size should never exceed twelve members.⁴⁶ Best practice reveals that “smaller boards allow for real strategic discussion and are less prone to become rubberstamping entities.”⁴⁷ The SCGRs suggest that the board members of a listed company not exceed eleven,⁴⁸ which falls within the range consistent with best practice. However, no mandatory upper limit on the number of board members has ever been adopted.⁴⁹ Mohammad al-Jabor has taken issue with this lack of a mandatory upper limit for board of director membership because he asserts that this situation may encourage the unnecessary over-appointment of board members so as to benefit those persons through remuneration.⁵⁰ This scenario is perhaps more likely in companies where the dominant shareholder is the government, under which the supervising bureaucrats of the

⁴⁵ See CADBURY, *supra* note 16, at 42.

⁴⁶ *See id.* at 43.

⁴⁷ OECD Guidelines, 48.

⁴⁸ SCGRs Article § (12) paragraph (a). The setting a limit of the board member maximum number is an appropriate move by the CMA authority which cope with corporate law scholars demand since the CL only specify the minimum number of the board of directors but has left the matter open for the maximum number. *See* MOHAMMAD HASAN AL-JABOR, SAUDI COMMERCIAL LAW 326 (4th ed. 1996) (al-Jabor argued that large boards may cause waste of the company resources of unneeded board members).

⁴⁹ C.L. article § (66). In fact, the board size of the Saudi publicly traded companies normally comprise of 7 to 11 directors. *See* Fahad Mohammad Almajid, A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective 247 (Ph.D.) (2008) (unpublished dissertation University of Manchester).

⁵⁰ *See* AL-JABOR, *supra* note 48. *See* Fahad Mohammad Almajid, A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective 247 n.844 (Ph.D.) (2008) (unpublished dissertation University of Manchester)

company might appoint their friends or relatives (nepotism) in order to benefit financially or socially by means of the company.

7.5.2 Ownership and Nationality

The shareholders elect the members of the board of directors (by direct or cumulative voting methods).⁵¹ As in the French system,⁵² board members of Saudi listed companies must be shareholders of the company.⁵³ Each board member is required to provide qualification shares.⁵⁴ The ownership condition conforms to best practices, tending to align the board member's interests with those of the company.⁵⁵ However, the small value of qualification shares (about \$3000) is not likely to create genuine property interests within the company.⁵⁶ For instance, the

⁵¹ C.L. article § (66). For the voting methods for electing the board members, see chapter (VIII).

⁵² French Commercial Code (FCC) article § (L 225-25). The size ownership is determined by the company bylaws. *Id.*

⁵³ C.L. article § (68). That does not mean the member has to be a shareholder at the time of his election to the board, but he has to acquire this status within the first thirty days of his appointment to the board. *Id.*

⁵⁴ The guarantee shares provision aims to ensure that any injured persons (from the board members' actions) will find available assets of that board member to enforce his (the injured) rights. C.L. article § (68).

⁵⁵ *See, e.g.,* French Commercial Code (FCC) article § (L 225-25). *Also see* AFEB-MEDEF, Corporate Governance Code of Listed Corporations, Principle 23.2.1. (2013) and Fahad Mohammad Almajid, A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective 247 (Ph.D.) (2008) (unpublished dissertation University of Manchester).

⁵⁶ *See* ALI AL-ZAINI, USUL AL-ALQANOUN AL-TIJARI, vol. 1, pt. 2, 389 (1935). Mustafa Taha suggests that directors should be required to hold a significance percentage of the company's shares as an alternative to the exiting ownership scheme for directors. TAHA, *supra* note 4, at 257. *Cf* Mohammad al-Jabor argue against the abolition of liability guarantee shares of the board members because he thinks this might lead to appointing persons at the company board whom does not have a real tie with the company. *See* AL-JABOR, *supra* note 48, at 329. I take issue with al-Jabor position in this regard because the amount of shares this scheme requires is so minimal which not expected to create a real ownership interest in the company. Therefore, it seems more logical under this circumstances that any board member would care about his professional reputation more than the increase or decrease of three thousand dollars shareholding he provided as a guarantee of his managerial liability. In addition, insurance on the board members liability may serve as a more practical approach of guaranteeing the shareholders and the company will receive a compensation for any damages caused to any one of them by the wrongdoing director.

giant Saudi Telecom Company (STC), with \$18 billion in market capitalization, requires its board members to provide only three thousand dollars' in qualification shares.⁵⁷

Saudi nationality is not a prerequisite for being a board member in any of the Saudi-listed companies. Nonetheless, the boards of most listed companies consist of Saudi citizens (see Figure 1).

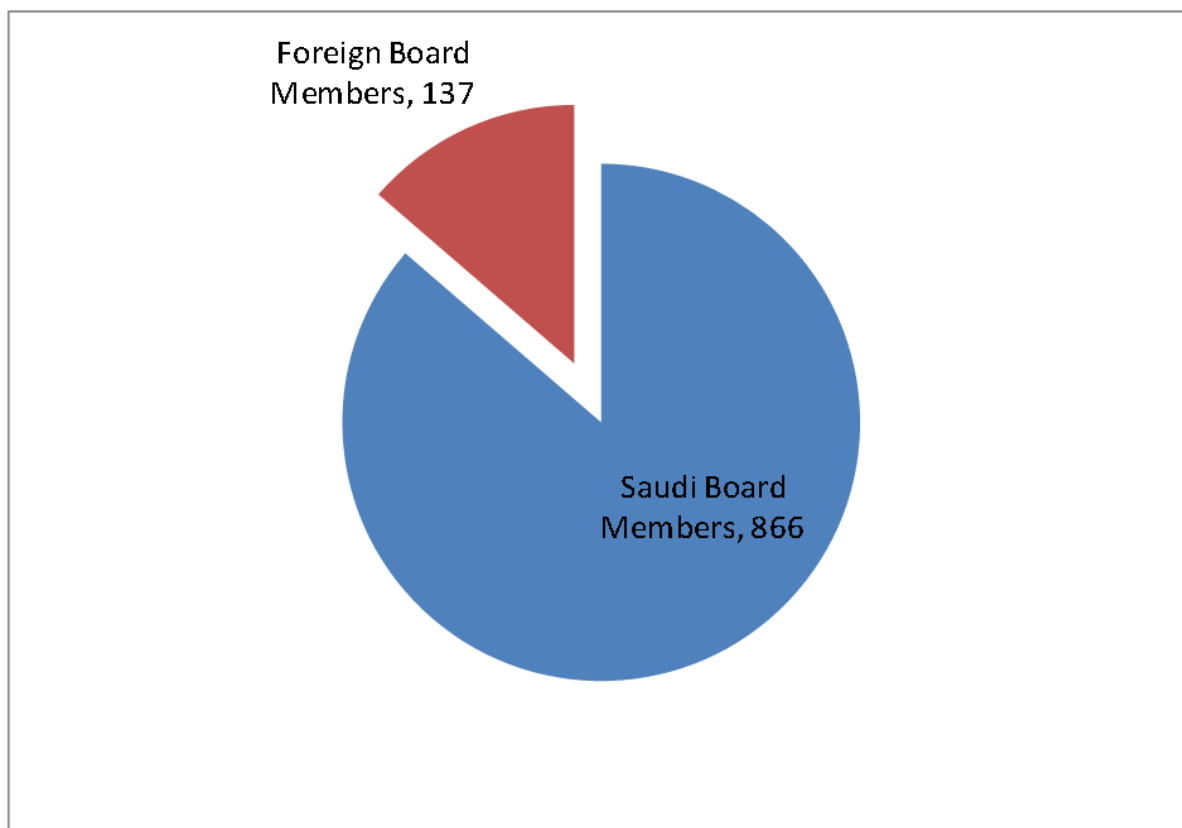


Figure 1. Foreign Membership in the Boards of Directors of Saudi Listed Companies (2011)

Source: the Saudi Capital Market Authority (CMA), the Annual Statistical Report on Corporate Governance of the listed companies (2011/2012) [on file with the author]

⁵⁷ See the Saudi Telecom Company STC bylaws article § (22).

7.5.3 Membership Ceilings

7.5.3.1 Number of Board Memberships

Although directors are obliged to devote time to fulfilling their responsibilities, they are not expected to commit all of their time to one board membership. Board membership is not a full time job, and moreover, board members normally have other equally important business or private commitments. Nonetheless, a number of corporate governance systems have imposed limits on the number of board memberships an individual may hold concurrently.⁵⁸ Such a ceiling aims to insure that board members will have ample time and singularity of focus to perform their duties.⁵⁹

The Saudi corporate governance system does not permit board members to hold positions on more than five listed company boards at the same time.⁶⁰ Historically, the prohibition was against joining more than five joint stock companies, listed or not listed.⁶¹ In 2011, however, the Council of Ministers has retained this restriction only on listed companies.⁶² For instance, a

⁵⁸ For instance the French Commercial Code (FCC) provides:

Any natural person who is in breach of the provision of the present article shall resign from one of his directorships within three months of being appointed, or from the directorship in question within three months of the occurrence of the event which resulted in a condition of the previous paragraph no longer being met. Upon expiry of that period, he shall be deemed to have resigned either from his new directorship or from which no longer meets the conditions laid down in the previous paragraph, whichever applies, and shall return the remuneration received. This shall not affect the validity of the deliberation in which he participated.

French Commercial Code (FCC) Article § (L 225-21).

⁵⁹ See MOHAMMAD KAMIL AMIN MALISH, AL-SHRIKAT 307 (1957).

⁶⁰ Article (1) of the Saudi Council of Ministers Resolution No. 284 in 22 Ramadan 1432 H, corresponding to 22 August 2011.

⁶¹ Article (2) of the Saudi Council of Ministers Resolution No. 55 in 28 Safar 1419 H, corresponding to 23 June 1998.

⁶² See the Saudi Council of Ministers Resolution No. 284 in 22 Ramadan, 1432 corresponding to 22 August 2011.

person may have a membership of twenty joint stock companies, but no more than five of those can be listed companies.⁶³

Furthermore, such a ceiling on board memberships increases the opportunity for more people to participate on listed companies' boards, an action which will broaden the experience base of board members in the country. Otherwise, board membership may stay closed, limited to a small circle of persons.⁶⁴

7.5.3.2 Age of Directors

Most of the large U.S. companies have no set retirement age for directors (only 16% of the S&P 500 companies impose such a limit).⁶⁵ The French system advocates that fewer appointments to the board be elders,⁶⁶ recommending that no more than a third of the board members should be over seventy years old.⁶⁷ Moreover, the age of the board chairman of the company should not be more than sixty five.⁶⁸ In contrast, Saudi corporate governance has not considered this matter at all. Adopting the French retirement age limit for directors might be advisable as a means of

⁶³ The SCGRs is still advocating the old stricter policy by suggesting that: “[a] member of the board of directors must not act as a member of the board of directors of more than five joint stock companies at the same time.” SCGRs Article § (13) paragraph (h).

⁶⁴ See MALISH, *supra* note 59. See also Fahad Mohammad Almajid, A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective (Ph.D.) 250 (2008) (unpublished dissertation University of Manchester).

⁶⁵ See Spencer Stuart Boards Index, 15 (2013).

⁶⁶ French Commercial Code (FCC) Article § (L 225-19).

⁶⁷ *Id.* French Commercial Code (FCC) Article § (L 225-19). Although the FCC left the retirement age designation for the company, “[i]n the absence of an explicit provision in the bylawss, the number of directors over the age of seventy years may not be more than one third of the directors in office ... [,] the oldest director shall be deemed to be retiring from office when the age limit for the directress specified in the ... bylaws specifying anther procedure, the oldest director shall be deemed to be retiring from office when the age limit for the directors ... is exceeded.” *Id.*

⁶⁸ French Commercial Code (FCC) Article § (L 225-48) and § (L 225-54). The bylaws may raise the age limit for both functions. *Id.*

ensuring injection of new blood into boards of directors. A generational mixture among board members may bring to the board both the energy of younger members and the experience and wisdom of elder members.

However, in an emerging market like the Saudi capital market, which aims to encourage family businesses to go public, imposing an age restriction on the board chairman, as in the French system, may discourage many family businesses from having themselves listed. Hence, retaining the current approach, which indirectly deals with this issue by preventing the board chairman from serving more than two consecutive terms in that position, is more advisable.⁶⁹

Saudi Arabian society is a socially connected society, that has a strong respect for seniority among family members, a practice which has a significant impact on the choice of the board chairman.⁷⁰ In this regard, a western observer remarked “[t]he authority, wisdom, and counsel of elder family members are still to a great extent accepted, and the young family members must wait sometimes far into middle age before being accorded that status.”⁷¹ Accordingly, on the boards of family-controlled companies, the seniority factor more likely will determine who is going to chair the board of directors, with complete disregard for differences in competence or skills. The restriction on the renewal of the board chairman indefinitely may facilitate solving this social issue by allowing more competent members of the family or other elected board members to assume this position without any embarrassment or insult, which might otherwise ensue from asking the senior family member formally to hand over the position.

⁶⁹ C.L. article § (79). This restriction aims to offer opportunity for other board members to serve in this function. *See* the Legal Memo of the Ministry of Commerce and Industry No. 11/1283 in 27/6/1407 [on file with the author].

⁷⁰ *See* DAVID E. LONG, CULTURE AND CUSTOMS OF SAUDI ARABIA 38 (2005).

⁷¹ *Id.*

7.5.4 Women's Representation

A well structured board should contain a group of members with diverse and balanced experiences.⁷² Diversity, also, requires a fair representation of both genders on the board,⁷³ insuring fairness especially for women. For instance, French corporate governance advocates representation by women at a level of not less than 40% of the board's membership.⁷⁴ At the most recent count, 18% of the seats on boards of U.S. companies are occupied by women.⁷⁵

Gender diversity on the boards of Saudi companies is not part of the Saudi corporate governance reform agenda. A few years ago, the Ministry of Commerce and Industry declared that women are eligible to be appointed to boards of directors.⁷⁶ The resolution stresses respect for Islamic values when women are fulfilling membership duties, especially as to the refraining from intermingling with unrelated males.⁷⁷ However, the intermingling part of this resolution has never come to the point of actual enforcement. Clearly, that part of the resolution was inserted merely for the sake of satisfying the conservative elements of Saudi society, who generally stand against women's empowerment in the business sphere.⁷⁸

⁷² See AFEB-MEDEF, Corporate Governance Code of Listed Corporations, Principle 6.1. (2013).

⁷³ See Recommendation (10) of the Finish Corporate Governance Code (2010) which provides that “[b]oth genders shall be represented on the board.”

⁷⁴ AFEB-MEDEF, Corporate Governance Code of Listed Corporations, Principle 6.4. (2013).

⁷⁵ Spencer Stuart Boards Index, 17 (2013).

⁷⁶ See Section 1 of the Circular No. 222/ 1732 in 12/6/ 1432 H; Issued by the General Directorate of Companies in the Ministry of Commerce and Industry. [on file with the author].

⁷⁷ See Section 1 of the Circular No. 222/ 1732 in 12/6/ 1432 H; Issued by the General Directorate of Companies in the Ministry of Commerce and Industry. [on file with the author].

⁷⁸ The conservative elements of the society base their reject of work of women in public realm on solid justifications issued by well respected Islamic scholars. See Fatwa No. 25164, the Permanent Committee in the General Presidency of Scholarly Research and Ifta, vol. 2, pp. 327–28, n.d., available at <http://www.alifta.net/Search/ResultDetails.aspx?language=ar&lang=ar&view=result&fatwaNum=&FatwaNum>

In practice, the representation of women on the boards of Saudi listed companies is minimal: four women.⁷⁹ The recent social distress triggered by the Ministry of Labor's decision to permit women to work as cashiers in shopping centers- and the political pressure placed on the government to repeal that decision⁸⁰ strongly suggest that Saudi women have a prolonged struggle ahead of them in expanding their share of membership on the boards of Saudi publicly traded companies. Accordingly, Saudi corporate governance should emphasize the importance of the participation of women on the board, treating it as best corporate governance practice and suggesting for the time being that at least one director on each board should be female.⁸¹ Such a

ID=&ID=15293&searchScope=3&SearchScopeLevels1=&SearchScopeLevels2=&highLight=1&SearchType=exact&SearchMoesar=false&bookID=&LeftVal=0&RightVal=0&simple=&SearchCriteria=allwords&PagePath=&siteSection=1&searchkeyword=216185217133217132032216167217132217133216177216163216169#firstKeyWordFound (accessed on Sept. 6, 2013). Recently, the Saudi Ministry of Labor mandatory appointment of Saudi women the retail sector (i.e. sellers and cashiers) triggers a strong wave of rejection against such move by the Ministry. For nature of the struggle over this issue, see, e.g., The financial Times, Twitter war over writer's call to molest Saudi Women Cashiers, by Abeer Allam Michael Peel (May 28, 2013. 4:33 PM), available at <http://www.ft.com/cms/s/0/f195a62e-c798-11e2-be27-00144feab7de.html#axzz2e9CHSxJU> (accessed on Sept. 6, 2012). Furthermore, the Permanent Committee in the General Presidency of Scholarly Research and Ifta, which chaired by the *Mufti* (the highest Islamic authority in Saudi Arabia), issued *fatwa* (opinion) that prohibit women from working cashiers in place attended by men See Fatwa No. 24937, the Permanent Committee in the General Presidency of Scholarly Research and Ifta, Vol. 2, P. 326, n.d., available at <http://www.alifta.net/Search/ResultDetails.aspx?language=ar&lang=ar&view=result&fatwaNum=&FatwaNumID=&ID=15292&searchScope=3&SearchScopeLevels1=&SearchScopeLevels2=&highLight=1&SearchType=exact&SearchMoesar=false&bookID=&LeftVal=0&RightVal=0&simple=&SearchCriteria=allwords&PagePath=&siteSection=1&searchkeyword=217131216167216180217138216177216167216170#firstKeyWordFound> (accessed on Sept. 6, 2013).

⁷⁹ The four women are; Lubna al-Olayan (Saudi Hollandi Bank), Rasha al-Hoshan (Kingdom Holding Company), Maha Fitaihi (Fitaihi Holding Group), and Najla abu-Nayyan (Ash-sharqiyah Development Company). Saudi Stock Exchange homepage, http://www.tadawul.com.sa/wps/portal!/ut/p/c1/04_SB8K8xLLM9MSSzPy8xBz9CP0os3g_A-ewIE8TIwP3gDBTA08Tn2Cj4AAvY_dQA_3g1Dz9gmxHRQCHg5RU/ (accessed on May 2, 2013).

⁸⁰ See generally Saudi Gazette, *Supermarket snub fatwa against women cashiers on November 7, 2010*, available at <http://www.saudigazette.com.sa/index.cfm?method=home.PrintContent&fa=regcon&action=Print&contentid=2010110786939&simplelayout=1> (accessed Feb. 21, 2014).

