

**Building an Effective Framework
for Institutional Investor Activism and
Minority Shareholder Protection in Saudi Arabia:
Lessons from the UK**

**A thesis submitted to the University of Manchester for the degree of Doctor
of Philosophy in the Faculty of Humanities**

2014

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Abstract The University of Manchester

Candidate's Full Name: Hani A Aljahdali

Degree Title: Doctor of Philosophy in the Faculty of Humanities

Thesis Title: Building an Effective Framework for Institutional Investor Activism and Minority Shareholder Protection in Saudi Arabia: Lessons from the UK

Date: May 2014

Corporate governance practice differs regionally and nationally, depending on how each legal environment protects minority investors, capital markets and company ownership structure. Governance can also change spectacularly in regions or countries with comparatively high levels of institutional investment.

The notion of institutional investors' activism is increasingly important in developed markets as the ideal corporate governance mechanism to monitor corporate managers and overcome agency problems arising from dispersed corporate ownership in modern companies. These institutions can work together on an improved corporate governance framework more effectively than individual investors, monitoring corporate controllers of listed companies in emerging and developing markets, using their influence more vigorously and in ways more fitting to a concentrated ownership environment such as that in Saudi Arabia. Consequently, the role of institutional investors in emerging and developing markets will depend strongly on institutional investors' activism and the arrangements determined and undertaken by the corporate governance regulatory framework in these markets. In considering the influential role of institutional investors to improve corporate governance practice, a high level of minority shareholder protection thus remains an indicator of good corporate governance and regulatory pressure of rights and incentives, which are necessary to empower non-controlling shareholders in these concentrated ownership markets to exert a strong activist influence in monitoring corporate activities, thus improving the corporate governance practices of investee companies.

In this context, this thesis contends that in Saudi Arabia in particular, shareholder involvement in corporate governance is inadequate, as a result of a variety of economic and regulatory obstacles. It goes on to identify what improvements are necessary and where, to ensure a sound framework for effective institutional investor activism and to improve the level of minority shareholder protection. It also cautions Saudi legislators against erecting hurdles to the future engagement of Saudi and foreign institutional investors in monitoring corporate activities which may affect the conditions for access, allocation and monitoring of equity, which is so important for value creation and sustainable economic growth. The main benefit to be derived from this research is that it facilitates a fuller understanding of the Saudi approach to corporate governance, the corporate ownership environment and trends in the capital market. The analysis also deepens knowledge of corporate governance regimes, including the role of institutional investors, and of their characteristics and investment behaviours. In short, it considers whether institutional investors are willing or have been encouraged to use their power to engage in the companies in which they invest and whether they are qualified to solve the agency problem.

Declaration

No portion of the work referred to in the thesis has been submitted in support of an application for another degree or qualification of this or any other university or other institute of learning.

Signed

Hani Aljahdali

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Acknowledgments

The development of this thesis has been an interesting and challenging journey and there are many people whose support I wish to acknowledge. First and foremost, I would like to thank my main supervisor, Professor Emiliou Avgouleas, because this thesis would not have been completed without his continual assistance, guidance and encouragement, which pushed me to progress in my research throughout the PhD process. His support was essential to this research and he was always there to offer me valuable advice and comments which were very helpful in creating an integrated thesis. I am particularly grateful for his generosity in providing direction and guidance that influenced and shaped my understanding of research and law, and from which I have learnt greatly. In fact, he often went beyond his role as a supervisor and acted as a true friend, showing me care and concern and giving me valuable advice. I still remember many incidents in each of our research meetings where he clearly acted in my interests and in favour of my research. Therefore, I pay tribute to his efforts and would like to thank him from the depths of my heart for everything he has done for me throughout my PhD research.

I am profoundly grateful to my parents and all of my brothers and sisters for their continued support and love, and to my beloved daughters, Zaina and Sara, who waited so patiently and eagerly for this research to be completed. I also owe special thanks to my best friend Mishael, who helped me to push on when it seemed an impossible task to complete. Similarly, I extend my appreciation to my good friends in Saudi Arabia, UAE, Qatar, the UK and the US for their encouragement.

I would like to thank all the other staff, both academic and administrative, and to offer special thanks to Ms. Jackie Boardman for her kind assistance and unstinting support during the completion of this thesis. Finally, thanks go to the library staff and to my fellow postgraduate students at Manchester Law School, all of whom have provided me with invaluable help in conducting my research and assisting my transition from a professional environment to an academic one.