⁸¹ The suggested number of women holding positions on the boards of director should be increased gradually, taking into account the difficulty of finding well qualified women for board positions in Saudi Arabia. The encouragement of appointing well-qualified non-Saudi females at the beginning may facilitate societal acceptance of women's participation on boards of directors and may raise the aspiration of young Saudi females to assume such positions in the future.

move by itself may not have an immediate effect on the status of women's participation in Saudi companies, but rather will at least draw attention to this governance issue.

7.6 INDEPENDENCE OF THE BOARD

7.6.1 Separation of Leadership Posts

Best practice suggests that the Board chairman should not serve as a chief executive officer (CEO), as the OECD principles explain:

Separation of the two posts [chief executive and board chairman] may be regarded as good practice, as it can help to achieve an appropriate balance of power, increase accountability and improve the board's capacity for decision making independent of management.⁸²

The French governance system pursues a different approach, which requires companies with single-tiered board structures to choose between two “formulas” of board governance, separating the function of the CEO from that of the board chairman or combining both functions in the hands of the chairman.⁸³

Under the Saudi governance system, the CL permits the board chairman to combine the position of managing director (board member) with his position or to elect other board members to serve in such a position (managing directors).⁸⁴ The SCGRs, however, reject this practice,

⁸² See OECD Principles, at 63–64.

⁸³ FCC article § (L225-51-1) and AFEB-MEDEF, Corporate Governance Code of Listed Corporations, principle 3.1. (2013). French governance system “does not favor either formula and allows the board of directors to choose between the two forms.” *Id.*

⁸⁴ The bylaws should articulate the powers of the board chairman and the managing director and in absence of such articulation the board has the power do so. C.L. article § (79). Historically, the vague language of CL with

suggesting that the chairman of the board should not perform any managerial role or “conjoin” the board chairman and managing director positions or any other executive posts.⁸⁵ This suggestion contradicts the management structure delineated by the CL, which assumes that day-to-day management should be vested in the managing director (either as a separate person or in combination with the chairman). The elimination of the managing director’s position from the CL may eradicate this policy contradiction in the Saudi corporate governance system with regard to this issue (the separation of the chairmanship from executive positions).

7.6.2 Independent Directors

It is anticipated that the participation of independent directors in the decision-making process will raise the governance standards of the company.⁸⁶ The lack of personal interests on the part of such directors increases the expectation that they will serve the company’s best interests.⁸⁷ The inclusion of independent members on the board raises the confidence of the stakeholders concerning the company’s governance.⁸⁸ Professor Jeffery Gordon believes that

regard to the appointment of managing directors in joint stock companies has caused some troubles for lawyers and joint stock promoters because the language of article (76) of the CL law was not clear about whether the appointment of the managing director for the company was mandatory or optional. *See* AL-JABOR, *supra* note 48, at 327–28 n.2; *See* Fahad Mohammad Almajid, *A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective* (Ph.D.) 257-258 (2008) (unpublished dissertation University of Manchester).

⁸⁵ SCGRs Article § (12) paragraph (d). The chairman and managing directors are regarded as agents of the board and exert their delegated power under the supervision and responsibility of the board as principals. *See* YOUNES, *supra* note 3, at 276. The managing director position should not be confused with the executive manager of the company, as the former is a member of the board of directors, an organ of the company, while the other is an employee of the company, governed by labor law. *See* AKTHAM AMEIN AL-KHOULI, *DOUROUS FI AL-QANOUN AL-TIJARI AL-SAUDI* 235 (1973).

⁸⁶ *See* OECD Principles, at 64.

⁸⁷ *See id.* at 64–65.

⁸⁸ *See id.* at 65.

Independent directors solve three different problems: First, they enhance the fidelity of managers to shareholder objectives ... Second, they enhance the reliability of the firm's public disclosure ... Third, and more controversially, they provide a mechanism that binds the responsiveness of firms to stock market signals.⁸⁹

The number of non-executive directors determines the ability of the board to exert “objective and independent judgment on corporate affairs.”⁹⁰ The proportion of independent directors represented on the board depends on the degree of control in the company. The boards of non-controlled companies should contain at least 50% independent directors, while controlled companies should allot one third of their seats to independent directors.⁹¹ The New York Stock Exchange (NYSE) applies these same standards for the appointment of independent directors.⁹²

In contrast, the Saudi system provides that Independent directors need only comprise one-third of the board of directors.⁹³ However, “the majority of the members of the board of directors shall be non-executive members.”⁹⁴ The concentration of ownership in most Saudi listed companies justifies this deviation from the best practice rule of maintaining a majority of

⁸⁹ Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 No. 6 STANFORD L. REV. 1465–1568 (Apr. 2007) (cited page is 1469).

⁹⁰ OECD Principles (VI)E.

⁹¹ AFEB-MEDEF, Corporate Governance Code of Listed Corporations, Principle 9.3 (2013).

⁹² Both NYSE listing rules and French corporate governance have exempted companies with a 50% level of ownership concentration.

⁹³ SCGRs Article § (12) paragraph (e). The SCGRs does not provide an exclusive definition for the independent director; however, it does provide examples of several violations that infringe the expected independent standards. The board member is not considered independent, for instance, if the member possesses a shareholding of five percent of the company's outstanding shares. Previous senior executives of the company or of one of its group companies are considered not independent directors unless that relationship ended two years before serving as an independent director in the board. Likewise, if the member is an employee of a party who has an affiliation with the company, “such as external auditors or main suppliers,” he will not be deemed an independent. Also, an independent director cannot have a close family member occupying an executive position in the company. The violation of independence is not, in fact, limited to those examples, as article (2) of the SCGRs is also applicable to any scenario that may violate the “complete independence” of the board member. *See* SCGRs Article § (2).

⁹⁴ SCGRs Article § (12) paragraph (c). “Non-executive director” under Saudi corporate governance system refers to any “member of the board of directors who does not have a full-time management position at the company, or who does not receive a monthly or yearly salary.” SCGRs Article § (2).

independent directors.⁹⁵ Data collected recently by the CMA indicates that the majority of the listed companies' boards consist of non-executive and independent members (see Figure 2).

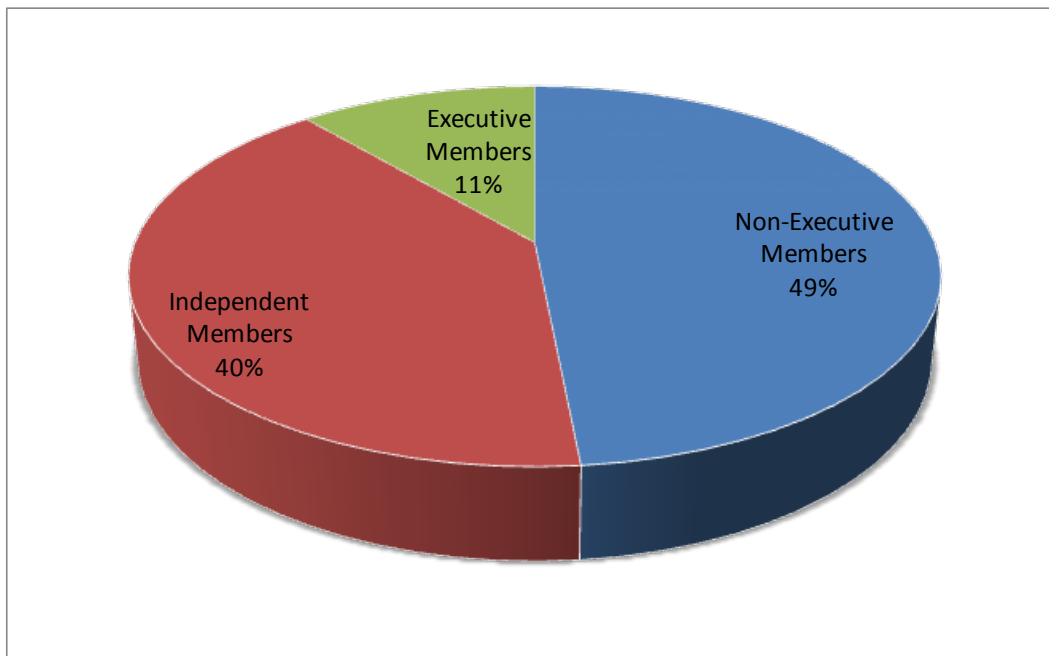


Figure 2. The Composition of the Saudi-Listed Companies' Boards of Directors in 2011

Source: the Saudi Capital Market Authority (CMA), the Annual Statistical Report on Corporate Governance of the listed companies (2011/2012) [on file with the author]

Furthermore, the inclusion of independent directors from the private sector on the boards of SOEs may increase the independence of the board from political interference.⁹⁶ Moreover, members from the private sector “will help in making boards [of SOEs] more business oriented.”⁹⁷ Accordingly, the appointment of independent directors conveys an extra value on the Saudi corporate governance system, given that it is dominated by government ownership.

⁹⁵ Both NYSE listing rules and French corporate governance have exempted companies with a 50% level of ownership concentration.

⁹⁶ OECD Guidelines, page 49.

⁹⁷ *Id.*

On the other hand, the inclusion of independent directors from the private sector on the boards of SOEs may increase the independence of the board from political interference.⁹⁸ Moreover, members from the private sector “will help in making boards [of SOEs] more business oriented.”⁹⁹ Accordingly, the appointment of independent directors conveys an extra value on the Saudi corporate governance system, given that it is dominated by government ownership.

7.6.3 Independence and Board Committees

The OECD suggests that a board of directors should face the issue of conflicts of interest by establishing specialized committees consisting of a majority, if not totality, of independent directors to deal with matters in which the ability of individual executive members to make independent judgments might be impaired by their personal interests.¹⁰⁰ Otherwise, for instance, executive members on specialized committees such as the remuneration committee may “serve each other’s” interests.¹⁰¹ Needless to say, an accurate delineation of the functions, formation, and standards of operation for each of the board’s committees is crucial for the good performance and accountability of the committees.¹⁰² The French system, for instance, suggests

⁹⁸ OECD Guidelines, page 49.

⁹⁹ *Id.*

¹⁰⁰ *See* OECD Principles, at 65.

¹⁰¹ *See id.*

¹⁰² OECD Principles (VI)E(2). A precise definition of the specialized board committees’ functions and responsibilities would facilitate the assessment of their performance. *Id.* at 65.

that auditing, nomination, and remuneration committees need to be filled so that independent directors are in the majority.¹⁰³

The Saudi governance has proposed that each board committee should contain a sufficient number of non-executive board members if that committee’s mandates are connected to the supervision of “conflicts of interests” in general, or have the tasks such as the “ensuring of the financial and non-financial reports, reviewing the deals concluded by the related parties, nomination to membership of the board, appointment of the executive directors, and determination of remuneration.”¹⁰⁴



Figure 3. The Composition of the Nomination and Remuneration Committee in Saudi Listed Companies (2011)

Source: the Saudi Capital Market Authority (CMA), the Annual Statistical Report on Corporate Governance of the listed companies (2011/2012) [on file with the author]

¹⁰³ See AFEB-MEDEF, Corporate Governance Code of Listed Corporations, Principle 16.1 & 17.1 & 18.1 (2013).

¹⁰⁴ SCGRs article (13) paragraph (c).

Executive board members are excluded from joining the audit committee.¹⁰⁵ In accordance with influence from the U.S. Sarbanes-Oxley Act, the Saudi system requires that one of the non-executive committee members have financial and accounting expertise.¹⁰⁶

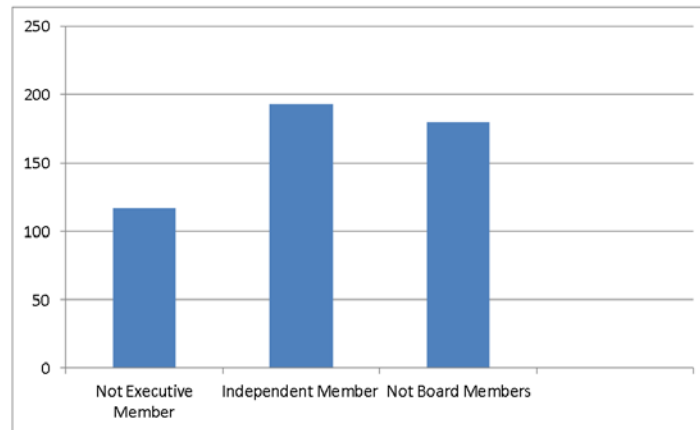


Figure 4. The Composition of the Audit Committee in Saudi Listed Companies (2011)

Source: The Saudi Capital Market Authority (CMA), the Annual Statistical Report on Corporate Governance of the listed companies (2011/2012) [on file with the author]

7.7 THE BOARD MEMBERS' DUTIES AND LIABILITY

7.7.1 The Duty of Care

The CL did not set a statutory standard for the director's behavior when directing the company. The statutes of nearly all other Arab countries companies also fail to address this issue. The literature of company law indicates that most Arab counties apply the standard of care laid down

¹⁰⁵ SCGRs article (14) paragraph (a).

¹⁰⁶ *Id* and Sarbanes-Oxley Act of 2002 § (407)(a).

in the agency contract (agency is a contract in the civil law tradition).¹⁰⁷ Accordingly, the board member, as an agent of the company, is obliged to perform his duties in conformity with the civil code standard of care, which is normally the ordinary person standard.¹⁰⁸

However, Saudi Arabia does not have a civil code. Accordingly, this matter is governed by the general theory of agency contract as delineated in Islamic jurisprudence. The restatement of the *Hanbali* jurisprudence, *Majallah al-Ahkam al-Shyariyah*, indicates that the agent, volunteer or paid, is a trustee, not liable for the loss or damages that happens to the deposited assets under his control unless the loss or damages were a results from his fault or negligence.¹⁰⁹

The SCGRs attempt to cover this loophole in the Saudi statutory framework by laying down several provisions requiring standards of performance from board members. Board members should discharge their duties in a “good faith, responsible manner and with diligence.”¹¹⁰ The decisions of the members of the board of directors should be grounded in adequate “information.”¹¹¹ Accordingly, board members should not rely on the information provided to them by the management alone; they should seek information “from any other

¹⁰⁷ For instance, The Egyptian Civil Code states: [a]n agency is a contract by virtue of which the agent shall carry out a legal work for account of the principal.” The Egyptian Civil Code Article § (699). *See also* Article § (903) of the Moroccan Civil Code and Article § (833) of the Jordanian Civil Code.

¹⁰⁸ AL-JABOR, *supra* note 48, at 339.

¹⁰⁹ *See Majallah al-Ahkam al-Shyariyah* article § (1265). In the same meaning, see *Majallah al-Ahkam al-Adliyah (the restatement of the al-Madhab al-Hanafie which was a civil law of the Ottoman Empire) article (1463) which states that:*

Property received ... by a person, who is [agent] to sell or buy, or to pay or receive a debt, or to receive and existing specific thing is like a thing deposited for safe keeping. If it is destroyed without fault and there is no neglect, no compensation is necessary.

THE MEJELLE: BEING AN ENGLISH TRANSLATION OF MAJALLAH EL-AHKAM-I-ADLIYA AND A COMPLETE CODE OF ISLAMIC CIVIL LAW (C.R. Tyser et al. trans., 2001).

¹¹⁰ SCGRs article § (11) paragraph (c).

¹¹¹ *See id.*

reliable source.”¹¹² Clearly, the standard of care proposed by the SCGRs is higher than the standard of care implemented by the civil codes of Arab countries.¹¹³ However, this is still not a binding standard of care, and case law is not available which would allow scholars to discern the trajectory of Saudi courts in this matter. The best hope is that the courts would adopt the SCGRs’ standard of care; if that is not possible, then no less than the ordinary person standard of care should be upheld by the judiciary.

7.7.2 Duty of Loyalty

The duty of loyalty obliges board members to devote their actions to “the best interest of the company and the shareholders,”¹¹⁴ putting the interests of the company ahead of their own interests.¹¹⁵ Each board member must represent all shareholders, not just those shareholders who

¹¹² *Id.*

¹¹³ The ordinary person standard of care is the standard adopted by most Arab countries laws. The Egyptian Civil Code provides that “if the Agency is in return for remuneration, the agent shall always exert in executing its duties the ordinary person’s care.” Article § (704) paragraph (2) in the Egyptian Civil Code. See also Article § (840) of the Jordanian Civil Code; Article § (934) paragraph (2) in the Iraqi Civil Code. However, It should be noted, this standard of care is required from the agent who receives compensation for his work not the voluntarily one. The volunteer agent is only required to perform his agency as if he performing his own work and this standard care required here shall not exceed the limits of the ordinary person standard even if the volunteer agent tends to perform his own work in the ordinary or higher standards of care. The Egyptian Civil Code states:

If an Agency granted, without remuneration being payable for it, the agent shall exert in performing its duties same care as he would do for his private work, without being required to exert for that more than an ordinary person’s care.

Article § (704) paragraph (2) in the Egyptian Civil Code. *See also* Article § (840) of the Jordanian Civil Code; Article § (934) paragraph (1) in the Iraqi Civil Code; Article § (929) of the Yamani Civil Code. To the contrary, the Moroccan Civil Code imposes a reasonable standard of care on the agent with disregard if the agent is paid or not paid for his job. *See* Article § (903) of the Moroccan Civil Code. Nonetheless, the standard shall be higher than the reasonable standard care if the agent is compensated for his work. *See* Article § (904) paragraph (1) of the Moroccan Civil Code.

¹¹⁴ OECD Principles, Principle (VI)A.

¹¹⁵ *See* Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. OF FINANCE 737, 742 (1997).

elected them to the board.¹¹⁶ However, in the real world, the case is different, whereby many board members may utilize their positions in the company to enrich themselves on account of the company.¹¹⁷ Such conflicts of interests between the board member's personal interests and the company's interests represent notable problems for modern corporate governance (the agency problem).¹¹⁸ The existence of conflicts of interests in any company may increase its agency costs, undermining the company's efficiency and the shareholders' value. In response to this key governance issue, the Saudi corporate governance system, like other such systems, prohibits board members from entering into any form of economic competition;¹¹⁹ receiving a loan from the company (or guaranteeing a loan to a board member);¹²⁰ or having a personal interest in contracts that the company has concluded with other parties.¹²¹

¹¹⁶ The equality principle among shareholders obliges board members to "carry out their duties in an even-handed manner with respect to all shareholders." OECD Principles, at 59. Otherwise, board members will be deemed agents for the controlling shareholders rather than for the company and all of its shareholders.

¹¹⁷ For agency cost problem see chapter IV.

¹¹⁸ See generally *id.*

¹¹⁹ C.L. Article § (70). The Ministry of Commerce and Industry provides several examples for this form of conflict of interests. For example, the board member has to refrain from forming any business enterprise that aims to conduct a business activity similar to the company's line of business. In addition, the board member will be regarded as competing with the company if he serves in any managerial position in another business enterprise trading in the same line of business as the company where he is a board member. See The Minister of Commerce and Industry Circular No. (222/205/3800) in 26 thul-Hijjah, 1422, corresponding to 10 March, 2002.

If the interested member would like to enter into an economic relationship covered under the noncompetition restriction, the member needs to notify the company about the competition situation and receive authorization from the shareholder meeting to pursue this business opportunity. C.L. Article § (70).

¹²⁰ C.L. Article § (71) and the SCGRs Article § (18) paragraph (c). Literal application of this restriction may deter group companies from furnishing loans or guaranteeing loans to their subsidiaries (and *vice versa*). A main objective of the holding company, normally, is to loan or guarantee the loans of its subsidiaries. Accordingly, such a legal restriction may cause a hardship to the corporate group enterprises.

¹²¹ C.L. Article § (69) and the SCGRs Article § (18) paragraph (a). However, the shareholders' general meeting may grant the interested member permission to contract with the company. *Id.* The board member is not allowed to sell or buy nor rent or lease the company assets. The board member may not represent the interest of any other business enterprise in front of the company in which he has board membership. The Minister of Commerce and Industry Circular No. (222/205/3800) in 26 thul-Hijjah, 1422, corresponding to 10 March, 2002.

The Ministry of Commerce and Industry expands the application of conflict of interest restrictions to include every contract the interested board member enters into with a company under his real name, or under another person's name,¹²² or for the benefit of persons with any special business relationship with the board member.¹²³

In any event, the issue of conflicts of interest in Saudi companies seems deeper than one might expect. In a country where many public officials own business enterprises disguised as joint venture companies (silent companies), or under other persons' names, and with a lack of public scrutiny over the official assets, especially in absence of an individual income tax, it is difficult to discern who is contracting with whom.¹²⁴ Accordingly, the real value of anti-conflict interest provisions in relation to Saudi companies is merely to keep these transactions on a low profile mode, avoiding public outrage.¹²⁵

¹²² The Minister of Commerce and Industry Circular No. (222/205/3800) in 26 thul-Hijjah, 1422, corresponding to 10 March, 2002.

¹²³ *Id.*

¹²⁴ See the press release issued by the Saudi National Anti-Corruption Commission in re the discovery of public servants grating public contracts to business enterprises owned by themselves under other persons' names, available at <http://www.nazaha.gov.sa/Media/News/Pages/news358.aspx> (accessed on Sept. 11, 2013).

¹²⁵ That does not negate the Saudi government's awareness of the positive impact of good corporate governance on the national economy. In 1999, King Fahd issued an order to the Ministry of Commerce and Industry to strengthen its supervision over joint stock companies' boards of directors and to make sure that the board members of these companies are composed of persons endowed with expertise, ability, and trustworthiness. The order has rested its holding upon the Council of Ministers' view on the importance of the protection of the joint stock companies and the need to keep these companies away from any financial problems that might cause bankruptcy. See The President of the Saudi Council of Ministers [Prime Minister] order No. 7/19772 in 22 thul-Hijjah, 1410 H, corresponding to 15 July 1991.

7.7.3 Liability of Directors

Any board member's violation of his duties may trigger criminal and civil liabilities at the same time.¹²⁶ Although the study of the criminal liability falls outside of the scope of this section of the paper, criminal liability arises normally when any board member intentionally commits fraudulent or deceptive acts, such as disclosing false information.¹²⁷ Whenever a civil liability arises, the board members will be held jointly liable for the board's directorial wrong behavior.¹²⁸ A civil liability action against the board members might be brought by the company, shareholders, or a third party, for example, creditors and liquidators.¹²⁹

From the perspective of corporate governance, an error in the administration of the company represents a key civil liability cause of action.¹³⁰ Any error in administration inherently involves the existence of three elements: wrongful behavior (action or inaction), damages, and causation between the first two elements.¹³¹ However, not every error in the administration of the company triggers a civil liability. Only errors that do not comply with the relevant standard of

¹²⁶ See MALISH, *supra* note 59, at 334.

¹²⁷ See AL-JABOR, *supra* note 48, at 339.

¹²⁸ The C.L. Article (76). Even if the wrongful action has been rendered by a majority vote, the whole board will still be held responsible for that behavior unless the minority members stood against the action and documented their dissension in the minutes of the board meeting. Board member absence from a board meeting does not excuse a member from liability, except if the absent member proves that he did not know about the attention of rendering the decision which caused harm to the company, or the member was not enabled to record his dissension to the actionable decision. *Id.*

¹²⁹ The release of the board of directors from their liability by the shareholders' annual meeting denotes a symbolic release from liability only, because the board members may be still be sued, unless three years lapse from the date of the discovery of the harmful acts committed by the board member. The C.L. Article § (76) and the Legal Memo of the Deputy of the Minister of Commerce and Industry for Technical (legal) Affairs No. 11/2566 in 11/5/1412 [on file with the author]. The legal process for suing the board members will be discussed in details in the next chapter.

¹³⁰ Aside from this cause of action is the civil liability, which arises when there is a breach of the C.L. provisions, or violation of the company's bylaws. The C.L. Article (76).

¹³¹ AL-JABOR, *supra* note 48, at 339.

care may inflict such liability. The board members have to perform their responsibilities in conformity with the expected standards of care.¹³² By doing so, the board members will shelter themselves from any liability, even if their actions cause damage to the company.¹³³ Accordingly, the existence of damage, by itself, does not offer sufficient grounds for the civil liability: wrongful behavior has to exist as well.¹³⁴

Narrowing the board member's liability for certain kinds of errors is a common practice implemented in most countries, a notable example of which is the business judgment rule in the U.S. legal system, which shields directors from liability for ordinary directorial faults.¹³⁵ The real difference among countries in this regard is the standard of care imposed on the board members. Under Arab corporate laws, the ordinary person standard of care is the dividing line between the actionable error and the non-actionable error.¹³⁶ By contrast, theoretically at least, U.S. company law applies a lower standard of care, which merely requires a decision to be made in good faith, based on sufficient information, and for the best interests of the company.¹³⁷ Satisfying these aforementioned criteria normally shields directors from being held liable for negative results of their decisions through a so-called business judgment rule, which refers to the courts' precedent of refusing to second guess decisions made by boards of directors.

¹³² *See id.*

¹³³ *See id.* at 340.

¹³⁴ *Id.* at 339–40.

¹³⁵ For the duty of care under the U.S. law, *see generally* ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 226–44 (2013).

¹³⁶ AL-JABOR, *supra* note 48, at 339, and TAHA, *supra* note 4, at 274.

¹³⁷ But Business judgment rule offers no protection for directors who do nothing.

Theoretically speaking, the lower standard of care system aims to encourage honest board members to take risks and increase the company's return.¹³⁸ Conversely, the higher standard is that of the ordinary person standard, under which board members are expected to be more risk averse. A comparative empirical investigation is required in this area to furnish better insights into Saudi policy makers and as to whether there is a need to formally adopt the ordinary person standards in the CL (as most Civil codes of Arab countries [and other Civil law tradition countries] have) or whether there is a need to shift towards a business judgment rule legal framework as in the U.S.

On the other hand, Saudi corporate governance does not impose a duty of care and loyalty on key executives, especially the CEO. This situation might exist because the company was supposed to be managed by a managing director. The Ministry of Commerce and Industry's interpretation of the CL has provided companies with some leeway in appointing a managing director.¹³⁹ Apart from banks, most Saudi companies do not have managing directors. Most managerial affairs are in the hands of the CEO and top executives, not the directors. The expansion of the duty of care and loyalty to key executives represents a necessary step in reducing agency costs in Saudi publicly traded companies and in improving Saudi corporate governance.

¹³⁸ See MODEL BUS. CORP. ACT § 8.30 (official Comments).

¹³⁹ See *supra* note 83.

7.8 THE DIRECTORS AND EXECUTIVES REMUNERATION

7.8.1 The “Pay Without Performance” Issue

7.8.1.1 Introduction

The excessive remuneration of directors and top executives represents a problem on the agendas of modern corporate governance systems, a problem which annoys shareholders and policy makers in both developed and developing economies.¹⁴⁰ Directors and top executives who serve under a flat rate (salary) remuneration scheme normally lack the motivation to further the company’s interests to the greatest extent possible.¹⁴¹ The performance of such remunerated directors and key executives normally expected to stop at a point which enables them to retain their jobs. The amount of remuneration paid to such directors and executives normally exceeds the value of the work they convey to the company, “a pay without performance” problem.¹⁴² The underperformance of such directors and executives increases agency costs in the company and diminishes value for shareholders.

Accordingly, best practices such as those enumerated in the OECD principles suggest the utilization of performance-based remuneration plans.¹⁴³ Performance-based remuneration tends

¹⁴⁰ See JEAN JACQUES DU PLESSIS, JAMES MCCNVILL & MIRCO BAGARIC, *PRINCIPLES OF CONTEMPORARY CORPORATE GOVERNANCE* 127–28 (Cambridge University Press, N.Y. 2005).

¹⁴¹ See LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 19 (2004).

¹⁴² Furthermore, such fixed remuneration schemes may decrease directors and executives desire to take risks out of concern for protecting their future fixed income. For outline of “Pay Without Performance” problem in modern corporate governance see Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issue* 117, in *PERSPECTIVES ON CORPORATE GOVERNANCE* (Scott Kief & Troy A. Paredes eds., 2010).

¹⁴³ For different types of performance-based plans, see generally ROBERT CHARLES CLARK, *CORPORATE LAW* 202–09 (1986).

to unite the interests of directors and executives with the company's interests,¹⁴⁴ promoting a "sense of solidarity and motivation with the company."¹⁴⁵ The French corporate governance code, for instance, indicates that the inclusion of stock options and performance shares in the remuneration scheme of directors and executives is more likely to raise "the executive directors' loyalty and promote the alignment of their interests with the corporate and shareholders' interests."¹⁴⁶

7.8.1.2 Remuneration in Saudi Companies

Saudi corporate governance suggests linking directors' and top executives' remuneration to their performance.¹⁴⁷ However, two issues are associated with the implementation of incentive-based remunerations in the country. First, the Ministry of Commerce and Industry has issued a resolution stating that each director shall not receive remunerations exceeding 200,000 SR (about \$50,000).¹⁴⁸ Such fixed ceiling may deter the designing of incentive-based remuneration plans for directors. No justification exists for keeping such a ceiling on remuneration which, moreover,

¹⁴⁴ OECD Principles, Principle (VI)d(4).

¹⁴⁵ AFEB-MEDEF, Corporate Governance Code of Listed Corporations, Principle 23.2. (2013).

¹⁴⁶ *Id.* To achieve its goals, granting stock options and performance shares to executives has to be conditioned on the achievement of specific operation objectives. Therefore, executive directors who fail to realize the intended targets should not be entitled to receive "termination payment upon departure." AFEB-MEDEF, Corporate Governance Code of Listed Corporations, Principles 23.2.4 and 23.2.5. (2013).

¹⁴⁷ Article 74 of the CL provides:

The company bylaws shall set forth the manner of remunerating the board members; such remuneration may take the form of a lump sum amount, attendance allowance, rights *in rem* of a certain percentage of the profits. Any two or more of these privileges may be conjoined.

¹⁴⁸ Article (1) on the Ministry of Commerce and Industry resolution No. 1071 in Thu al-Qadah 1412 H corresponding to May 5, 1992. Furthermore, the remuneration for attending the board meeting shall not exceed 3,000 SR (about \$800) Article (2) on the Ministry of Commerce and Industry resolution No. 1071 in Thu al-Qadah 1412 H corresponding to May 5, 1992.

contradicts provisions in the CL.¹⁴⁹ The CL permits the board of directors to receive up to 10% of the company's net profits after distributing dividends to shareholders equal to at least 5% of the company's capital.¹⁵⁰

Furthermore, the Saudi government has imposed a ceiling on the remuneration of government representatives on the boards of directors.¹⁵¹ This remuneration ceiling for government representatives is lower. In practice, most OECD countries remunerate their representatives to SOEs at a lower rate on average than other; non-SOEs remunerate their board members.¹⁵² The OECD suggests that governments must remunerate their representatives to the board adequately in a way that promotes the "long term interest of the company and can attract and motivate qualified professionals."¹⁵³ The remuneration of Saudi government representatives on boards of directors should be determined under the same process as that which determines the remuneration of other directors.

Secondly, the underdevelopment of the Saudi capital market has prevented companies from implementing non-cash incentive plans. Remuneration plans are limited to cash bonuses because the Saudi capital market does not permit stock options. Accordingly, incentive plans focus mainly on persuading executives to improve the company's financial results (not its market price).

¹⁴⁹ C.L. Article § (74).

¹⁵⁰ *Id.* This five percent distribution has to be from the net profits of that year, and not be fully or partially complemented from the retained profits.

¹⁵¹ Council of Ministers resolutions No. (202) in Shaban 13, 1404 H correspondent to (May. 15, 1984) and No. (344) in Thul-Qadah 16, 1428H correspondent to (Nov. 26, 2007).

¹⁵² OECD Guidelines, at 31.

¹⁵³ OECD Guidelines, ch. (II) F 5.

Recent data indicates that Saudi publicly held companies pay lucrative remunerations to top executive (see Table No. 1).

Table 18. Executive Remuneration in the Ten Largest Saudi Publicly Held Companies in 2012

No.	Company Name	Number of Top Executives	Remunerations Million SR	% of Profits
1	SAPIC	5	34	.13
2	AlRajahi	7	16.8	.21
3	STC	5	13.7	.18
4	Saudi Electricity	5	8.8	.34
5	SAFCO	5	7.4	.19
6	SAMBA	6	32.1	.73
7	Etihad Etisalat	5	71	1.17
8	Riyadh	5	20.3	.58
9	Kingdom	4	16.7	2.16
10	SABB	7	22.9	.70

Source: Saudi Stock Exchange (Tadawul), Annual Statistical Report (2011): Financial Indicators 56-63 and Argaam Report on Top Executives' Remunerations in Saudi listed companies in 2012 (2013).

The executive remuneration is determined through arm's length negotiation with the board of directors. Due to the existence of dominant shareholders in most Saudi companies, the board of directors is expected to be supervised to fulfill its obligation of representing the best interests of the company and shareholders.¹⁵⁴ In the U.S., shareholders are too weak (dispersed) to compel the board to protect their best interests, as the statutory design envisaged. This, at least theoretically, exacerbates the issue of executives' remuneration in dispersed ownership systems.

Similarly, directors appointed by the government, as dominant shareholder, may lack the economic motivation (agency problem) to protect the interests of the company and its shareholders, including the government, even though the government is their (the directors')

¹⁵⁴ See CORPORATE GOVERNANCE: A FRAMEWORK FOR IMPLEMENTATION VI, at 33 (Magdi R. Iskander & Nadereh Chamlou eds., World Bank Group 2000).

principal. At the same time, the government as major shareholder may not be able to supervise incumbent directors in comparison to major private shareholders.

In such companies, shirking and conflicts of interest may accompany the process of hiring and remunerating top executives, in ways such as favoring less qualified relatives or friends to assume high ranking positions, or receive huge remuneration. In other words, an agency problem similar to that of determining remuneration for executives in defused ownership systems may arise in concentrated ownership systems in which the government is the dominant shareholder.

Accordingly, special scrutiny over executive remuneration in companies with major government holdings is more urgent than in companies with a majority of private shareholders, such family and private institutional investors. For instance, comparing the remuneration packages of top executives in such companies (those with majority government holdings) to packages of executives in other companies (national and international), as an indicative benchmarking is recommended.¹⁵⁵ Furthermore, shareholders should minimally have the right to speak their minds concerning executives' remunerations, a concept referred to as "say on pay."¹⁵⁶

¹⁵⁵ French Corporate Governance suggests implementing a benchmarking procedure in determining all top executives. *See* AFEF-MEDEF, Corporate Governance Code of Listed Corporations, Principle 23.1. (2013) ("the compensation must be assessed within the context of a business sector and the benchmark European or global market."). *Id.*

¹⁵⁶ *See generally* LISA M. FAIRFAX, SHAREHOLDER DEMOCRACY 145–46 (2011).

7.8.2 “Say on Pay”

The OECD suggests that shareholders should have a say concerning the top executive remunerations (say on pay), at least in terms of issuing an “advisory vote.”¹⁵⁷ French corporate governance adopts this best practice standard and proposes that shareholders’ meeting should issue an advisory vote on remuneration packages.¹⁵⁸ For instance, the board of French companies should respect shareholders “negative” views and reconsider the remuneration scheme, informing the shareholders of the steps taken by the board to address the shareholders’ concerns.¹⁵⁹ Recently, the U.S. Dodd Frank Act (2010) has incorporated “say on pay” into the procedures for governing American companies.¹⁶⁰

Conversely, Saudi corporate governance does not observe any right of “say-on-pay” for shareholders; therefore, under current practices top executives’ remuneration is left exclusively to the board of directors. Accordingly, Saudi corporate governance should comply with best practices and permit shareholders to issue an advisory vote on the remuneration of top executives.

¹⁵⁷ See OECD Principles, Principle (II)c(3) and OECD Principles, at 34. However, OECD suggests that approval from shareholders is required for “equity-based [remuneration] schemes.” *Id.*

¹⁵⁸ AFEB-MEDEF, Corporate Governance Code of Listed Corporations, Principle 24.3. (2013).

¹⁵⁹ *Id.*

¹⁶⁰ Section (951) of Dodd-Frank Wall Street Reform and Consumer Protection Act (2010). For an extensive discussion of say on pay under the U.S. legal system, see, e.g., Randall S. Thomas, Alan R. Palmiter & James F. Cotter, *Dodd-Frank’s Say on Pay: Will it Lead to a Greater Role for Shareholders in Corporate Governance?*, 97 CORNELL L. REV. 1213 (2012).

7.9 CONCLUSION

This chapter has examined the legal structure governing boards of directors in Saudi publicly traded companies. The better governed the boards of directors is, the more efficient the national corporate governance system will be.

Comparative corporate governance has offered a number of insights to increase the governing efficiency of boards of directors in the Saudi publicly held companies. Accordingly, Saudi corporate governance should consider:

- Permitting two-tiered board structures and setting a legal foundation for the two-tiered board in the CL.
- Observing the *shura* value by promoting consensus over the board's decisions and allowing labors to participate in decision making process at least in an advisory form.
- Regulating the positions of top executives in the company.
- Imposing a mandatory ceiling on the size of boards of directors, at no more than 12 directors.
- Recognizing the importance of gender diversity in boards of directors and suggesting appointing at least one female on each board.
- Abolishing the position of managing director and imposing a restriction of conjoining the position of board chairman with that of CEO.
- Incorporating the ordinary person standard of care in the CL.
- Making express the applicability of the duties of care and loyalty to the CEO and other high executives.
- Eliminating the ceiling on directors' incentive-based remunerations.
- Providing shareholders with an advisory voting right over top executives remunerations (say on pay).

Implementing these reforms more likely will strengthen the mechanisms of internal corporate governance in Saudi Arabia and overall corporate governance in the country.