Abbreviations

ABI	Association of British Insurers
AGM	Annual general meeting
AGSM	Annual general shareholder meeting
AIC	Association of Investment Companies
CalPERS	California Public Employees' Retirement System
CEO	Chief executive officer
CGR	Corporate Governance Regulations
CMA	Capital Market Authority
CML	Capital Market Law
CSR	Corporate social responsibility
CTU	Central Trading Unit
EGM	Extraordinary general meeting
ESIS	Electronic Securities Information System
FDI	Foreign direct investment
FPI	Foreign portfolio investment
FRC	Financial Reporting Council
FSA	Financial Services Authority
GCC	Gulf Cooperation Council
GDP	Gross domestic product
GOS	Social Security Agency
GOSI	General Organization for Social Insurance
IIC	Institutional Investor Committee
ICG	Islamic corporate governance
IMA	Investment Management Association
IFRs	Investment Fund Regulations
IPO	Initial public offering
IVIS	Institutional Voting Information Service
LRs	Listing Rules
MENA	Middle East and North Africa
MOC	Ministry of Commerce
MOF	Ministry of Finance and National Economy
NAPF	National Association of Pension Funds

NCB	National Commercial Bank
OECD	Organisation for Economic Cooperation and Development
PIRC	Pensions and Investment Research Consultants
PIF	Public Investment Fund
PPA	Public Pension Agency
RREV	Research, Recommendation, Electronic Voting
ROSC	Report on the Observance of Standards and Codes
SAMA	Saudi Arabian Monetary Agency
SAMBA	Saudi American Bank
SCR	Saudi Companies Regulations 1965
SOCPA	Saudi Organization for Certified Public Accountants
SR	Saudi riyal
SRI	Socially responsible investment
SSRC	Saudi Share Registration Company
STC	Saudi Telecom Company
WTO	World Trade Organisation

Glossary

Fatawa	Plural of <i>fatwa</i>
Fuqaha	Jurists
Gharar	Risk
Maisir	Gambling
Mudarabah	Profit-sharing
Musharaka	Joint venture
Riba	Interest
Sukuk	Islamic bonds
Tadawul	Saudi Stock Exchange
Takaful	Islamic insurance
Wakala	Agency

Chapter 1

Introduction

1.1 Saudi Arabia and Foreign Capital

The increase in the movement of foreign capital in the first two decades of this century is a consequence of economic liberalisation and globalisation. Additionally, the emergence of the World Trade Organization (WTO) has encouraged developing economies to increase their integration with global capital markets in order to access external finance. Indeed, sources of foreign capital have increasingly become strategically essential to these countries since they liberalised their capital markets and privatised many government entities to enhance labour productivity and stimulate growth.¹ However, in order for emerging and developing countries to compete at the global level and bring the required cash flow to their markets, they must make improvements in corporate governance.² Accordingly, many such countries have undertaken major legal reforms and sought to establish effective corporate governance standards so as to attract foreign portfolio investment and promote growth.

Saudi Arabia, although considered a developing country, is an important member of international financial organisations such as the G20, having the largest economy in the Gulf region, with a GDP of \$376 billion in 2009, and the largest regional stock market, valued at \$202.5 billion in 2010.³ As part of the country's accession agreement with the WTO, the Saudi government promised to open its markets to trade and foreign investment. Eventually, after Saudi Arabia became a WTO member in 2005, the government undertook major reforms of its economic policies and legal system in an attempt to make the country the most attractive investment location in the Middle East

¹ Mats Isaksson and Serdar Çelik, 'Who Cares? Corporate Governance in Today's Equity Markets' (2013), OECD Corporate Governance Working Paper 8, 10 <<http://oecd-ilibrary.org/docserver/download/5k47zw5kdnmp.pdf?expires=1374430163&id=id&accname=guest&checksum=F60D18D871D3FBAB04255CB8275558C2>> [Accessed on 05/03/2014].

² For advantages to developing countries of WTO membership, see <wto.org/english/tratop_e/devel_e/d1who_e.htm> [Accessed on 05/03/2014].

³ Yaser Fallatah and Denise Dickins, 'Corporate Governance and Firm Performance and Value in Saudi Arabia' (2012) 6 African J Business Management 10025 <academicjournals.org/ajbm/PDF/pdf2012/12Sept/Fallatah%20and%20Dickins.pdf> [Accessed on 05/03/2014].

and to host the itinerant cash flow.⁴ On 8 August 2008, the Saudi Arabian Capital Market Authority (CMA) announced further steps towards opening its capital market to foreign investors, allowing them to invest in it to some extent through Saudi intermediaries, with the ultimate aim of opening the capital market to foreign direct ownership by large institutional investors, following the gradual liberalisation of the economy.⁵

Saudi policymakers have lately realized the importance of the capital market as an appropriate way to finance the government privatization initiative or a plausible alternative to bank financing for encouraging strong economic growth.⁶ One analysis is this:

Although bank financing is the most popular financing channel in Saudi Arabia, ... traditional bank financing was not sufficient to fund the Kingdom's rapid economic development. In retrospect, the selective lending policy of banks hindered the Kingdom's economic growth. This highlighted the need to bridge this financing gap through efficient allocation of financial resources and reduce the stress on country's banking system.⁷

According to the same source,

Historically (commercial) banks have been the prime source of financing in Saudi Arabia... However, ... the equity market has progressively evolved as an alternative mode of financing. SMEs and private sector entities keen on raising capital have increasingly preferred the equity market, as many of these companies do not enjoy the leverage of easy financing from banks, given their relatively smaller size and risk profiles.⁸

⁴ It first attained observer status in 1986. M Chemingui and R Safadi, 'Saudi Arabia's Long Road to WTO Membership: The Potential Payoffs' (2005) ERF paper 122005030, 1 <erf.org.eg/CMS/uploads/pdf/1184497573_Chemingui_Safadi.pdf> [Accessed on 05/03/2014].

⁵ Robin Wigglesworth and Camilla Hall, 'Saudis Set to Open up Access to Bourse', *Financial Times* (London, 15 January 2012) <ft.com/cms/s/0/1ce9aaf4-3e1b-11e1-ac9b-00144feabdc0.html#axzz2O1iQS6Zd> [Accessed on 05/03/2014].

⁶ Although many privatization processes in Saudi Arabia were not carried out through public share issues, there remains a positive relationship between privatization and capital market development and liquidity. E Perotti and Pieter van Oijen, 'Privatization, Political Risk and Stock Market Development in Emerging Economies' (abstract) (1999) 2-5 <http://ssrn.com/abstract=157797> [Accessed on 05/03/2014].

⁷ Aljazira Capital, 'The Financing Role of the Saudi Capital Market: Promising Prospects' (2010) Research Department Economic Report 7 <aljaziracapital.com.sa/jaziracapital/report_file/ess/ECO-4.pdf> [Accessed on 05/03/2014].

⁸ *ibid* 1.

1.2 The Need for Portfolio Diversification in Saudi Arabia

Against this background, the financing role of foreign portfolio investment has recently become globally more important for many initial owners, to meet their eventual requirements for raising external capital to finance their long-term growth and thus overcome the borrowing limitations of the Saudi banks.⁹ However, there is an agency costs associated with foreign institutional investors, who are less likely to exercise or maintain a controlling right in the companies in which they invest. When undertaking portfolio diversification and deciding to finance the expansion and growth of any local business in any of the emerging and developing countries such as Saudi Arabia,¹⁰ they must ensure that their investment is in the right hands and allocated efficiently, so they will wish to protect and if necessary enforce their voting and certain other rights. Shareholders' passivity and poor minority shareholder protection could therefore become serious sources of anxiety for those with investment interests in Saudi Arabia.

This thesis proposes a framework to analyse the historical background and recent development of the Saudi capital market, as it has significant implications for attempts to underline and illuminate corporate ownership structures and to understand the agency problem, particularly since it is dominated by highly concentrated government and family ownership. It examines some of the legal strengths and weakness that need to be implemented and challenged by Saudi policymakers to develop a corporate governance framework ensuring capital market stability and development. The thesis also appraises the landscape and value of institutional investors and of minority shareholders' protection, particularly suggesting improvements to the corporate governance regulatory framework intended to encourage activism among institutional investors as minority shareholders embedded in the existing system. Improving the protection of minority shareholders is considered important for long-term sustainable value creation in the Saudi capital market, helping to underpin company performance in the presence of many dominant shareholders and acting as direct monitors to ensure that these owners do not impose upon the development of equity markets by expropriating private benefits at shareholders' expense.

⁹ G Smith, 'The Exit Structure of Venture Capital' (2005) 53 UCLA Law Review 318 <<http://ssrn.com/abstract=272231>> [Accessed on 05/03/2014].

¹⁰ Although the government gradually removed restrictions and enabled a certain volume of FII through swap agreements, the Saudi capital market is still not completely liberalized for FII capital flows.