8.0 INTERNAL CORPORATE GOVERNANCE IN SAUDI ARABIAN PUBLICLY TRADED COMPANIES: SHAREHOLDERS RIGHTS, DUTIES AND PROTECTION OF MINORITY

8.1 INTRODUCTION

The inclusion of shareholders in the decision-making process of the company is justified by traditional (property) and modern (the residual claimant) theories.¹ Corporate governance in Arab countries, including Saudi Arabia, is heavily influenced by traditional theory. This theory dominates the views of legal scholars, especially with regard to the hierarchy of the organs of the company. This view upholds the supremacy of shareholders, which thus provides the shareholders with residual jurisdiction over all matters that are not precisely assigned to another organ of the company.²

The division of power between the board and the shareholders, as The OECD Principles indicate, is a crucial corporate governance tool, which generates a checks-and-balances decision-making system.³ Checks and balances enhance the decision-making quality in the company and

¹ For more information on the traditional and modern theories theory see chapter IV.

² See the Legal Memo of the Deputy of the Minister of Commerce and Industry for Technical (legal) Affairs No. 11/1141 in 11/5/1415 [on file with the author].

³ See OECD Principles, at 33.

promote control over the actions of the board of directors. Generally speaking, the style of distributing power in the Saudi corporate governance system is similar to that of the French “shareholders centered” system, rather than the U.S. “board centered” system.⁴

This chapter is devoted to the analysis of the position of shareholders under the Saudi corporate governance system, along with an evaluation of this position in light of comparative corporate governance, primarily in relation to the French and U.S. governance systems with reference to best practices as articulated by OECD corporate governance standards.⁵ One fundamental objective of this chapter is to open an avenue for discussion leading to reforms in Saudi corporate governance. To attain this objective, the chapter will examine a number of main topics: shareholders’ rights, collective power as exercised through shareholders’ meetings, shareholders’ duties, and the protection of minority shareholders.

8.2 WHO IS THE SHAREHOLDER?

Financing the corporation through issuance of equity rights is the basic way of forming a joint stock company. Equity financing is termed stock (shares) issuing.⁶ The outstanding shares

⁴ See Klaus J. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation*, 59 AM. J. COMP. L. 1, 47 (2001).

⁵ OECD standards refer here to the corporate governance principles expressed by the *OECD Principles of Corporate Governance 2004* (The *OECD Principles*) and the *OECD Guidelines on Corporate Governance of State-owned Enterprises 2005* (The *OECD Guidelines*).

⁶ A share could be issued in return for cash or in kind contribution. The issued shares may be nominal or bearer shares. CL. Article § (99). However, shares for bearer have never been issued in Saudi Arabia. Some countries such as the U.S. eliminate the issuance of bearer shares to prevent people from evading income taxes. See CL. Article § (99).

represent the company's registered capital.⁷ The person who owns the issued share is called a shareholder. The shareholder has property rights over the company assets, which remain after company liquidation and the settling of all company debts.⁸ Such a position makes a shareholder a "residual" claimant of company assets, as opposed to the debt finance supplier, the creditor, who has a fixed but superior return claim against the company.⁹

A joint stock company is authorized to issue several kinds of stocks:¹⁰ by tradition, the most notable kinds are the common and preferred stocks.¹¹ A common share, as a dominant form of issued stock, entitles its holder to fundamental ownership rights, such as a vote in the shareholders' general meeting and the receipt of dividends.¹² On the other hand, a preferred stock holder concedes his control (voting right) for preferential treatment in receiving dividends and priority over common shareholders upon company liquidation.¹³

⁷ The C.L. Articles § (48) which states that: "[t]he capital of a company shall be divided into negotiable shares of equal value."

⁸ The C.L. Articles § (222).

⁹ For more information about residual claimant *see* chapter IV.

¹⁰ Those kinds are the common, preferred, decreased, and enjoyment shares. However, upon information received from Ministry of Commerce and Finance, no company has ever issued shares other than common shares in Saudi company law history.

¹¹ *See* the C.L. Article § (103).

¹² The C.L. Article § (108)(1). Rights for the shareholder are stated as follows:

The right to obtain a share in the profits declared for distribution, the right to obtain an equity in the company's assets upon liquidation, the right to attend stockholders meetings and participate in the deliberations and vote on the resolutions (proposed) therein, the right to dispose of his shares, the right of access to the company's books and documents, and the right to control the acts of the board of directors, to institute the action in liability against the directors, and to contest the validity of the resolutions adopted at stockholders' meetings.

However, these listed rights are not ultimate because the last part of the aforementioned article provides for the ability to restrict them in the company bylaws.

¹³ *See* the C.L. Articles § (103) and (108)(2).

The CL prohibits the issuance of preferred stock for more than fifty percent of the company capital.¹⁴ The CL does not allow the issuance of multiple voting right shares.¹⁵ The shareholder's rights and obligations depend on the kind of the share the shareholder holds. Saudi listed companies have never issued preferred stocks although a number of listed companies have bylaws which permit such issuance.¹⁶

The avoidance of issuing preferred stocks might be connected to the negative view expressed by Islamic scholars toward these kinds of shares. Many Islamic scholars opine that preferred stocks, which provide a shareholder with preferential economic rights, are not compatible with Islamic principles¹⁷ because the fixed return guaranteed to preferred stockholders and the priority-upon-liquidation feature constitute unfair preferential treatment for this group of shareholders over other shareholders.¹⁸ Accordingly, most of this chapter is dedicated to the legal framework connected to the holders of common stocks.¹⁹

¹⁴ The C.L. Articles § (103) and (108)(2).

¹⁵ The C.L. Articles § (103).

¹⁶ *See, e.g.* The Industrialization Company Bylaws article § (5.4).

¹⁷ *See, e.g.*, SALEH ZABIN AL-MARZOUQI, SHARIKAT AL-MOSAHAMAH FI AL-NIDAM AL-SAUD 358–61 (H 1406), and Islamic *fiqh* International Academy resolution No. 63 (1/7) in May 9–14, 1992 (Jeddah), *In re* Capital Markets. However, multi voting rights shares are not prohibited. *Id.*

¹⁸ *See* AL-MARZOUQI, *supra* note 17, at 359–61.

¹⁹ Unless otherwise indicated.

8.3 THE SHAREHOLDERS' RIGHTS

Almost all corporate governance systems including the Saudi system confer a number of property rights to shareholders; these rights are called shareholder's fundamental rights.²⁰ They are fundamental because the company cannot deprive the shareholder of these rights. Company law literature often draws a comparison between the joint stock company (JSC) and modern democratic states.²¹ According to this comparison, a shareholder is comparable to the citizens of that state in that he (the shareholder) has legally protected rights similar to the political and economic rights of the citizen. The scope of these fundamental rights which the shareholders enjoy depends on the scope of entitlement conferred upon them by the national corporate governance system. Shareholders in systems with strong shareholders' rights are better equipped to participate in the governance of the company and to reduce its agency costs.

8.3.1 Shareholder Political Rights

8.3.1.1 Right to attend the Shareholders' General Meeting (GM)

Generally speaking, every shareholder has the right to attend the shareholders' General Meetings (GMs).²² However, a key issue with the Saudi corporate governance system is that the company

²⁰ See the C.L. Article § (108).

²¹ See, e.g., MOHSIN SHAFIQ, AL-WASEET FI AL-QANOUN AL-TIJARI AL-MISRY, vol. 1., 622 (1955).

²² The C.L. Article § (108)(1) and SCGRs Article § (3).

has the power to restrict this right, allowing only shareholders who possess a specific amount of shares to attend such meetings.²³

Shareholder apathy is a common tendency in both defused and concentrated patterns of ownership.²⁴ The Saudi Corporate Governance principles recognize the shareholder apathy problem in listed companies, suggesting that the company take proper measures to encourage “the participation of the greatest number of the shareholders in the general meeting.”²⁵ Models of corporate governance in developed countries such as France and the U.S. promote the utilization of various forms of modern communication such as conference call to facilitate and increase the participation of shareholders in GMs.²⁶ The Saudi corporate governance, however, does not provide shareholders with such rights yet.²⁷ Saudi Arabia needs to consider the utilization of forms of distance communication in conducting GMs.

Furthermore, French law permits the creation of a shareholders’ association to represent the interests of shareholders, especially the minority shareholders.²⁸ For instance, a shareholder association has the right to call for a GM convocation, to add items to the meeting agenda, to vote in the general meetings, and to file direct and derivative legal suits. The shareholders’

²³ The C.L. Article § (83). If a shareholder owns twenty shares or more, the company has no authority to prevent that shareholder from attending the GM. The C.L. Article § (83). The shareholder who wants to attend the GM must communicate his desire to attend before the commencement of the meeting. The C.L. Article § (90). Furthermore, the shareholder has to arrive before the commencement of the GM, as no shareholder will be admitted to the GM after its commencement. See the Legal Memo of the Deputy of the Minister of Commerce and Industry for Technical (legal) Affairs No. 11/2722 in 28/12/1414 [on file with the author]. The shareholder has to adhere to the rules of conduct during the GM and not cause any disturbance. See the Legal Memo of the Ministry of Commerce and Industry No. 11/556 in 18/7/1400 [on file with the author] (the chairmen of the GM may expel any shareholder from the meeting if the shareholder deviates from the expected code of conduct).

²⁴ See chapter IV.

²⁵ SCGRs Article § (5)(e).

²⁶ French Commercial Code (FCC) article § (L 225-107) paragraph II.

²⁷ The new Saudi Company Law Draft permits the use of modern technology.

²⁸ French Commercial Code (FCC) article § (L 225-120).

association functions as a corporate governance tool that can increase the shareholders' involvement in the company's affairs. Accordingly, incorporation of such association into the Saudi corporate governance system may strengthen the participation of shareholders in the company and enhance the protection of shareholders' rights.

The legal framework governing the exercise of shareholder rights by proxy in Saudi listed companies' represents another impediment to the shareholders' right to participate in the company governance. This framework aims to curtail the voting power controlled by the proxy, under which no proxy is permitted to represent more than 5% of the company outstanding shares. Such political interference deters a development of a culture of proxy contests in the country and favor incumbent boards of directors.²⁹ Tender offers and hostile takeovers are prominent corporate governance tools in the U.S. and other corporate governance systems. Thus, the U.S. and other have implemented a more liberal approach to proxy solicitation, which aims to facilitate the removal of board members as a disciplinary tool for underperforming boards.

The U.S. proxy framework is more complex and elaborate, being governed for the most part by the rules of the Securities Exchange Commission (SEC), than is its Saudi counterpart.³⁰ This elaboration is primarily the result of the high number of proxy contests triggered in connection with hostile takeovers.³¹ Such an acquisition technique does not exist in Saudi Arabia due mainly to the pattern of ownership and political interference which restrict proxy solicitation to no more than 5% of the companies' shares.³² At any event, the rise in the market share of

²⁹ See Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. OF FINANCE 737, 757 (1997).

³⁰ See article § (14) of the Securities Exchange Act of 1934 and see article § (7.22) of the MBCA.

³¹ See STEPHEN M. BAINBRIDGE, *MERGERS AND ACQUISITIONS* 235–34 (2003).

³² For takeover, see generally Shleifer & Vishny, *supra* note 29, at 737, 756–57.

institutional investors may increase the occurrence of proxy contests and necessitate a radical reform in Saudi proxy regulation.³³

8.3.1.2 Right to Vote

Shareholders are the only stakeholders under Saudi corporate governance who have the right to vote in the GM.³⁴ Voting right resides on the top of the shareholders' political rights because voting provides the shareholder, theoretically, with the power to share in the governance of the company with the board of directors. In this context, the SCGRs provide:

Voting is deemed to be a fundamental right of a shareholder, which shall not, in any way, be denied. The company must avoid taking any action which might hamper the use of the voting right; a shareholder must be afforded all possible assistance as may facilitate the exercise of such right.³⁵

A key problem with the Saudi governance system is that a company may impose restrictions on the shareholder's voting powers.³⁶ SAFOLA Company's bylaws, for example, grant one vote for every ten shares.³⁷ Accordingly, the Saudi corporate governance system permits deviations from the best practice principle of one vote per share.³⁸ The World Bank has criticized the Saudi CL approach of providing the company with the right to impose a minimum ownership level for attending meeting and regards Article (83) of the CL "as a procedural

³³ Because such increase is normally coupled with increase of proxy contests. *See* Hopt, *supra* note 4, at 1, 48.

³⁴ The C.L. Article § (108)(1) and SCGRs Article § (3).

³⁵ SCGRs Article § (6)(a).

³⁶ See the C.L. Article § (107). The shares voting power is assigned to the bylaws. *Id.* However, the CL mandates that every shareholder attending the shareholders' GM is entitled to cast at least one vote.

³⁷ SAFOLA Joint Stock Company Bylaws Article § (34).

³⁸ *See id.*

obstacle that impedes entitled shareholders from participating and voting in [the shareholders' GM].”³⁹

Nonetheless, experience in Saudi listed companies indicates that they tend to implement the one vote per share principle.⁴⁰ Such practice is similar to U.S. corporate governance.⁴¹ Puig and al-Haddab advocate the formal inclusion of the one vote per share principle in the CL to increase the protection of minority shareholders:

The codification of this principle [one vote per share], which would establish the right to call for poll and, with it, a count of vote by shareholders, would facilitate the participation of minority shareholders in the company decisions.⁴²

On the contrary, the true benefits of formal integration of the “one vote per share” principle seem more connected to the protection of the majority shareholders from the minority shareholders. In systems such as the French system, which permit the issuance of multi-voting rights shares, the company might be controlled by a shareholder who has voting power that exceeds his equity rights in the company.⁴³ These “super stocks” are a problem that cannot occur in a Saudi listed company due to statutory ban on the issuance of multi-voting rights shares.⁴⁴ Recently, however, a number of modern Islamic scholars have called for permitting the issuance of multi voting rights stock in Saudi Arabia, in lieu of preferred stocks that would confer

³⁹ The World Bank, Report on the Observance of Standards and Codes (ROSC), Corporate Governance Country Assessment: Kingdom of Saudi Arabia, 19 (2009).

⁴⁰ Gonzal Villata Puig & Badar Al-Haddab, *The Protection of Minority Shareholders in the Gulf Cooperation Council*, 13 J. CORP. LAW STUD. 123, 136 (2013).

⁴¹ See Hopt, *supra* note 4.

⁴² Puig & Al-Haddab, *supra* note 40.

⁴³ See Lucian Arye Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of the Separation Control from Cash-Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP 295, 297 (Randall K. Morck ed.).

⁴⁴ See the C.L. Article § (103).

financial advantages of a type which are prohibited in Islam.⁴⁵ Adoption of such proposal will undermine shareholders voting right and decrease the efficiency of Saudi corporate governance system.

8.3.1.3 Right to Have Access to Company Information

Like the French and the U.S. systems, the Saudi corporate governance system grants the shareholder the right to have access to the company's information.⁴⁶ The SCGRs encourage listed companies to offer the shareholders "[a]ll information which enables shareholders to properly exercise their rights."⁴⁷ According to this view, a shareholder's right of information is a passive right that requires the shareholder to wait for the information offered to him in accordance with the disclosure framework.⁴⁸ Thus, the quality of the disclosure framework has a strong connection to the degree of fulfillment of the shareholders' right to information. However, the disclosure of the company's information represents a single flip of the "right to information" coin.

The wording of the CL suggests that the shareholder has another positive right connected to the right to information.⁴⁹ This positive right would entitle every shareholder to examine the documents and books of the company, especially the ones that are not covered by "affirmative disclosures." The CL does not provide a method or scope for the implementation of shareholder access to the company's documents and books, in contrast to the U.S. system, in which this

⁴⁵ See Mubark bin Sulaiman Alfowaz, *alawsaq almaliyah min mandur islami*, 18 (2010).

⁴⁶ The C.L. Article § (108)(1).

⁴⁷ SCGRs Article § (4)(b).

⁴⁸ For disclosure under Saudi system see Chapter VI.

⁴⁹ The C.L. Article § (108)(1).

access would be achieved by filing a lawsuit.⁵⁰ Providing shareholders with a statutory right to access the company's documents and books would fill any such loophole in the CL's disclosure framework, strengthening the shareholders' right to supervise the company's performance.⁵¹

Up to this point, the Saudi corporate governance system has disregarded the right of shareholders to have access to the list of shareholders. The lack of such a provision may undermine the ability of shareholders to communicate with each other and to form blocks that can form a united position at the shareholders meeting. In contrast, the U.S. and French legal systems, as well as the OECD principles, recognize the importance of and provide a process for granting shareholders the right to access the shareholders list.⁵² This difference in provision for the right to access shareholder lists may be due to the absence of the practice of tender offers in the Saudi system.

8.3.1.4 Right to Sue

The shareholder's right to seek judicial redress is a fundamental right secured for every shareholder.⁵³ The shareholder's entitlement to sue the company aims to allow the shareholder to protect his rights and interests from any prejudice inflicted upon him by the company. The company has no authority to eliminate or restrict this fundamental right, and any action in this

⁵⁰ See MBCA Article § (16.04)

⁵¹ However, this right may have a negative effect on the company, especially if it is utilized to harm the company's interests by "bad intent" parties. For instance, the company's competitors may use this right as an excuse to access undisclosed information of the company. Therefore, the approval of the shareholder request to access the company documents and books should be implemented guardedly, permitted only under special circumstances.

⁵² See MBCA Article § (7.20) French Commercial Code (FCC) article § (L 225-116) and the OECD Principles, Principle (II)G. Shareholders in Saudi companies, also, do not have the power to send their proxy by mail. See Fahad Mohammad Almajid, A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective (Ph.D.) 232 (2008) (unpublished dissertation University of Manchester).

⁵³ The C.L. Article § (108)(1) and SCGRs Article § (3).

regard will be considered null.⁵⁴ The law entitles the shareholder to sue the company to protect his personal interests and to sue on behalf of the company to protect the company's interests (the derivative suit).

i. Direct Suits

The OECD Principles suggest that a corporate governance system has to offer a reliable and effective mechanism for redressing any injuries inflicted on shareholders.⁵⁵ The direct suit is one of these mechanisms, aimed at enabling shareholders to protect their rights. This suit is filed by the shareholder against the board of directors to redress any damages caused to him (the shareholder) personally.⁵⁶ Unlike French law, Saudi law does not provide shareholders with the statutory right to pursue direct suit.⁵⁷

In any event, the direct suit represents a pivotal tool for the shareholders to guard their fundamental rights in the company. The refusal to allow the shareholder to attend the shareholders' GM, or to have access to the company's information, provide examples of causes of action for a direct suit. Filing a direct suit is not conditioned on any permission from the company. If the company's action has harmed a group of shareholders, for example by denying them any of the rights associated with holding shares in the company, these shareholders may collectively sue the company. A possible deficiency is that the Saudi legal system does not

⁵⁴ The C.L. Article § (85).