1.3 Research Background

This thesis explores two topical issues in international corporate governance: institutional shareholders' activism and the protection of minority shareholders in Saudi Arabia. Many financial crises appear to originate in emerging markets.¹¹ This happened between 1973 and 1995 in markets characterized by weak regulation and poor corporate governance practice.¹² One obvious characteristic of any system of corporate governance is to ensure that foreign investors, particularly minority ones, receive the protection required to sustain their confidence in the regulatory and corporate environment.¹³ Such investors will not have the confidence to invest in emerging markets again if they are perceived to have weak corporate governance systems and capital market regulations, in contrast with the strong protection of minority investors afforded by many developed countries such as the UK.

Conversely, the recent global financial crisis originated in the USA in 2007, emphasising the general failure of many corporate governance mechanisms not only in banking but also in corporations generally. This underlines the need for wholesale reform of existing corporate governance mechanisms, designed and developed over a number of years.¹⁴ It is alleged that one of the main causes of the recent crisis was the passivity of shareholders, who failed to exercise discipline over management.¹⁵ A Dutch former Minister of Finance thus asked what shareholders had done 'to prevent and manage the crisis. Unfortunately, [...] the answer is almost nothing'.¹⁶ However, the ability of shareholders to exercise a disciplinary role over management depends on the 'type, size, and capability of a particular shareholding and ... each type of shareholding has different monitoring abilities'.¹⁷ Consequently, the activism of institutional

¹¹ Renee Adams, 'Governance and the Financial Crisis' (2009) ECGI - Finance Working Paper 248/2009, 2 <<http://ssrn.com/abstract=1398583>> [Accessed on 05/03/2014].

¹² *ibid.*

¹³ Rafael La Porta et al, 'Investor Protection and Corporate Governance' (1999) 57 *J Financial Economics* 3 <<http://ssrn.com/abstract=183908>> [Accessed on 05/03/2014].

¹⁴ Mike Burkart and Panunzi Fausto, 'Agency Conflicts, Ownership Concentration, and Legal Shareholder Protection' (2006) 15 *J Financial Intermediation* 1 <<http://dx.doi.org/10.1016/j.jfi.2004.12.004>> [Accessed on 05/03/2014].

¹⁵ Hector Sants, 'The Crisis: The Role of Investors' (Paper presented at FSA NAPF Investment Conference, 2009) <fsa.gov.uk/pages/Library/Communication/Speeches/2009/0311_hs.shtml> [Accessed on 05/03/2014].

¹⁶ Speech at Eumedion Conference 3 March 2009 <minfin.nl/english/News/Speeches/Wouter_Bos/2009/02/Six_Questions_for_the_Banking_Sector> [Accessed on 05/03/2014].

¹⁷ A Kara, A Van Rixtel and Y Altunbas, 'Corporate Governance and Corporate Ownership: The Investment Behaviour of Japanese Institutional Investors' (2007) Banco de España Research Paper OP-0703, 3 <<http://ssrn.com/abstract=989286>> [Accessed on 05/03/2014].

investors has attracted commentators' attention as a promising potential avenue for overcoming problems related to corporate governance failures, and such shareholders are increasingly considered to be suitable parties to monitor management and dominant owners. Indeed, they are increasingly becoming a key factor in global capital markets.¹⁸ Institutional investors are major players not just in developed markets; they are rapidly extending their role in emerging and developing markets.¹⁹ Their role is to improve governance at the corporate and national levels, as much published research provides evidence of the important role that they play in promoting economic growth in countries with developing financial systems and in generating more dynamic growth and job creation.²⁰ This is because institutional investors have a fiduciary obligation to demand better performance and have considerable potential to demand improved corporate governance practices by becoming more active in the affairs of the companies whose shares they hold.²¹ In addition, the involvement of institutional investors should raise demand for a company's shares²² and lower the cost of its capital.²³

1.4 The Main Research Issue

The phenomenon of active institutional share ownership has received enormous academic attention in the field of corporate governance in the Western World, where diffused corporate ownership is a principal concern. Such institutions can work together on an improved corporate governance monitoring framework more effectively than individual investors for the governance of publicly-traded companies, using their influence more vigorously and in ways more fitting to a dominant concentrated corporate ownership environment in emerging and developing markets, such as in Saudi

¹⁸ Assets under management of institutions have tripled since the early 1990s. International Monetary Fund, 'Global Financial Stability Report' (2005) Market Developments and Issues <imf.org/External/Pubs/FT/GFSR/2005/02/index.htm> [Accessed on 05/03/2014].

¹⁹ A Khorana, H Servaes and P Tufano, 'Explaining the Size of the Mutual Fund Industry around the World' (2004) EFA 2003 Annual Conference Paper 804, 28 <<http://ssrn.com/abstract=573503>> [Accessed on 05/03/2014].

²⁰ Franck Wiebe, 'Institutional Investors and Corporate Governance Reform', The Asia Foundation 11 <<http://ier.hit-u.ac.jp/jprc/us-japan0304/wiebe-ppt.pdf>> [Accessed on 05/03/2014].

²¹ James Cox and Randall Thomas, 'Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?' (2002) Washington University Law Quarterly 16 <<http://ssrn.com/abstract=321426>> [Accessed on 05/03/2014].

²² Sergey Stepanov and Anton Suvorov, 'Agency Problem and Ownership Structure: Outside Blockholder as a Signal' (2009) EEA Session on Corporate Finance 15 <eea-esem.com/EEA-ESEM/2009/prog/viewpaper.asp?pid=2488> [Accessed on 05/03/2014].

²³ Stuart L Gillan and Laura Starks, 'Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective' (2003) Weinberg Center for Corporate Governance Working Paper 2003-01, 35 <<http://ssrn.com/abstract=480983>> [Accessed on 05/03/2014].

Arabia; their louder voice in environments dominated by concentrated ownership is more likely to bring improvements in corporate governance standards. However, while the level of share ownership in public companies by institutional investors has increased recently in emerging and developing markets, they are still too lax in their monitoring in most of these countries, because they are not influential enough to exercise shareholder activism. Therefore, a strengthened role for institutional investors in markets such as Saudi Arabia depends not only on the size of their investments but also on whether these horizontal concentrated ownership markets encourage institutional investors to exercise shareholder activism and are able to provide better legal protection for these investments.²⁴ Roe rightly argues that the level of access to capital will increase when the corporate governance regime becomes more efficient at protecting minority investors, because this will send a clear message to potential foreign institutional investors that the law prevents managers or dominant owners from gaining direct and indirect financial benefits for themselves.²⁵ Indeed, the contribution to emerging and developing markets of foreign institutions will grow when the laws and regulations governing these markets reassure them of the security of such investments, for example by protecting investors' rights, as the confidence of potential foreign investors comes partly from knowing that national laws will offer them solid protection and that the courts are well prepared to enforce their rights whenever needed, such as when managers or dominant owners of publicly-traded firms violate the terms of their contracts. Managers of companies in a weak legal system (that is, lacking strong company and capital market laws and an effective judiciary) may promise to treat potential foreign investors well, but can easily break their promises.²⁶ They may simply expropriate foreign investments, and investors will find themselves unable to resist for want of effective remedies.²⁷

Good company and capital market regulations can reduce the potential for expropriation, but there is a limit to what the country's legal system itself can do to mitigate governance problems as a consequence of the separation between ownership

²⁴ A Khorana, H Servaes and P Tufano, 'Explaining the Size of the Mutual Fund Industry around the World' (2004) EFA 2003 Annual Conference Paper 804, 4 <<http://ssrn.com/abstract=573503>>[Accessed on 05/03/2014].

²⁵ Mark Roe, 'Corporate Law's Limits' (2002) 31 J Legal Studies, Colombia Law and Economics Working Paper 186, 1 <<http://ssrn.com/abstract=260582>>[Accessed on 05/03/2014].

²⁶ Reinier Kraakman and Bernard Black, 'A Self Enforcing Model of Corporate Law' (1996) 109 HLR, 1912 <<http://ssrn.com/abstract=10037>>[Accessed on 05/03/2014].

²⁷ Rafael La Porta et al, 'Investor Protection and Corporate Governance' (1999) 57 J Financial Economics 2 <<http://ssrn.com/abstract=183908>>[Accessed on 05/03/2014].

and control in the modern company, by using derivative action to prevent managers or controlling owners from stealing the firm's assets or benefiting themselves in many ways.²⁸ Without such protection for shareholders' rights, the Saudi capital market will not develop sufficiently to attract all types of foreign investors.²⁹ If company and capital market regulations are not strong enough to protect investors' rights, particularly minority ones, investment will flow abroad and the country will lose the benefit of reforms made by the government to provide a strong foundation for investment. This would ensure that more institutional investors were actively involved in the workings of investee companies; it would encourage participation by institutional investors, contributing significantly to an improvement in Saudi corporate governance practices.