⁵⁵ See OECD Principles, at 40.

⁵⁶ See MOHAMMAD HASAN AL-JABOR, SAUDI COMMERCIAL LAW 342 (4th ed. 1996) [in Arabic]. Corporate law scholars in the Middle East argue that the plaintiff does not have to be a shareholder at the time of filing the direct suit as long as the plaintiff was a shareholder when the prejudice occurred. See THARWAT ABDELRAHEIM, AL-GANOUN AL-TJARI ALMASRI 443–44 (1982).

⁵⁷ See French Commercial Code (FCC) article § (L 225-252).

recognize a class action suit. Accordingly, in Saudi Arabia, filing a direct suit by large scale group of shareholders may face procedural obstacles.

In fact, without the existence of an effective class action avenue for redress, given the low return expected from this endeavor, a shareholder who has been discriminated against is not expected to pursue any judicial redress. A class action in a developed legal system, such as in the U.S, relies on the risk-taking lawyers who normally earn out-sized legal fees out of such cases by charging a small percentage of the compensation granted to every shareholder.⁵⁸

ii. Derivative Suits

Aside from the direct suit, the shareholder has a statutory right to file a derivative suit on behalf of the company against the board of directors.⁵⁹ The cause of action in a derivative suit differs from that of a direct suit whereby, in the derivative suit, the shareholder sues to protect the interest of the company and the interests of all shareholders from the board's wrongful actions, while in the direct suit the shareholder seeks a judicial remedy for his personal injuries.⁶⁰ The distinction between the cause of action of the direct suit and that of the derivative suit is not always crystal clear.

The derivative suit represents an extraordinary course of action because, under the normal circumstances, the company – and not the shareholder or anyone else – is responsible to protect its (the company's) own interests by suing its own directors for violation of the duties they owe the company. However, since the board of directors, as the legal representative of the

⁵⁸ JOSEPH SHADE, BUSINESS ASSOCIATIONS 208 (2006).

⁵⁹ The C.L. Article § (108)(1) and SCGRs Article § (3).

⁶⁰ For the distinction between the direct and derivative suits, see MUSTAFA KAMAL TAHA, AL-SHARIKAT AL-TIJARIYAH 278–79 (1997).

company, may not have the desire to bring a suit against itself or one of its members, shareholders are granted this right to fill this void and assist the company in defending its interests.⁶¹ A prominent example of a derivative suit cause of action is the case in which the board of directors fails in administering the company, an action which normally triggers civil liability on the part of the board members.

The shareholder is obligated to notify the company about his intention to file a derivative suit.⁶² However, the company does not have the right to permit or deter the shareholder from filing a derivative suit.⁶³ The suing shareholder has to prove that the board's action caused damages to his personal interests. It is not enough to prove general harm caused to the company.

The limitations imposed on the derivative suit are stated clearly in the CL:

Every shareholder shall have the right to institute the action in liability against directors on behalf of the company if the wrongful act committed by them is of a nature to cause him personal prejudice. However, the shareholder may institute such action only if the company's right to institute it is still valid and after notifying the company of his intention to do so. If a shareholder institutes such action, he shall be adjudged (compensation) only to the extent of the prejudice caused to him.⁶⁴

Permitting the shareholder to file a derivative suit without the approval of the company or offering the company, an opportunity to decide whether to take action or not against the board of directors, is in contradiction to the nature of a derivative suit. The company is the principal in this case, not the shareholder, as the shareholder is merely suing on the company's behalf. The

⁶¹ See AL-JABOR, *supra* note 56.

⁶² The C.L. Article § (78).

⁶³ AKTHAM AMEIN AL-KHOULI, *DOUROUS FI AL-QANOUN AL-TIJARI AL-SAUDI* 244 (1973).

⁶⁴ The C.L. Article § (78).

CL's lenient requirements for derivative suits are consistent with the French legal approach.⁶⁵ In contrast, U.S. law does not permit shareholders to file a derivative suit before requesting formally (the demand principle) that the company protects its interests.⁶⁶ Only if the company fails to do so, may the shareholder file a suit on its behalf.⁶⁷

French law permits shareholders to sue for the entire amount of damages inflicted on the company,⁶⁸ whereas Saudi law only permits suing for personal damages inflicted on the shareholder filing the suit.⁶⁹ Limiting compensation granted in a derivative suit to personal damages represents another nonsense restriction, especially considering the fact that any compensation goes to the company, not the shareholder.

8.3.2 Economic Rights

The Saudi corporate governance provides shareholders with a number of economic rights. Remarkably, shareholders have the right transfer shares,⁷⁰ obtain dividendness,⁷¹ and receive part

⁶⁵ The French Commercial Code (FCC) article § (L 225-253). *See also* James A. Fanto, *The Role of Corporate Law in French Corporate Governance*, 13 J. CORNELL INT'L L.J. 31, 82 (1998). Nonetheless, a cost-benefit analysis by any small shareholder would lead that shareholder to shy away from pursuing a suit against the company. *See* Fahad Mohammad Almajid, *A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective* (Ph.D.) 242 (2008) (unpublished dissertation University of Manchester).

⁶⁶ *See* Model Business Corporation Act (MBCA) Article § (7.42).

⁶⁷ *See id.*

⁶⁸ The French Commercial Code (FCC) article § (L 225-252).

⁶⁹ The C.L. Article § (78).

⁷⁰ Shareholders normally purchase stocks to resell for profit. The right to transfer ownership is a fundamental right that is guaranteed by the CL for every shareholder. *See* the C.L. Article § (108)(1) and SCGRs Article § (3). However, the right to transfer shares is not an absolute right. Statutory and contractual restrictions may deter the transferability of public (listed) joint stock companies' shares. There are statutory and contractual restrictions on the transferability of shares. The statutory restrictions on share transferability aim to protect lay people from investing in economically unviable enterprises. The founding shareholders have to prove that they are

of the assets that remain after liquidation.⁷² Generally speaking, the shareholders' economic rights under Saudi corporate governance system are similar to the rights granted under most governance systems and conform to the OECD Principles.

However, a number of issues are associated with the approach adopted by the Saudi system to implementing such rights. For one thing, the Saudi corporate governance is not aligned with the Islamic disapproval of preferred stocks, which provide the shareholder with the right to obtain a pre-determined amount of dividend or to have a priority over other shareholders in receiving company assets in the event of liquidation.⁷³ Accordingly, such statutory rights, more than likely, will be disregarded by courts.⁷⁴

The Saudi corporate governance does not oblige the company to distribute dividends; however, if the company decides to distribute any dividends, the distribution has to be not less

inviting investors to participate in a real project, not just a fraudulent scheme that intends just to collect assets from unsophisticated investors. For statutory restrictions see Article § (100) of the C.L. and LRs Article § (49)(a).

Bylaws, on the other hand, may impose some restrictions on the transferability of shares, a practice called "contractual restrictions." *See* C.L. Article § (101). However, contractual restrictions on share transferability represent an exceptional matter in listed companies because such restriction contradicts with the idea of listing, which aims to offer investors a liquid market of stocks.

In this context, the LRs have stipulated for admission to the Saudi Stock Exchange (Tadawul):

The securities must be freely transferable and tradable. Any restriction on transferability must be approved by the [CMA] and all investors must be provided with appropriate information to enable dealing in such securities to take place on an open and fair basis.

LRs Article § (12)(b).

⁷¹ The C.L. Article § (108)(1) and Article § (127) and SCGRs Article § (3). The shareholder right of receiving dividends emerges after the shareholders' GM approves the proposed distributions. The C.L. Article § (127). The shareholders' GM role in this process is merely to approve or reject the payout proposal: the GM has no legal power to modify the board's proposal.

⁷² The C.L. Article § (108).

⁷³ The C.L. Article § (108)(2)b.

⁷⁴ For the importance of compatibility with Islamic rules under Saudi legal system *see* chapters II, V and VI.

than five percent of the company's capital.⁷⁵ This mandatory distribution percentage represents an investor protection tool. However, such an action may hinder the company's plans to expand by reinvesting profits in new projects. The "five percentage distribution or nothing" policy may prevent many companies from distributing dividends at all. Additionally, the distribution of five percent of capital is high enough to discourage companies from raising their capital to avoid a rise in the required distribution threshold in the future.

Accordingly, a shift from this "one size fits all approach" towards a more flexible approach of dividend distribution is recommended. The Saudi corporate governance may rectify this matter by instituting one of the following options: abolishing the mandatory distribution percentage entirely; lowering the mandatory of distribution threshold; or linking the mandatory percentage to the net profit, not the capital. It is worth noting, however, that such practices do not find support in the corporate governance systems of developed countries, which for the most part, have left this matter for words of duties to handle, with providing judicial protection for aggravated shareholders on a case by case basis.

⁷⁵ Although this is the adopted practice under Saudi law, the language of CL implies a mandatory distribution of five percent of capital:

The company's bylaws shall specify the percentage to be distributed among stockholders out of the net profits, after deduction of the statutory and the contractual reserves, provided this percentage is not less than 5% of the capital.

The C.L. Article § (127).

If the company does not realize enough net profits in any financial year, it could cover the shortage to the five percent with retained profits and thus pay out dividends to the shareholders.

8.4 THE SHAREHOLDERS' DUTIES

The shareholder, as an element of the company's production team, has several duties. For instance, the shareholder has to pay the full price of shares,⁷⁶ major shareholders have to disclose their ownership in the company,⁷⁷ and all shareholders must respect restrictions on transferability.⁷⁸

A shareholder must refrain from using his rights in a manner that may cause unfair prejudice to his fellow shareholders.⁷⁹ Unfair prejudice is commonly inflicted by the majority shareholders on the minority shareholders, for example, by not paying dividends for several years while enjoying the merits of the company assets, such as board membership or contracting with the company. Islamic law is against all forms of unfair practice, whether inflicted by the majority or by the minority.⁸⁰ Although such a duty does not imply that shareholders have a fiduciary duty to one another, this non-statutory duty has a key implication for the Saudi corporate governance system, especially with regard to the protection of minority shareholders.

In any event, a shareholder in Saudi Arabia is expected to act in accordance with Islamic principles. Practices such as unfair prejudice, or provisions in the CL and other corporate governance documents that contradict Islamic principles will not excuse shareholders from their

⁷⁶ The C.L. Article § (110). The shareholder is required to pay at least twenty-five percent of the nominal value of the share and pay the rest upon demand from the company. The C.L. Article § (58).

⁷⁷ See chapter VI.

⁷⁸ See *supra* note (68).

⁷⁹ See KHALID AL-RWAIS & RIZG AL-RAYIS, *ALMADKAL LEDRAST ALAULUM ALQANONIAH* 341 (maktabit alshugri: 2002). Unfair prejudice occurs if the holder of the right exercises his right in a way that may cause harm to others, or if such exercise may inflict harm on others that exceeds the interests the holder of the right aims to achieve, and if this right is employed to realize illegitimate interests. See *generally id.* at 342–46.

⁸⁰ For the Islamic perspective on unfair prejudice, see generally FATHI AL-DURANI, *NADARIYAH ALTAASUF FI ISTIMAAL ALHAQ FI ALFIQH ALISLAMI* (4th ed. 1988).

obligation; moreover, any rights which stem from these conflicting provisions will not be recognized in Saudi courts of law. Any contradiction between statutes and *Shariah* (Islamic law) as the supreme law of the land, represents a major problem in the Saudi legal system and with the reliability of its corporate governance system. Finally, the government as a shareholder is expected to refrain from using its political power to interfere in company business.⁸¹

8.5 SHAREHOLDERS' POWER: THE ORDINARY SHAREHOLDERS' GM VS. THE EXTRAORDINARY SHAREHOLDERS' GM

The CL recognizes two types of shareholders' GMs, the ordinary shareholders' GM and the extraordinary shareholders' GM.⁸² Every company is obliged to hold at least one ordinary shareholder's GM every year (the annual ordinary shareholders' GM).⁸³ Other ordinary GMs (exceptional ordinary GMs) may be held on an *ad hoc* basis.⁸⁴ However, not every responsibility assigned to shareholders can be decided by the ordinary shareholder' GM (annual or exceptional). A number of key decisions have to be decided by a special kind of shareholders' meeting, the shareholders' extraordinary GM.

⁸¹ OECD Guidelines, Chapter (II)B and C.

⁸² There is a shareholders meeting that is convened only once in the company's life, during the incorporation period, and is called the "constituent shareholders' meeting." This meeting is responsible for supervising and approving the incorporation process, including the valuation of in-kind contributions, the appointment of the first board members, and the designation of the first external auditor. *See* the C.L. Article §§ (60–62).

⁸³ The C.L. Article § (84) and SCGRs Article § (5)(a).

⁸⁴ The other regular meetings might be called by the board, shareholders, external auditor, or administrative authority.

Nearly all civil law countries have a similar organization for shareholders' GMs.⁸⁵ Such an organizational framework follows subjective criteria in differentiating between the functions of ordinary and extraordinary shareholders GMs. Matters concerning the regular course of business are assigned to the ordinary shareholders' GM, whereas non-ordinary matters are assigned to the extraordinary shareholders GM. The U.S corporate governance system, by contrast, has adopted objective criteria, which designate an annual shareholder GM, which is held once a year, and special shareholders GMs that are convened on an *ad hoc* basis by request for the purpose of deciding on any matter that falls within the shareholders' scope of authority.⁸⁶ The main goal in creating two different schemes of shareholders' GMs is to increase the protection of shareholders. Accordingly, extraordinary shareholders' GMs have a different scope of power, as well as stricter convocation and resolution quorums. Requiring that key decisions comply with higher procedural requirements conforms with best practice in corporate governance, as for example the OECD Principles suggest.⁸⁷

8.5.1 Scope of Shareholders' Power

Ordinary shareholders' GMs (annual or exceptional) have a power of regular business matters. The ordinary shareholders' GM is responsible, for instance, for appointing and removing board members,⁸⁸ relieving board members of their liability for administrating the company at the end

⁸⁵ See, e.g., The French Commercial Code (FCC) Article § (L 225-38).

⁸⁶ See MBCA Articles §§ (7.01) and (7.02)

⁸⁷ See OECD Principles, at 40.

⁸⁸ The C.L. Article § (66).

of every financial year,⁸⁹ and approving conflicts of interests in transactions connected to members of the board of directors.⁹⁰ Recent data on shareholders' GMs demonstrate that requests for approval of transactions involving conflicts of interest by the board of directors have increased recently (see Figure No. 5). This increase may have come as a result of improving the framework of corporate governance in the country.

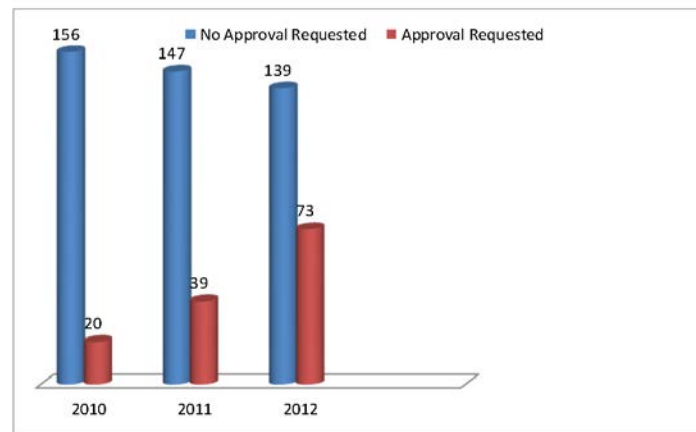


Figure 5. The Conflict of Interests Approval Requests to the Shareholders GM of the Saudi Listed

Sources: The Saudi Capital Market Authority (CMA), the Annual Statistical Report on Corporate Governance of the listed companies (2011/2012) [on file with the author]

On the other hand, the extraordinary shareholders' GM has exclusive authority to approve any alterations of the company's bylaws.⁹¹ Any increase or decrease in the company's

⁸⁹ The relive has to happen at the end of every financial year. The C.L. Article § (77).

⁹⁰ The C.L. Articles §§ (69, 70, 71).

⁹¹ *Id.* § (85). The power of the extraordinary meeting to modify the company's bylaws has several limitations. The extraordinary meeting is not permitted to insert any change to the company's bylaws that may lead to depriving a shareholder from any fundamental right, to change the nationality of the company, to move the company headquarters outside of Saudi Arabia, or enact modifications that may impose additional financial burden on the shareholder. In addition, the extraordinary GM is not permitted to change the company's objectives. *See id.* That does not mean the meeting cannot add objectives that are connected directly or indirectly to the company's original goals. If the company desires to change its objectives completely, it has to dissolve and start over again as a new enterprise. This strict restraint on alterations to the main objectives represents an outdated and impractical approach that hinders the perpetual survival of a Saudi company. Pursuing a more liberal approach in this regard will permit companies to adapt their businesses and pursue new objectives when such companies lose their competitive advantage in their original business objectives or find better, more lucrative business ventures to pursue.

capital requires approval from this meeting.⁹² The extraordinary GM is responsible for making decisions regarding dissolving or not dissolving the company, whenever the company loses three quarters or more of its capital.⁹³

A key issue in the Saudi corporate governance system is that no approval from shareholders is required before selling all or most of the company's assets. This represents a legal deficiency, which conflicts with the good governance standards, which are recommended in the OECD Principles.⁹⁴ The sale of assets is a tool commonly used to strip minority shareholders of their economic rights. Furthermore, such a loophole may increase the chance of an external entity acquiring the company without the shareholders approval, through a "triangular merger."⁹⁵ By contrast, the U.S. corporate governance system requires shareholders' approval for such an extraordinary action.⁹⁶ Saudi corporate governance needs to adopt such a provision in order to prevent the board of directors (typically, dominant shareholders) from transferring the company's assets to other pocket without the knowledge (stripping off assets) or assent (reverse merger) of shareholders.

Accordingly, a remarkable company like Nokia, which started in the wood business and later evolved into one of the most important telecommunication companies of the world, would not have succeeded if it had been incorporated under Saudi law. For the story of Nokia object adaption. *See* Nokia website, *available at* <http://www.nokia.com/global/about-nokia/about-us/the-nokia-story/> (accessed on July 10, 2013).

⁹² The C.L. Article § (134) and § (142).

⁹³ *Id.* § (148). If the meeting is in favor of keeping the company in existence, the meeting has to reduce the company's capital to the limit which reflects the company's actual financial standing. *See* the C.L. Article § (142).

⁹⁴ OECD Principles, Principle (II)B.

⁹⁵ *See* Fanto, *supra* note 65, at 31, 37.

⁹⁶ *See* MBCA § (12.02)(a).

8.5.2 B. Procedural Guarantees

The Saudi corporate governance system has established number of procedural guarantees, which surround the convocation of shareholder' GM, as well as the decision making process in the GMs. The main aim of these formalities is to ensure that decisions of the company represent of the will of majority of shareholders while protecting the interests of minority shareholders. The extent of procedural protection is linked to the nature of the decisions which the shareholders are expected to make. Accordingly, the Saudi corporate governance system implements higher procedural standards for extraordinary GMs in comparison to the standards required for the ordinary GM, due to the crucial function bestowed upon the extraordinary GM.