1.5 Research Aims

This thesis proposes that there should be a real strengthening of the role of institutional investors in corporate governance and improved protection for minority shareholders in publicly-traded companies in Saudi Arabia, to create a favourable investment destination for international capital.³⁰ It will argue that such reform would augment existing qualities of the Saudi legal environment in Arabia to attract domestic and foreign institutional investment. Institutional investors will also catalyse the modernization of the state- and family-dominated ownership structure of publicly-traded companies, rebalancing the power of governance in the Saudi capital market, where the many individual shareholders are presently unable to affect company policy, and turning it into a healthier pattern of ownership which will encourage the rapid growth and development of the country's capital markets.³¹

Therefore, the thesis will examine various elements of Saudi law concerning the legitimacy and extent of institutional shareholder activism, including regulations protecting minority shareholders and their interests in Saudi publicly-traded companies; that is, primary legislation as well as modern laws, including self-regulatory codes and capital market regulations. It will also examine the development of the Saudi corporate governance regime, focusing on the legal system and the history and development of corporate ownership structure, critically analysing the weaknesses of the Saudi legal

²⁸ Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and operation* (OUP 2007) 23.

²⁹ Roe (n25) 1.

³⁰ R Aggarwal, L Klappa and P Wysocki, 'Portfolio Preferences of Foreign Institutional Investors' (2003) MIT Sloan Working Paper 4328-03, 31.

³¹ Roe (n25) 1.

system and the difficulties the capital market would face in pursuing the reforms needed to make it a more conducive environment for institutional investor activism and the protection of minority investors. The aim is to promote a broader understanding among Saudi legislators of potential barriers to the engagement of domestic and foreign institutional investors as minority shareholders in monitoring corporate activities which need reform to prevent future corporate misbehaviour, having regard to lessons drawn from the experiences of developed countries. To boost the effectiveness of suggestions for reform, a comparison will be made with the UK corporate governance regime, focusing on the potential of institutional investor activism and minority shareholder protection to improve economic efficiency and growth in the Saudi capital market, as well as enhancing investors' confidence in Saudi Arabia.

1.6 Comparative Framework

The transferability of law or experience, called 'legal transplantation' from one jurisdiction to another, has been identified as an indicator of the growth of a country's legal rules as a result of borrowing.³² This practice has become increasingly important in the field of corporate governance as an effect of globalization, whereby increased global competition drives the adoption of best practice models of corporate governance to increase capital investment in a country.³³ This thesis draws comparisons between UK and Saudi practice, because the UK corporate governance framework is more advanced than those of many other markets.³⁴ 'The work which has been done in the [UK] has spurred reviews of corporate governance in markets around the world and has provided a yardstick against which investment frameworks in other countries are measured'.³⁵ Indeed, the UK can be said to lead developed countries in terms of the quality and transparency of the governance environment facing local and foreign investors in the companies in which they are most likely to invest.³⁶ It has made major

³² A Watson, *Legal Transplants: An Approach to Comparative Law* (Scottish Academic Press, Edinburgh 1974) 93-94.

³³ OECD , *Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets* (Paris: OECD 1998) 83. <<http://dx.doi.org/10.1787/9789264162709-en>>, [Accessed on 05/03/2014].

³⁴ Brian Cheffins, 'Current Trends in Corporate Governance: Going from London to Milan via Toronto' (1999) 10 *Duke J Comparative and International Law* 6 <<http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1225&context=djCIL>> [Accessed on 05/03/2014].

³⁵ *ibid.*

³⁶ Ian W Jones and Michael G Pollitt, 'Who Influences Debates in Business Ethics? An Investigation into the Development of Corporate Governance in the UK since 1990' (2001) ESRC Centre for

contributions to the field of corporate governance since the Cadbury Code in 1992; many countries have adopted the Cadbury principles, as have international organisations such as the OECD, in its principles of 1999.³⁷

Of particular interest are the comparative advantages for Saudi Arabia of adopting elements of the UK's 'third way' between shareholder primacy and stakeholders' rights and interests. The new corporate governance approach, of 'enlightened shareholder value', is exemplified by the UK Corporate Governance Code of 2010, while the Stewardship Code of 2010 is designed to encourage the engagement of institutional investors in corporate governance; by contrast, institutional shareholder activism is a new and rare phenomenon in Saudi Arabia. The Stewardship Code has become the UK's hallmark; there are 'similar initiatives under way in France, Canada, the Netherlands and elsewhere [and] there is growing interest in the UK's pioneering effort – which, like the 1990s Cadbury code on which today's code is based, may well become a model.'³⁸