8.5.2.1 1. Convocation of Shareholders' GMs

The valid convention of an ordinary meeting requires the attendance of a group of shareholders who collectively control at least half of the company's capital.⁹⁷ If that threshold is not met, another invitation for a second meeting is required.⁹⁸ The second meeting will be valid no matter how many shareholders are in attendance.⁹⁹ Official records indicate that most ordinary GMs are successfully convened the first time (see Figure No. 6). Conversely, extraordinary GM requires the attendance of shareholders who own at least fifty percent of the company's capital.¹⁰⁰ Not

⁹⁷ The C.L. Article § (91).

⁹⁸ *Id.* The company cannot issue an invitation to two meetings in the same invitation. For instance, the invitation to the first ordinary GM notes that if the attendance of the first ordinary GM does not reach the prescribed quorum for convention, a second ordinary GM will be held at other specified date. See the legal memo of the Deputy of the Minister of Commerce and Industry for Technical (Legal) Affairs No. 11/2589 in 25/11/1411 [on file with the author].

⁹⁹ The C.L. Article § (91).

¹⁰⁰ *Id.* § (92).

satisfying this threshold requires an invitation for a second meeting, which will be valid only if shareholders owning at least a quarter of the company capital are present or represented in the meeting.¹⁰¹

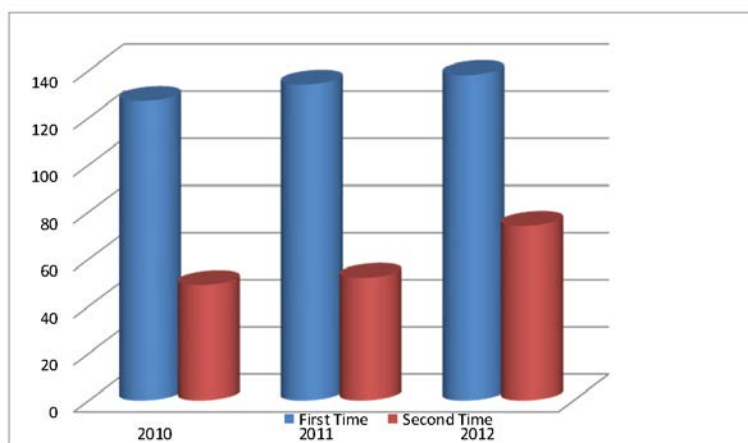


Figure 6. The Number of Ordinary GM Convened According to First and the Second Times Invitations

Source: the Saudi Capital Market Authority (CMA), the Annual Statistical Report on Corporate Governance of Listed Companies (2011/2012) [on file with the author]

8.5.2.2 2. Resolutions of Shareholders' GMs

The resolutions presented at the ordinary GM are adopted by a simple majority vote of the shares present or represented in the meeting,¹⁰² while at the extraordinary GM, resolutions require an affirmative vote of two thirds.¹⁰³ Furthermore, a three quarters affirmative vote is required if the resolution is related to changing the company's capital (increasing or decreasing it), extending the life of the company, dissolving the company before the time prescribed in the company

¹⁰¹ *Id.*

¹⁰² *Id.* § (91).

¹⁰³ *Id.* § (92).

bylaws, or merging the company with or into another company.¹⁰⁴ The OECD Principles encourage imposing such higher voting thresholds in various crucial matters as a tool to protect small investors from the power of the majority of the shareholders.¹⁰⁵

The question of shareholders voting on measures in which they have a particular interest raises an issue under the Saudi corporate governance system. On one hand, there is no rule preventing interested shareholders from voting at any of the shareholders' meetings.¹⁰⁶ In practice, however, the Ministry of Commerce and Industry has banned interested shareholders from voting on relevant resolutions.¹⁰⁷ In contrast, the French system merely prevents an interested major shareholder (owning 10% of the shares) from voting.¹⁰⁸ In another approach to the issue, U.S. law does not prevent interested shareholders from voting on resolutions at shareholders' meeting.¹⁰⁹

Deterring interested shareholder from voting seems a reasonable measure in a concentrated ownership system, such as the Saudi system, which also lack an effective judicial system to supervise such issues on a case by case basis. However, the current practice of preventing all interested shareholders from voting under any circumstance is without justification; shareholders are expected to vote in a manner that might further their personal

¹⁰⁴ *Id.*

¹⁰⁵ *See* OECD Principles, at 40.

¹⁰⁶ One exception of that is members of the board of directors are not permitted to vote on matters which could involve releasing them from liability. The C.L. Article § (93).

¹⁰⁷ For abstaining votes exclusion from voting quorum *see* the Legal Memo of the Ministry of Commerce and Industry No. 11/283 in 10/12/1405 [on file with the author].

¹⁰⁸ *See* The French Commercial Code (FCC) article § (L 225-38).

¹⁰⁹ *See* ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 278 (2013).

interests.¹¹⁰ Accordingly, limiting such restrictions to situations such as that of major shareholders as in the French system is more advisable.

8.6 MINORITY SHAREHOLDERS' PROTECTION

8.6.1 Introduction

The shareholders' role in publicly held companies mainly refers to the role of the majority shareholders.¹¹¹ The validity of the majority decision making model is not challenged here; it is deemed the best available governance model for large organizations such as listed companies, wherein the consensus decision making model could not effectively serve as an alternative governance model.¹¹²

However, the majority shareholders may use this model as an opportunity to neglect the interests of the minority shareholders,¹¹³ for example, in event of a tender offer, excluding the

¹¹⁰ See PINTO & BRANSON, *supra* note 109 (“[g]enerally a shareholder has no fiduciary duty when voting her shares because pursuing one’s economic self interest is the usual reason why one invests in shares”). *Id.*

¹¹¹ The rule of the majority is the commonly accepted decision making structure for joint stock companies. The shareholders who own more than fifty percent of company shares (in some cases two thirds or three quarters of the shares) have control of the decision making process in the shareholders’ GM.

¹¹² See ABDULFADEIL MOHAMMAD AHMED, HIYMAYIT AL-AGALEIH 13 (1987).

¹¹³ The C.L. law does not provide a definition of minority shareholders. However, the SCGRs defines minority shareholders as the “shareholders who represent a class of shareholders that does not control the company and hence they are unable to influence the company.” SCGRs Article § (1).

Similarly, the new Principles of Corporate Governance for Banks Operating in Saudi Arabia defined minority shareholders as the “shareholders who represent a segment of non-controlling investors of the bank and, therefore, they are not able to affect the bank’s policy and trends.” See the definition of “minority shareholders” in the Principles of Corporate Governance for Banks Operating in Saudi Arabia (2102).

minority from sharing in the company's financial gains. The exploitation of minority shareholders may take various forms that aim ultimately to absorb the company's resources, such as, contracting with the company for personal benefits, using the company assets for personal interests, or appointing relatives or friends to positions in the company).

The general rights of shareholders provide modest protection for minority shareholders. The best practices, such as laid out in the OECD Principles, suggest conferring a special protection on minority shareholders.¹¹⁴ Today, providing minority shareholders with special statutory protection is an encouraged practice in nearly all corporate governance systems. However, the nature and scope of such protection vary from one system to another. The protection of minority shareholder aims to increase the confidence of the minority in the market and in companies, which will hopefully boost the equity finance supply for companies and allocate investor assets to a better wealth-production engine: the company.

Saudi corporate governance contains a number of rules aimed at providing minority shareholders with special rights. The protection of minority shareholders represents one of the most significant and challenging issues for the Saudi corporate governance model due to the concentrated ownership pattern prevailing in the listed companies.

The rule of the majority is the commonly accepted decision making structure for joint stock companies. The shareholders who own more than fifty percent of company shares (in some cases two thirds or three quarters of the shares) have control of the decision making process in the shareholders' GM.

¹¹⁴ See OECD Principles, at 40.

8.6.2 Protection through Specific Statutory Provisions

8.6.2.1 Right to Call and Attend the Shareholders' GM

Like their counterparts operating under French and U.S. corporate laws,¹¹⁵ minority shareholders in Saudi listed companies are empowered to request the convention of an *ad hoc* (exceptional) ordinary GM.¹¹⁶ If this meeting had not been convened within the legally prescribed period, a minority shareholder with two percent ownership of the company's capital has the right to request to the convention of a shareholder's annual ordinary GM.¹¹⁷ The minority shareholders' right to call an *ad hoc* GM provides the minority with the ability to participate in the governance of the company and to raise their concern through a formal process under which the "Saudi minority shareholders can exert pressure on the board of directors when their interests are at stake."¹¹⁸

Shareholders in the United State have to file a petition with the court in order to force the convention of a belated meeting.¹¹⁹ The French system grants minority shareholders the right to

¹¹⁵ See French Commercial Code (FCC) article § (L 225-103) and the MBCA (7.02) paragraph (a) subparagraph (2).

¹¹⁶ See the C.L. Article § (87). The CL does not explicitly require minority shareholders to provide a reason for requesting the convention of the GM. However, it is implausible that the minority shareholders would submit a request for calling the GM without enclosing a reason because no shareholders' GM will be conducted without an agenda. If the reason provided for convening the shareholders GM is evidently beyond the ordinary GM powers, for example, amending the company's bylaws, increasing or decreasing the company's capital, or dissolving the company), the board may have discretion to reject the minority shareholder's request.

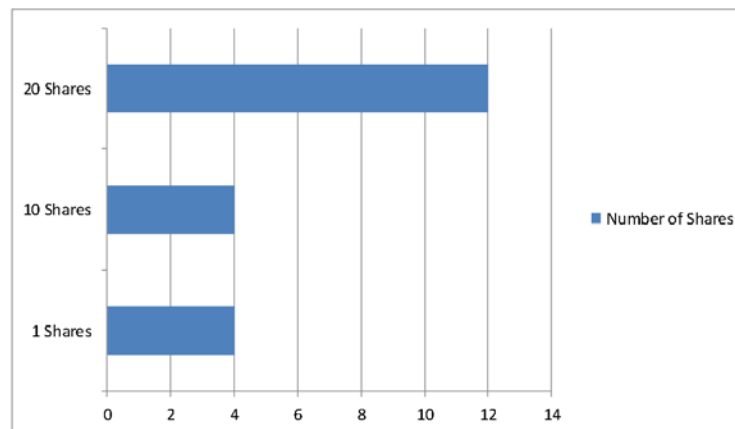
¹¹⁷ The C.L. Article § (87).

¹¹⁸ Puig & Al-Haddab, *supra* note 40, at 123, 135. See also Fahad Mohammad Almajid, A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective (Ph.D.) 233 (2008) (unpublished dissertation University of Manchester) (he said: " Saudi legal system can be regarded as pro-shareholder, since the percentage required to call . . . [GM] is only 5%." *Id*

¹¹⁹ MBCA § (7.03)(a)(1).

request the convention of ordinary and extraordinary GMs.¹²⁰ Unlike the French system, the Saudi governance system does not provide minority shareholders with the right to request the convention of an extraordinary GM. Accordingly, the minority shareholders' right to call shareholders' GM is truncated under the Saudi corporate governance system. The adoption of provisions based on the French approach will increase the protection of minority shareholders in Saudi companies and will increase of their opportunity for participation in the company's decision making process. Without such provisions, minority shareholder in Saudi companies will be locked out of process of proposing major actions concerning company business such as decrees, increasing company capital, or even dissolving the company.

One the other hand, Saudi corporate governance system does not guarantee every shareholder the right to attend the shareholders' GM.¹²¹ Only shareholders with at least twenty shares have such a guarantee.¹²² Many companies have imposed the twenty-share threshold as the qualification for attending the shareholder's meeting (see figure 7).



¹²⁰ French Commercial Code (FCC) article § (L 225-103) paragraph II subparagraph 2.

¹²¹ The attendance requirements of the shareholders GM are outlined in the company's bylaws. The C.L. Article § (83).

¹²² The C.L. Article § (83).

Figure 7. Number of Shares Required for Shareholders GM Attendance in the Largest 20 Saudi Listed Companies (Based on Market Capitalization)

Source: The Companies' Bylaws [on file with the author]

This restrictive approach may impede many minority shareholders from attending general meetings.¹²³ Permitting shareholders in Saudi listed companies to form shareholder' associations, as in the French system,¹²⁴ may decrease this problem in the corporate governance of the Saudi system.

8.6.2.2 Right to Add Items to the GM Agenda

Agenda preparation for the shareholders' GM is the responsibility of the board of directors.¹²⁵ Although the CL, theoretically, intends to exclude shareholders from agenda preparation, economic reality indicates that this goal may not always be appropriate. In a concentrated ownership system, like the Saudi pattern of ownership, the majority of the shareholder controls the board of directors, and their actions include indirect control of the shareholders GM agenda.¹²⁶ Accordingly, several corporate governance systems, specifically the French system and the OECD Principles compensate for such problems by providing minority shareholders with

¹²³ See the World Bank, Report on the Observance of Standards and Codes (ROSC), Corporate Governance Country Assessment: Kingdom of Saudi Arabia, 19 (2009). Nonetheless, shareholders who do not meet the attendance threshold and who express an interest to attend may collaborate and collect the required amount of shares for attending the meeting. TAHA, *supra* note 60, at 294–95.

¹²⁴ See French Commercial Code (FCC) article § (L 225-120).

¹²⁵ The C.L. Article §§ (87) and (88).

¹²⁶ It should be noted this problem exists in dispersed ownership systems.

a specific holding percentage the right to add items to the GM agenda.¹²⁷ Unfortunately, the Saudi corporate governance system has not pursued the same path.

The SCGRs complement this vacuum in the Saudi corporate governance system by suggesting that “shareholders holding not less than 5% of the company’s shares are entitled to add one or more items to the agenda.”¹²⁸ The scope of implementation of this nonbinding principle is not relevant if enough protection is provided for minority shareholders or if mandatory empowerment of this group is necessary. Accordingly, the Saudi corporate governance system should grant minority shareholders the explicit mandatory right to add items to the agenda of the shareholders’ meeting.

8.6.2.3 Right to Request Dividends

The company is not obliged to pay out dividends to the shareholders.¹²⁹ The majority shareholders, through their elected board, could retain the company’s profits, reinvesting the profits indefinitely. The CL does not include any statutory protection which might allow minority shareholders to compel the company to distribute dividends under certain conditions. Similarly, the French and U.S. legal systems do not provide shareholders with a statutory right to request dividend payouts.

¹²⁷ French Commercial Code (FCC) article § (L 225-105) and OECD Principles, at 40.

¹²⁸ SCGRs Article § (6)(f). *See* Fahad Mohammad Almajid, A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective (Ph.D.) 233 (2008) (unpublished dissertation University of Manchester) (Almajid argues that: “ such right can help to support the position of small shareholders against that of the state or of families which have a powerful stake in the companies through their heavy investment.” *Id*

¹²⁹ The profits realized by the company are for the company, not for the shareholders. Shareholder rights over this profit appear at the time of the shareholders GM approval of the dividends payout. *See* the C.L. Article § (127).

Brazil is a rare example of a country that provides shareholders of publicly held companies with mandatory annual payouts of dividends.¹³⁰ The adoption of such a right may work for countries with patterns of concentrated ownership and weak institutional frameworks, such as that of the Saudi system. Providing shareholders with mandatory dividend payments may not prevent the majority shareholders from exploiting company assets and reinvesting company profits, but it may decrease such abuse of minority shareholders rights.

8.6.2.4 Cumulative Voting in Board Elections

In Saudi Arabia, the appointment of the board members comes through regular voting mechanisms which give all of the board seats to the majority shareholders. However, the SCGRs strongly recommend the adoption of a cumulative voting mechanism for electing board members.¹³¹ Cumulative voting aims to allow minority shareholders to elect one or more board members to represent their interests on the board, a situation that would be almost impossible under conventional “straight” voting mechanisms.¹³² The board members elected by the minority shareholders are expected to be whistleblowers, whose function is to ensure that board members are exerting the board’s power for the interests of the company and all the shareholders, not solely those of the interests of the dominant shareholders or the board members’ personal

¹³⁰ See Daniela Mesquita, *Brazil*, in GOVERNANCE AND RISK: AN ANALYTICAL HANDBOOK FOR INVESTORS, MANAGERS, DIRECTORS, AND STAKEHOLDERS 424, 432 (George S. Dallas ed., 2004).

¹³¹ SCGRs Article § (6)(b).

¹³² *Id.* § (2). See Fahad Mohammad Almajid, A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective (Ph.D.) 238 (2008) (unpublished dissertation University of Manchester) (he remarked: “[w]hether this new tool [CV] will work in favor of minority shareholders remain to be seen. However, at least, in a theoretical sense, the position of minority shareholders has been reinforced by the introduction of cumulative voting.”) *Id.*

interests. The inclusion of a mandatory cumulative voting method in a national corporate governance system complies with the best practices suggested by the OECD Principles.¹³³

In contrast to these Principles, the French corporate governance system takes issue with the use of cumulative voting as a tool for enabling minority shareholders to have representation on the board and thus a window (not control) on corporate affairs.¹³⁴ This position leads directly to the formation of the board exclusively in the hands of the majority shareholders, despite the fact that the board is required to observe the interests of the company which includes the interests of all minority shareholders.¹³⁵

Today, many listed companies adopt cumulative voting, and it is expected that most listed companies will be implementing this voting method within a very few years (see Figure 8). The rapid pace of adopting this voting method is surprising because it is not supported by any legal sanction or listing requirements. In any case, the formal incorporation of mandatory cumulative voting rules for board member election is advisable under the CL.

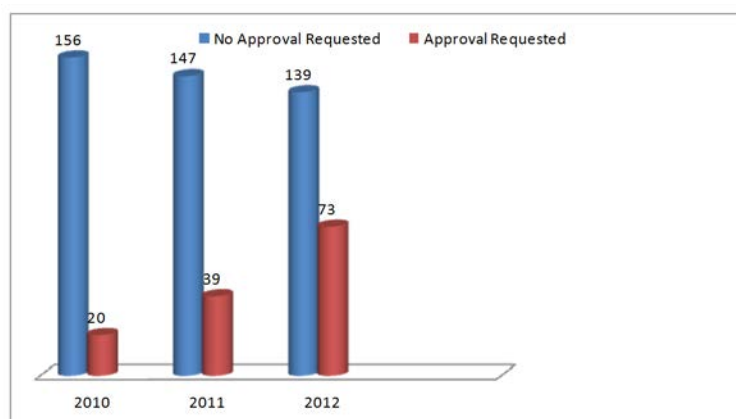


Figure 8. The Adoption of Cumulative Voting in Electing the Board Members (2010–2012)

¹³³ See THE OECD CORPORATE GOVERNANCE PRINCIPLES 42 (2004).

¹³⁴ AFEB-MEDEF, Corporate Governance Code of Listed Corporations, Principle 9 (2013).

¹³⁵ *Id.*

8.6.3 Equal and Fair Treatment of Shareholders and its Implications for Minority

Shareholders

8.6.3.1 Preemptive Rights

The company has the power to increase its capital through the issuance of new stock.¹³⁶ This method of obtaining new capital may cause an alteration of the ownership structure of the company.¹³⁷ To protect shareholders' ownership stake and prevent any dilution of their ownership rights, the CL provides existing shareholders with a priority right, called a "preemptive rights", to buy the newly issued stock.¹³⁸ U.S. law does not grant a mandatory preemptive right to shareholders.¹³⁹

Under these provisions, the company bylaws may restrict the shareholders' preemptive rights and possibly eliminate this right completely.¹⁴⁰ More importantly, the government has the

¹³⁶ The C.L. Article § (135)(1) and (2).

¹³⁷ See KHALID AL-SHAWI, QANUN AL-SHARIKAT AL-TIJARIYAH AL-IRAQI 360 (1968), cited in Mohammad al-Jabor, *The Capital Increase in Joint Stock Companies and the Preemptive rights in Subscribing in the Saudi Companies Law*, 9 J. OF THE COLLEGE OF ADMINISTRATIVE SCIENCE OF KING SAUDI UNIVERSITY 37, 52–53 (1984–1983).

¹³⁸ See the C.L. Article § (136). For detailed analysis for preemptive rights under Saudi law, see al-Jabor, *supra* note 137, at 37. Preemptive rights arise in the event of a proposal to issue shares in return for cash. Shares issued in return for in kind contributions do not give rise to preemptive rights. C.L. Articles § (135)(1) and § (136). See also Fahad Mohammad Almajid, *A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective* (Ph.D.) 243 (2008) (unpublished dissertation University of Manchester).

¹³⁹ See Model Business Corporation Act (MBCA) Article § (6.30)(a).

¹⁴⁰ The C.L. Article § (136).

right to restrict shareholders from using their preemptive rights and, in some cases, to eliminate this right.¹⁴¹

Although preemptive rights equally benefit all shareholders, this right may have a special meaning to the minority shareholders.¹⁴² Preemptive rights protect minority shareholders' position in the company by allowing them to keep their shareholding stake intact, leading to the retention of minority voting power.¹⁴³ For instance, a minority shareholder who has shares sufficient to entitle him to request the convention of a shareholders' GM may find himself below the required threshold because of the decrease in his percentage of ownership, as a result of increases in the outstanding share size of the company.¹⁴⁴ Accordingly, the recognition of preemptive rights in the CL increases the protection of the minority shareholders by permitting minority shareholders to safeguard their ownership from dilution.

8.6.3.2 Compulsory Purchase (Tagalong) Rights

The OECD Principles assert that shareholders are entitled to a fair price for their shares at the time of acquisition.¹⁴⁵ The CL lacks any provision to protect the interests of the minority

¹⁴¹ See article 136 of CL which provides:

The Council of Ministers ... may cancel or restrict the preemptive rights in respect of the following companies: (a) Concessionary companies; (b) Companies that manage a public utility; (c) Companies that receive subsidy from the Government; (d) Companies in which the Government is a shareholder; (e) Companies engaging in banking services.

¹⁴² See THE OECD CORPORATE GOVERNANCE PRINCIPLES 42 (2004).

¹⁴³ The World Bank, Report on the Observance of Standards and Codes (ROSC), Corporate Governance Country Assessment: Kingdom of Saudi Arabia, 24 (2009).

¹⁴⁴ This is known as "dilution of shareholders rights." The exercise of preemptive rights may open a door for minority shareholders to increase their shareholding on account of other shareholders who relinquish the exercise of their preemptive rights. Therefore, a minority shareholder who has an ownership level that does not permit him to request a convention of shareholder meeting may increase his ownership share to reach a level that permits doing so.

¹⁴⁵ See OECD Principles, at 42.

shareholders at the time of acquisition, except for the general provision that requires the treatment of all shares of the same class equally.¹⁴⁶ However, the Capital Market Law (CML) and the Implementing Regulation for Merger and Acquisition (MAR) fills in this crucial gap. Under the CML, the acquirer of the fifty percent or more of a listed company may have to buy the shares of the other shareholders, as Article 54 of the CML provides:

If any person increased its ownership of shares in a given company through a restricted purchase of shares or restricted offer for shares so that such person ... become the owner of (50%) fifty percent or more of a given class of voting shares listed on the Exchange, The [CMA] Board shall have the right ... to order such person to offer to purchase the shares of the same class.¹⁴⁷

This mandatory purchase requirement of minority shares is called a “compulsory purchase right.” The problem with this arrangement is that the CMA has no power to oblige the acquirer to buy the remaining shares (the minority shareholders stocks) at a price higher than the price the acquirer paid or offered ex-shareholders. Not bestowing minority shareholders with mandatory compulsory purchase rights would undermine the protection of minority shareholders and violate the shareholders’ right of equal treatment.¹⁴⁸ Conversely, U.S. law does not recognize any compulsory purchase right; instead, the U.S. legal system has an appraisal right for minority shareholders who reject the merger or acquisition.¹⁴⁹ This appraisal right provides

¹⁴⁶ See the C.L. Article § (103).

¹⁴⁷ *Id.* § (54).

¹⁴⁸ The C.L. Article § (103) and MAR Article § (3) paragraph (b) which states: “[a]ll shareholders of the same class of an offeree company must be treated equally by an offeror.” Additionally, the wide scope discretion granted to the CMA in regard with compulsory purchase right may open a window for corruption and bias treatment among minority shareholders in various companies. Accordingly, the Saudi corporate governance model has to guarantee the unconditional tag-along right for every minority shareholder.

¹⁴⁹ See Model Business Corporation Act (MBCA) Article § (13.02)(a).

these shareholders with right to sell their shares for fair value. However, this right is not available for shareholders of listed companies.¹⁵⁰

8.7 CONCLUSION

This chapter has examined the shareholders' position in Saudi listed companies, noting the various similarities and differences between their rights, roles, and protections under the Saudi system and equivalent provisions in the OECD principles, as well as in other corporate governance models such as the U.S. and French systems. The Saudi corporate governance system provides shareholders with a number of basic political and economic rights; however most significantly, it does not impose the one vote per share principle on all companies, and it allows the company to limit the minority shareholders' right to attend the shareholders' GM.

The shareholders' GMs have, *inter alia*, the power to appoint and dismiss members of the board of directors and the external auditor; to approve any increase or decrease in the company's capital; to review transactions which involve director's or manager's conflicts of interest restrictions; and to amend the company bylaws.

The Saudi framework governing derivative suits needs to undergo major reform. The CL should adopt the "demand principle" from the U.S. legal system.¹⁵¹ Shareholder should only be required to prove that some kind of injury was inflicted on the company, as opposed to being

¹⁵⁰ *See id.* § (13.02)(b).

¹⁵¹ Otherwise, shareholders may overuse this mechanism. Such reform is not an urgent matter due to the currently small number of derivative suits. However, any future increase in the number of such suits will necessitate the adoption of such provisions. *See Fanto, supra* note 65.

required to substantiate a personal injury. In addition, the company should compensate the shareholder for any expenses incurred during this suit process. Incorporating such reforms may increase the use of derivative suits in Saudi corporate governance as an extra enforcement mechanism.

The Saudi corporate governance provides minority shareholders with special protection, such as the right to call a convocation of the ordinary shareholders GM (annual and exceptional); the right to request the appointment of an external inspector; the protection of their ownership from dilution (preemptive rights); and the right to compulsory purchase (tagalong rights).

The framework of minority shareholders' protection, however, suffers from drawbacks that need to be addressed by the Saudi government, especially when taking into account the pattern of concentrated ownership in Saudi listed companies and the prospect of controlling shareholders exploitation of the minority shareholders.

To enhance the confidence of small investors in the Saudi capital market, the CL should incorporate several mandatory rights for minority shareholders: 1) the right to put items on the shareholders' GM agenda; 2) the right to request payment of dividends under special circumstances, such as the arbitrary reluctance by the board of directors (the majority shareholders' appointees) to distribute dividends; 3) the cumulative voting method of electing the board of directors; 4) the right of every shareholder to attend the shareholders' GMs, regardless of ownership stake; 5) the right to call extraordinary meetings of shareholders; 6) the right to one vote for every share; 7) the full enjoyment of preemptive rights with no restrictions and limitations; and 8) the right to compulsory purchase (tagalong rights) by the acquirer, without any discretionary power on the part of the CMA.

More importantly, the Saudi CL should allow the formation of shareholders' associations, as French law does; this feature of corporate governance will increase the power of minority shareholders in the company. Such associations must be granted the right to represent the minority shareholders and to exercise, on their behalf, those rights as are normally granted to the minority shareholders, including the right to request the convention of shareholders' meetings, to add items to the meeting agenda, to vote in the general meetings, and to sue either the company itself (direct suite) or another entity on behalf of the company (derivative suite).

9.0 CONCLUSION

Saudi Arabia is under pressure to diversify its economy and to expand the private sector's role. Such an agenda will not be easily achieved without the government creating a suitable regulatory and legal environment, and, moreover, specifically implementing an efficient system of corporate governance.

Corporate governance is a subject that has received focused interest only recently within Saudi Arabia. Until then the CL was the primary tool for addressing governance as well as other corporate issues in the country. Social and governmental attention to corporate governance was triggered after a formal capital market was established in 2003, to be followed by its subsequent collapse in 2006. Since then, the Capital Market Authority (CMA) has issued a set of principles and other regulations to enhance corporate governance in the country. Nonetheless, the Saudi corporate governance system is still widely deemed to be suboptimal. For instance, two studies conducted by respected international institutions have indicated that the Saudi corporate governance system needs rigorous reforms in order to comply with international benchmarks.

There is no 'one-size-fits-all' formula for corporate governance reform. Any system of corporate governance involves a complex framework and processes that are inextricably part of the legal, political, and economic structure of the country. Given this interconnectedness, a detailed examination of the Saudi corporate governance system can reveal only some of the

elements that may explain the nature of existing Saudi governance structure. And these same elements will most likely play a determining role in the Saudi system's evolution.

First, the Saudi system has an agency cost problem caused by the high concentration of ownership in Saudi publicly traded companies. Such dominant shareholder agency problems produce different corporate governance issues and require different governance solutions than do the U.S. (and U.K.) dispersed ownership systems. A chief goal of corporate governance in concentrated ownership systems is to guard the company's assets and protect the minority shareholders from the power of the controlling shareholder(s).

Second, the Saudi corporate governance system lacks the requisite institutions to implement corporate governance effectively. The Saudi judicial system, in particular, is underdeveloped in comparison to judicial systems in developed nations, as well as the legal systems of numerous other developing countries. Judges may decide not to enforce statutes that they view as contradicting Islamic law, such as the limited liability of shareholders and debt financing payment of interests. Furthermore, the adjudication process is time-consuming, and neither transparent nor predictable. Accordingly, the judicial system in Saudi Arabia cannot be expected to fill gaps in the corporate governance system in contrast to, for example, the U.S. judicial system, which has contributed positively to the cause of corporate governance.

Thirdly, the teachings of Islam represent the supreme law of the land, constituting an unassailable foundation for moral and ethical behavior in all facets of Saudi Arabian society, including business conduct. Religions such as Islam, along with moral codes, may provide effective tools for reducing agency costs, especially in societies composed largely of strong believers with compatible creeds. However, Saudi corporate governance, as it has developed, has ignored the Islamic view of governance and its implications for modern corporate ideology.

Connecting Saudi corporate governance principles with their Islamic counterparts would increase the acceptance of such principles in Saudi Arabia. People will adhere to principles of governance when such principles are seen to be part of their religious duties.

When constructing an agenda for reform of corporate governance, policy and law makers in Saudi Arabia must consider the aforementioned elements. Accordingly, Saudi corporate governance reform should focus on internal corporate governance, namely, on the board of directors and shareholders (including protection for minority shareholders). Improvements in the quality of internal corporate governance would expedite the process of corporate governance reform in this country. In contrast, development or reform of external corporate governance normally takes an extended period of time before it becomes capable of playing an effective role in agency costs' reduction.

Comparative corporate governance, including the benchmarks promoted by international organizations, namely, the OECD with its Corporate Governance Principles, in conjunction with the Islamic principles, have furnished valuable insights into the formation of this dissertation's proposals for improving internal governance in Saudi Arabia. Among other recommendations, this dissertation argues that Saudi corporate governance needs to shift its emphasis from shareholder primacy towards stakeholder primacy. Notably, publicly traded companies ought to be entitled to join labor in the decision-making process. Permitting a two-tiered board structure has the potential to increase board performance due to the clear division of managerial and supervisory functions. Companies should also have the right to set incentive based remunerations for directors. The powers granted to shareholders should include the right to issue an advisory vote over the remuneration of directors and key executives, known as "Say on Pay." Moreover, the sale of all or substantially all of the company's assets should not be permitted without

shareholders' approval. Guarantees on the political rights of shareholders must be clarified and strengthened, including the right to attend shareholders' meetings and the one-vote-per-share principle. Furthermore, minority shareholders should be permitted to form associations to represent their collective interests in the company. The imposition of mandatory cumulative voting in the election of directors may increase the power of minority shareholders in the company, reducing agency costs caused by dominant shareholder's control. Statutory protection for minority shareholder's, including the right to equal treatment, must be strengthened, especially during any process of merger or acquisition.

This dissertation has little devoted attention to the governance of Saudi publicly owned companies, controlled by the government or by semi-government institutions. Further investigation into so called SOEs (State Owned Enterprises) is needed, especially with regard to the nature of the agency problem and its implications for the Saudi corporate governance system. The degree of engagement by the government in the decision-making processes of controlled companies, along with the degree of divergence between governance and private business agenda, would be the determining factor of agency problem type in such companies.¹

Overall, the adoption of the proposals recommended in this dissertation is imperative to achieving the goals of improving corporate governance in Saudi Arabia and attracting greater investment in the country's capital market.

¹ See OECD Guidelines on Corporate Governance of State-Owned Enterprises 10 (2005). For instance, if participation by the government and semi-government institutions in decision-making is minimal, the agency problem would be similar to that which is found in dispersed ownership systems, namely that of management *v.* shareholders. Hence, agency costs reduction in such exceptionally concentrated systems would require the adoption of the corporate governance solutions that are promoted by dispersed ownership systems with the management *v.* shareholders agency problem. Or encourage the government and semi- government institutions to be engaged in the decision-making process and to supervise the management of the company. *See also* CORPORATE GOVERNANCE: A FRAMEWORK FOR IMPLEMENTATION VI, at 35 (Magdi R. Iskander & Nadereh Chamlou eds., World Bank Group 2000) (which states: "the governance issues in state-owned enterprise are more complex because of the lack of clarity about who the owner is, who is able to exercise the rights of the owner, and who is accountable."). *Id.*

APPENDIX A

CORPORATE GOVERNANCE REGULATIONS IN THE KINGDOM OF SAUDI ARABIA

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

Amended by Resolution of the Board
of the Capital Market Authority Number 1-10-2010
Dated 30/3/1431H corresponding to 16/3/2010G

CONTENTS

Part 1: Preliminary Provisions

- Article 1. Preamble
- Article 2. Definitions

Part 2: Rights of Shareholders and the General Assembly

- Article 3. General Rights of Shareholders
- Article 4. Facilitation of Shareholders' Exercise of Rights and Access to Information
- Article 5. Shareholders Rights related to the General Assembly
- Article 6. Voting Rights
- Article 7. Dividends Rights of Shareholders

Part 3: Disclosure and Transparency

- Article 8. Policies and Procedures related to Disclosure
- Article 9. Disclosure in the Board of Directors' Report

Part 4: Board of Directors

- Article 10. Main Functions of the Board
- Article 11. Responsibilities of the Board
- Article 12. Formation of the Board
- Article 13. Committees of the Board
- Article 14. Audit Committee
- Article 15. Nomination and Remuneration Committee
- Article 16. Meetings of the Board
- Article 17. Remuneration and Indemnification of Board Members
- Article 18. Conflict of Interest within the Board

Part 5: Closing Provisions

- Article 19. Publication and Entry into Force

PART 1
PRELIMINARY PROVISIONS

Article 1: Preamble

- a) These Regulations include the rules and standards that regulate the management of joint stock companies listed in the Exchange to ensure their compliance with the best governance practices that would ensure the protection of shareholders' rights as well as the rights of stakeholders.
- b) These Regulations constitute the guiding principles for all companies listed in the Exchange unless any other regulations, rules or resolutions of the Board of the Authority provide for the binding effect of some of the provisions herein contained.
- c) As an exception of paragraph (b) of this article, a company must disclose in the Board of Directors' report, the provisions that have been implemented and the provisions that have not been implemented as well as the reasons for not implementing them.

Article 2: Definitions

- a) Expression and terms in these regulations have the meanings they bear in the Capital Market Law and in the glossary of defined terms used in the regulations and the rules of the Capital Market Authority unless otherwise stated in these regulations.
- b) For the purpose of implementing these regulations, the following expressions and terms shall have the meaning they bear as follows unless the contrary intention appears:

Independent Member: A member of the Board of Directors who enjoys complete independence. By way of example, the following shall constitute an infringement of such independence:

1. he/she holds a five per cent or more of the issued shares of the company or any of its group.
2. Being a representative of a legal person that holds a five per cent or more of the issued shares of the company or any of its group.
3. he/she, during the preceding two years, has been a senior executive of the company or of any other company within that company's group.
4. he/she is a first-degree relative of any board member of the company or of any other company within that company's group.
5. he/she is first-degree relative of any of senior executives of the company or of any other company within that company's group.

6. he/she is a board member of any company within the group of the company which he is nominated to be a member of its board.
7. If he/she, during the preceding two years, has been an employee with an affiliate of the company or an affiliate of any company of its group, such as external auditors or main suppliers; or if he/she, during the preceding two years, had a controlling interest in any such party.

Non-executive director: A member of the Board of Directors who does not have a full-time management position at the company, or who does not receive monthly or yearly salary.

First-degree relatives: father, mother, spouse and children.

Stakeholders: Any person who has an interest in the company, such as shareholders, employees, creditors, customers, suppliers, community.

Accumulative Voting: a method of voting for electing directors, which gives each shareholder a voting rights equivalent to the number of shares he/she holds. He/she has the right to use them all for one nominee or to divide them between his/her selected nominees without any duplication of these votes. This method increases the chances of the minority shareholders to appoint their representatives in the board through the right to accumulate votes for one nominee.

Minority Shareholders: Those shareholders who represent a class of shareholders that does not control the company and hence they are unable to influence the company.