All these achievements, including the high level of protection of minority shareholders' rights, have given the UK model a desirable status, making it an appropriate point of comparison for any scholar of corporate governance, institutional investors' activism and the protection of minority shareholders. The question here is whether the UK's new corporate governance approach to directors' duties is suitable for the transplantation of rules and institutions to Saudi Arabian company law. It can be said that there is already clear evidence of a tendency to transplant elements of the Anglo-Saxon model of shareholder primacy into the Saudi corporate governance model, as discussed in chapter 6, and there are clearly many similarities between the two countries at the legislative level concerning, for example, shareholders' rights, directors' duties and the characteristics of the board of directors under company law.³⁹ Meanwhile, it can be said that a clear advantage for Saudi Arabia of transplanting elements of the UK's new corporate governance approach to directors duties is that this approach is aligned not only with rationality, but with Shariah principles, which extend the accountability of directors beyond the interests of shareholders to those of employees,

Business Research Working Paper wp221, 2 <cbr.cam.ac.uk/pdf/WP221.pdf>[Accessed on 05/03/2014].

³⁷ Brian Cheffins, 'Corporate Governance Reform: Britain as an Exporter' (2000) 8 Hume Papers on Public Policy 26 <<http://ssrn.com/abstract=215950>>[Accessed on 05/03/2014].

³⁸ John Plender, 'Investing: Rules of engagement' *Financial Times* (London, 11 July 2011).

³⁹ Section 6.3.1

suppliers and society as a whole. In other words, the new UK approach to directors' duties fits well with the existing framework of principles and rules under Shariah, which are concerned not only with maximizing the wealth of shareholders but also with providing comprehensive guidelines for duties and practices that ensure justice, fairness of value and social welfare, and which enhance Islamic business culture with long-term investment. Hafeez argues that

the principle-based British model of corporate governance on the basis of the 'comply or explain' approach is beneficial for Islamic states to adopt those corporate governance practices which are not contradictory with the rules of Sharia[h]. The self-regulatory approach of the British model provides flexibility for the adoption and operation of Islamic principles of corporate governance to achieve good governance through alternative practices. The objectives of both systems of corporate governance seem similar and are to establish a sound system of corporate governance through efficient, effective management, corporate reporting and disclosure for long-term corporate stability, which should not only be beneficial to investors but to the rest of the stakeholders as well.⁴⁰

Therefore, it is critical to the future of the Saudi corporate governance framework to develop legislation to ensure the effectiveness of shareholders' monitoring and disciplining schemes, which hold managers and directors accountable for their actions. Meanwhile, the comparative framework of this thesis is intended to be of value to Saudi policymakers and academics who wish to learn more about how shareholder involvement can be encouraged in an environment of the high concentration of share ownership by government and families, considering any complications that may occur when the capital market is opened to foreign institutional investors.

1.7 Research Questions and Contribution

Recognising the importance given by Saudi Arabia to liberalising its markets and the fact that its economy is still strong and healthy, notwithstanding the recent originated

⁴⁰Malik Hafeez, 'An Analysis Of Corporate Governance In Islamic And Western Perspectives' (2013) 2(3) IJBE 103 <<http://klibel.com/wp-content/uploads/2013/05/MALIK-M-HAFEEZ-An-Analysis-of-Corporate-Governance-in-Islamic-and-Western-Perspectives.pdf>> [Accessed on 05/03/2014].

global financial crisis of 2007,⁴¹ the following challenging and critical questions are pertinent: First, with respect to any monitoring costs potentially incurred in relation to institutional shareholders' activism as a result of the highly concentrated government and family ownership of shares in many Saudi publicly-traded companies, does the Saudi legal framework of corporate governance encourage institutional investors to become active and qualified to solve the agency problem? Second, is it realistic and convincing for Saudi Arabia to build a culture of activism among institutional investors? A tentative partial response is that although ownership concentration by institutional investors is a promising avenue for overcoming the problems related to corporate governance in Saudi Arabia, it is unlikely on its own to be able to eliminate such problems. Indeed, it is uncertain whether the country's regulatory framework efficiently encourages activism among institutional investors or whether there are any natural reasons for them not to become activists, as there are potential costs associated with their investment decisions that may reduce their overall effectiveness.