PART 2
RIGHTS OF SHAREHOLDERS AND THE GENERAL ASSEMBLY

Article 3: General Rights of Shareholders

A Shareholder shall be entitled to all rights attached to the share, in particular, the right to a share of the distributable profits, the right to a share of the company's assets upon liquidation; the right to attend the General Assembly and participate in deliberations and vote on relevant decisions; the right of disposition with respect to shares; the right to supervise the Board of Directors activities, and file responsibility claims against board members; the right to inquire and have access to information without prejudice to the company's interests and in a manner that does not contradict the Capital Market Law and the Implementing Rules.

Article 4: Facilitation of Shareholders Exercise of Rights and Access to Information

- a) The company in its Articles of Association and by-laws shall specify the procedures and precautions that are necessary for the shareholders' exercise of all their lawful rights.
- b) All information which enable shareholders to properly exercise their rights shall be made available and such information shall be comprehensive and accurate; it must be provided and updated regularly and within the prescribed times; the company shall use the most effective means in communicating with shareholders. No discrepancy shall be exercised with respect to shareholders in relation to providing information.

Article 5¹: Shareholders Rights related to the General Assembly

- a) A General Assembly shall convene once a year at least within the six months following the end of the company's financial year.
- b) The General Assembly shall convene upon a request of the Board of Directors. The Board of Directors shall invite a General Assembly to convene pursuant to a request of the auditor or a number of shareholders whose shareholdings represent at least 5% of the equity share capital.
- c) Date, place, and agenda of the General Assembly shall be specified and announced by a notice, at least 20 days prior to the date the meeting; invitation for the meeting shall be published in the Exchange' website, the company's website and in two newspapers of voluminous distribution in the Kingdom. Modern high tech means shall be used in communicating with shareholders.

¹ The Board of the Capital Market Authority issued resolution Number (3-40-2012) Dated 17/2/1434H corresponding to 30/12/2012G making paragraphs (i) and (j) of Article 5 of the Corporate Governance Regulations mandatory on all companies listed on the Exchange effective from 1/1/2013G.

- d) Shareholders shall be allowed the opportunity to effectively participate and vote in the General Assembly; they shall be informed about the rules governing the meetings and the voting procedure.
- e) Arrangements shall be made for facilitating the participation of the greatest number of shareholders in the General Assembly, including *inter alia* determination of the appropriate place and time.
- f) In preparing the General Assembly's agenda, the Board of Directors shall take into consideration matters shareholders require to be listed in that agenda; shareholders holding not less than 5% of the company's shares are entitled to add one or more items to the agenda. upon its preparation.
- g) Shareholders shall be entitled to discuss matters listed in the agenda of the General Assembly and raise relevant questions to the board members and to the external auditor. The Board of Directors or the external auditor shall answer the questions raised by shareholders in a manner that does not prejudice the company's interest.
- h) Matters presented to the General Assembly shall be accompanied by sufficient information to enable shareholders to make decisions.
- i) Shareholders shall be enabled to peruse the minutes of the General Assembly; the company shall provide the Authority with a copy of those minutes within 10 days of the convening date of any such meeting.
- j) The Exchange shall be immediately informed of the results of the General Assembly.

Article 6: Voting Rights

- a) Voting is deemed to be a fundamental right of a shareholder, which shall not, in any way, be denied. The company must avoid taking any action which might hamper the use of the voting right; a shareholder must be afforded all possible assistance as may facilitate the exercise of such right.
- b) In voting in the General Assembly for the nomination to the board members, the accumulative voting method shall be applied.
- c) A shareholder may, in writing, appoint any other shareholder who is not a board member and who is not an employee of the company to attend the General Assembly on his behalf.
- d) Investors who are judicial persons and who act on behalf of others – e.g. investment funds – shall disclose in their annual reports their voting policies, actual voting, and ways of dealing with any material conflict of interests that may affect the practice of the fundamental rights in relation to their investments.

Article 7: Dividends Rights of Shareholders

- a) The Board of Directors shall lay down a clear policy regarding dividends, in a manner that may realize the interests of shareholders and those of the company; shareholders shall be informed of that policy during the General Assembly and reference thereto shall be made in the report of the Board of Directors.

- b) The General Assembly shall approve the dividends and the date of distribution. These dividends, whether they be in cash or bonus shares shall be given, as of right, to the shareholders who are listed in the records kept at the Securities Depository Center as they appear at the end of trading session on the day on which the General Assembly is convened.

PART 3
DISCLOSURE AND TRANSPARENCY

Article 8: Policies and Procedure related to Disclosure

The company shall lay down in writing the policies, procedures and supervisory rules related to disclosure, pursuant to law.

Article 9²: Disclosure in the Board of Directors' Report

In addition to what is required in the Listing Rules in connection with the content of the report of the Board of Directors, which is appended to the annual financial statements of the company, such report shall include the following:

- a) The implemented provisions of these Regulations as well as the provisions which have not been implemented, and the justifications for not implementing them.
- b) Names of any joint stock company or companies in which the company Board of Directors member acts as a member of its Board of directors.
- c) Formation of the Board of Directors and classification of its members as follows: executive board member, non-executive board member, or independent board member.
- d) A brief description of the jurisdictions and duties of the Board's main committees such as the Audit Committee, the Nomination and Remuneration Committee; indicating their names, names of their chairmen, names of their members, and the aggregate of their respective meetings.
- e) Details of compensation and remuneration paid to each of the following:
 1. The Chairman and members of the Board of Directors.
 2. The Top Five executives who have received the highest compensation and remuneration from the company. The CEO and the chief finance officer shall be included if they are not within the top five.

For the purpose of this paragraph, “compensation and remuneration” means salaries, allowances, profits and any of the same; annual and periodic bonuses

² The Board of the Capital Market Authority issued resolution Number (1-36-2008) Dated 12/11/1429H corresponding to 10/11/2008G making Article 9 of the Corporate Governance Regulations mandatory on all companies listed on the Exchange effective from the first board report issued by the company following the date of the Board of the Capital Market Authority resolution mentioned above.

related to performance; long or short-term incentive schemes; and any other rights *in rem*.

- f) Any punishment or penalty or preventive restriction imposed on the company by the Authority or any other supervisory or regulatory or judiciary body.
- g) Results of the annual audit of the effectiveness of the internal control procedures of the company.

PART 4
BOARD OF DIRECTORS Article 10³:

Main Functions of the Board of Directors Among the main functions of the Board is the following:

- a) Approving the strategic plans and main objectives of the company and supervising their implementation; this includes:
 - 1. Laying down a comprehensive strategy for the company, the main work plans and the policy related to risk management, reviewing and updating of such policy.
 - 2. Determining the most appropriate capital structure of the company, its strategies and financial objectives and approving its annual budgets.
 - 3. Supervising the main capital expenses of the company and acquisition/disposal of assets.
 - 4. Deciding the performance objectives to be achieved and supervising the implementation thereof and the overall performance of the company.
 - 5. Reviewing and approving the organizational and functional structures of the company on a periodical basis.

- b) Lay down rules for internal control systems and supervising them; this includes:
 - 1. Developing a written policy that would regulates conflict of interest and remedy any possible cases of conflict by members of the Board of Directors, executive management and shareholders. This includes misuse of the company's assets and facilities and the arbitrary disposition resulting from dealings with the related parties.
 - 2. Ensuring the integrity of the financial and accounting procedures including procedures related to the preparation of the financial reports.

³ The Board of the Capital Market Authority issued resolution Number (1-33-2011) Dated 3/12/1432H corresponding to 30/10/2011G making paragraph (b) of Article 10 of the Corporate Governance Regulations mandatory on all companies listed on the Exchange effective from 1/1/2012. The Board of the Capital Market Authority issued resolution Number (3-40-2012) Dated 17/2/1434H corresponding to 30/12/2012G making paragraphs (c) and (d) of Article 10 of the Corporate Governance Regulations mandatory on all companies listed on the Exchange effective from 30/6/2013G.

3. Ensuring the implementation of control procedures appropriate for risk management by forecasting the risks that the company could encounter and disclosing them with transparency.
 4. Reviewing annually the effectiveness of the internal control systems.
- c) Drafting a Corporate Governance Code for the company that does not contradict the provisions of this regulation, supervising and monitoring in general the effectiveness of the code and amending it whenever necessary.
 - d) Laying down specific and explicit policies, standards and procedures, for the membership of the Board of Directors and implementing them after they have been approved by the General Assembly.
 - e) Outlining a written policy that regulate the relationship with stakeholders with a view to protecting their respective rights; in particular, such policy must cover the following:
 1. Mechanisms for indemnifying the stakeholders in case of contravening their rights under the law and their respective contracts.
 2. Mechanisms for settlement of complaints or disputes that might arise between the company and the stakeholders.
 3. Suitable mechanisms for maintaining good relationships with customers and suppliers and protecting the confidentiality of information related to them.
 4. A code of conduct for the company's executives and employees compatible with the proper professional and ethical standards, and regulate their relationship with the stakeholders. The Board of Directors lays down procedures for supervising this code and ensuring compliance there with.
 5. The Company's social contributions.
 - f) Deciding policies and procedures to ensure the company's compliance with the laws and regulations and the company's obligation to disclose material information to shareholders, creditors and other stakeholders.

Article 11: Responsibilities of the Board

- a) Without prejudice to the competences of the General Assembly, the company's Board of Directors shall assume all the necessary powers for the company's management. The ultimate responsibility for the company rests with the Board even if it sets up committees or delegates some of its powers to a third party. The Board of Directors shall avoid issuing general or indefinite power of attorney.

- b) The responsibilities of the Board of Directors must be clearly stated in the company's Articles of Association.
- c) The Board of Directors must carry out its duties in a responsible manner, in good faith and with due diligence. Its decisions should be based on sufficient information from the executive management, or from any other reliable source.
- d) A member of the Board of Directors represents all shareholders; he undertakes to carry out whatever may be in the general interest of the company, but not the interests of the group he represents or that which voted in favor of his appointment to the Board of Directors.
- e) The Board of Directors shall determine the powers to be delegated to the executive management and the procedures for taking any action and the validity of such delegation. It shall also determine matters reserved for decision by the Board of Directors. The executive management shall submit to the Board of Directors periodic reports on the exercise of the delegated powers.
- f) The Board of Directors shall ensure that a procedure is laid down for orienting the new board members of the company's business and, in particular, the financial and legal aspects, in addition to their training, where necessary.
- g) The Board of Directors shall ensure that sufficient information about the company is made available to all members of the Board of Directors, generally, and, in particular, to the non-executive members, to enable them to discharge their duties and responsibilities in an effective manner.
- h) The Board of Directors shall not be entitled to enter into loans which spans more than three years, and shall not sell or mortgage real estate of the company, or drop the company's debts, unless it is authorized to do so by the company's Articles of Association. In the case where the company's Articles of Association includes no provisions to this respect, the Board should not act without the approval of the General Assembly, unless such acts fall within the normal scope of the company's business.

Article 12⁴: Formation of the Board

Formation of the Board of Directors shall be subject to the following:

- a) The Articles of Association of the company shall specify the number of the Board of Directors members, provided that such number shall not be less than three and not more than eleven.
- b) The General Assembly shall appoint the members of the Board of Directors for the duration provided for in the Articles of Association of the company, provided that such duration shall not exceed three years. Unless otherwise provided for in the Articles of Association of the company, members of the Board may be reappointed.
- c) The majority of the members of the Board of Directors shall be non-executive members.
- d) It is prohibited to conjoin the position of the Chairman of the Board of Directors with any other executive position in the company, such as the Chief Executive Officer (CEO) or the managing director or the general manager.
- e) The independent members of the Board of Directors shall not be less than two members, or one-third of the members, whichever is greater.
- f) The Articles of Association of the company shall specify the manner in which membership of the Board of Directors terminates. At all times, the General Assembly may dismiss all or any of the members of the Board of Directors even though the Articles of Association provide otherwise.
- g) On termination of membership of a board member in any of the ways of termination, the company shall promptly notify the Authority and the Exchange and shall specify the reasons for such termination.
- h) A member of the Board of Directors shall not act as a member of the Board of Directors of more than five joint stock companies at the same time.

⁴ The Board of the Capital Market Authority issued resolution Number (1-36-2008) Dated 12/11/1429H corresponding to 10/11/2008G making paragraphs (c) and (e) of Article 12 of the Corporate Governance Regulations mandatory on all companies listed on the Exchange effective from year 2009.

– The Board of the Capital Market Authority issued resolution Number (3-40-2012) Dated 17/2/1434H corresponding to 30/12/2012G making paragraph (g) of Article 12 of the Corporate Governance Regulations mandatory on all companies listed on the Exchange effective from 1/1/2013G.

- i) Judicial person who is entitled under the company's Articles of Association to appoint representatives in the Board of Directors, is not entitled to nomination vote of other members of the Board of Directors.

Article 13: Committees of the Board

- a) A suitable number of committees shall be set up in accordance with the company's requirements and circumstances, in order to enable the Board of Directors to perform its duties in an effective manner.
- b) The formation of committees subordinate to the Board of Directors shall be according to general procedures laid down by the Board, indicating the duties, the duration and the powers of each committee, and the manner in which the Board monitors its activities. The committee shall notify the Board of its activities, findings or decisions with complete transparency. The Board shall periodically pursue the activities of such committees so as to ensure that the activities entrusted to those committees are duly performed. The Board shall approve the by-laws of all committees of the Board, including, *inter alia*, the Audit Committee, Nomination and Remuneration Committee.
- c) A sufficient number of the non-executive members of the Board of Directors shall be appointed in committees that are concerned with activities that might involve a conflict of interest, such as ensuring the integrity of the financial and non-financial reports, reviewing the deals concluded by related parties, nomination to membership of the Board, appointment of executive directors, and determination of remuneration.

Article 14⁵: Audit Committee

- a) The Board of Directors shall set up a committee to be named the "Audit Committee". Its members shall not be less than three, including a specialist in financial and accounting matters. Executive board members are not eligible for Audit Committee membership.
- b) The General Assembly of shareholders shall, upon a recommendation of the Board of Directors, issue rules for appointing the members of the Audit Committee and define the term of their office and the procedure to be followed by the Committee.
- c) The duties and responsibilities of the Audit Committee include the following:
 - 1. To supervise the company's internal audit department to ensure its effectiveness in executing the activities and duties specified by the Board of Directors.

⁵ The Board of the Capital Market Authority issued resolution Number (1-36-2008) Dated 12/11/1429H corresponding to 10/11/2008G making Article 14 of the Corporate Governance Regulations mandatory on all companies listed on the Exchange effective from year 2009.

2. To review the internal audit procedure and prepare a written report on such audit and its recommendations with respect to it.
3. To review the internal audit reports and pursue the implementation of the corrective measures in respect of the comments included in them.
4. To recommend to the Board of Directors the appointment, dismissal and the Remuneration of external auditors; upon any such recommendation, regard must be made to their independence.
5. To supervise the activities of the external auditors and approve any activity beyond the scope of the audit work assigned to them during the performance of their duties.
6. To review together with the external auditor the audit plan and make any comments thereon.
7. To review the external auditor's comments on the financial statements and follow up the actions taken about them.
8. To review the interim and annual financial statements prior to presentation to the Board of Directors; and to give opinion and recommendations with respect thereto.
9. To review the accounting policies in force and advise the Board of Directors of any recommendation regarding them.

Article 15⁶: Nomination and Remuneration Committee

- a) The Board of Directors shall set up a committee to be named "Nomination and Remuneration Committee".
- b) The General Assembly shall, upon a recommendation of the Board of Directors, issue rules for the appointment of the members of the Nomination and Remuneration Committee, terms of office and the procedure to be followed by such committee.
- c) The duties and responsibilities of the Nomination and Remuneration Committee include the following:
 1. Recommend to the Board of Directors appointments to membership of the Board in accordance with the approved policies and standards; the Committee shall

⁶ The Board of the Capital Market Authority issued resolution Number (1-10-2010) Dated 30/3/1431H corresponding to 16/3/2010G making Article 15 of the Corporate Governance Regulations mandatory on all companies listed on the Exchange effective from 1/1/2011G.

ensure that no person who has been previously convicted of any offense affecting honor or honesty is nominated for such membership.

2. Annual review of the requirement of suitable skills for membership of the Board of Directors and the preparation of a description of the required capabilities and qualifications for such membership, including, *inter alia*, the time that a Board member should reserve for the activities of the Board.
3. Review the structure of the Board of Directors and recommend changes.
4. Determine the points of strength and weakness in the Board of Directors and recommend remedies that are compatible with the company's interest.
5. Ensure on an annual basis the independence of the independent members and the absence of any conflict of interest in case a Board member also acts as a member of the Board of Directors of another company.
6. Draw clear policies regarding the indemnities and remunerations of the Board members and top executives; in laying down such policies, the standards related to performance shall be followed.

Article 16: Meetings of the Board

1. The Board members shall allot ample time for performing their responsibilities, including the preparation for the meetings of the Board and the permanent and ad hoc committees, and shall endeavor to attend such meetings.
2. The Board shall convene its ordinary meetings regularly upon a request by the Chairman. The Chairman shall call the Board for an unforeseen meeting upon a written request by two of its members.
3. When preparing a specified agenda to be presented to the Board, the Chairman should consult the other members of the Board and the CEO. The agenda and other documentation should be sent to the members in a sufficient time prior to the meeting so that they may be able to consider such matters and prepare themselves for the meeting. Once convened, the Board shall approve the agenda; should any member of the Board raise any objection to this agenda, the details of such objection shall be entered in the minutes of the meeting.
4. The Board shall document its meetings and prepare records of the deliberations and the voting, and arrange for these records to be kept in chapters for ease of reference.

Article 17: Remuneration and Indemnification of Board Members

The Articles of Association of the company shall set forth the manner of remunerating the Board members; such remuneration may take the form of a lump sum amount, attendance allowance, rights *in rem* or a certain percentage of the profits. Any two or more of these privileges may be conjoined.

Article 18. Conflict of Interest within the Board

- a) A Board member shall not, without a prior authorization from the General Assembly, to be renewed each year, have any interest (whether directly or indirectly) in the company's business and contracts. The activities to be performed through general bidding shall constitute an exception where a Board member is the best bidder. A Board member shall notify the Board of Directors of any personal interest he/she may have in the business and contracts that are completed for the company's account. Such notification shall be entered in the minutes of the meeting. A Board member who is an interested party shall not be entitled to vote on the resolution to be adopted in this regard neither in the General Assembly nor in the Board of Directors. The Chairman of the Board of Directors shall notify the General Assembly, when convened, of the activities and contracts in respect of which a Board member may have a personal interest and shall attach to such notification a special report prepared by the company's auditor.
- b) A Board member shall not, without a prior authorization of the General Assembly, to be renewed annually, participate in any activity which may likely compete with the activities of the company, or trade in any branch of the activities carried out by the company.
- c) The company shall not grant cash loan whatsoever to any of its Board members or render guarantee in respect of any loan entered into by a Board member with third parties, excluding banks and other fiduciary companies.

PART 5
CLOSING PROVISIONS

Article 19: Publication and Entry into Force

These regulations shall be effective upon the date of their publication.

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