Third, does the existing corporate governance regime afford Saudi and foreign shareholders the assurance and protection they need in order to attract their investment? How can this be done while protecting minority investors in particular, with effective legal devices to safeguard their interests, for example, in the event of misadministration by the management of Saudi publicly-traded companies or their dominant owners (insiders)? The focus of this thesis is thus mainly on whether the Saudi legal system is successful in providing strong protection to shareholders, particularly in relation to the rights of Saudi and foreign institutions as minority investors, allowing them to engage effectively in monitoring company affairs and controlling owners, and giving them access to effective remedies in the event of misadministration by directors. If the answer is affirmative, then the country and its publicly-traded companies will have adequate access to global finance. Conversely, external finance will remain inadequate or flow elsewhere, resulting in a significant decline in inward investment, if the country's legal system fails to maintain the confidence of foreign institutions as minority investors and to provide a culture of institutional investors' activism.

⁴¹ IMF Executive Board Article IV 09/109 (18 August 2009)
<imf.org/external/np/sec/pn/2009/pn09109.htm#P24_364>[Accessed on 05/03/2014].

1.8 Research Design and Structure

The first intention of this thesis is to enquire what role should be given to institutional investors in corporate governance, then to discuss the relationship between their activism and the protection of minority shareholders as a key development in the field of corporate governance. Therefore, chapter 2 begins by seeking a general understanding of the modern company and the agency problem between agents and principals in both diffused and concentrated ownership environments. The second step is to examine certain major corporate governance devices and to assess their tendency to reduce the agency problem between principals and agents. The chapter suggests that institutional investors have a major external role in corporate governance, helping to reduce the agency costs of the modern company, whatever the ownership environment. It also considers the national importance of protecting the interest and rights of minority shareholders, which is particularly desirable if the country seeks international capital to develop its economy. Chapter two ends by looking at the role that institutional investors can play in corporate governance and their contribution as an appropriate mechanism to reduce agency costs.

Chapter 3 seeks to classify institutional shareholders, to understand the general concept of institutional investment and to explore the influence of the various types of such investors on corporate governance, in terms of their approaches, investment strategies and activism behaviour. More importantly, the topic is their characteristic structures, which lead to the agency problem between institutional investors and beneficiaries.

Chapter 4 discusses the corporate governance regime and institutional shareholders' activism in the UK. It first offers a general understanding of the UK approach to corporate governance, then examines the recent development of the Companies Act 2006 as a core piece of corporate governance legalisation, particularly by reviewing section 172 and the protection of minority shareholders by the use of derivative actions. It then considers the role of institutional investors in corporate governance and the recent development of activism among them.

The focus of chapter 5 is on the Saudi capital market and its history; it discusses the development of corporate ownership to determine what role and value should be given to institutional investors. It also examines the role in corporate governance of the various types of Saudi institutional investors. Specifically, it diagnoses the investment

behaviours of public institutional investors such as public pension funds, of private institutional investors such as insurance companies and of other institutions including Islamic investment funds, with particular attention to the legal and regulatory frameworks that control them and their propensity toward activism.

Chapter 6 is mainly concerned with the legal framework of corporate governance and investor protection in Saudi Arabia. It catalogues the main legal bodies responsible for enacting laws and regulations and supervising their implementation, to show how such rules, whether binding or otherwise, are enacted and enforced. It describes the current legal status of the Kingdom, highlighting recent legal developments, then offers a critical evaluation of the main problems identified in its institutional settings and suggests solutions which might fit the Saudi environment. Next, it discusses the sources of law affecting the rights of minority shareholders and institutional investors' activism, whether or not they are primary. Finally, the chapter closely explores the level of shareholder activism in Saudi Arabia, identifies regulatory hurdles to institutional investors' activism and the protection of minority shareholders and proposes reforms.

The thesis ends with a general conclusion, which summarises the previous chapters concerning Saudi Arabia and makes general recommendations as to the necessary reform of laws and regulations promoting institutional investors' activism and ensuring the successful protection of minority shareholders.

1.9 Research Methods

Two main research methods are employed the doctrinal and traditional library based method. It consists of a review of the relevant literature from diverse sources, such as books, journals, magazines, newspapers and websites of both Western and Saudi origin. However, because concern with best practice, institutional investors' activism and the main principles of corporate governance has been relatively underdeveloped in the Saudi business and investment world, the literature on them is necessarily modest. In particular, scholarly journals, whether in Arabic or in any other language, have not discussed the legal aspects of corporate governance in the Kingdom. For this reason, other secondary sources will be important for the Saudi context, to allow for the comparative nature of the thesis. Examples of such resources are books, periodicals and

conference papers in both Arabic and English. Moreover, the relative dearth of academic literature covering business and investment in the Kingdom and the apparent lack of secondary sources on the subject require other tools to be used. Primary sources such as corporate laws, capital market regulations, cooperative insurance regulations, collective investment regulations, case law, other associated laws and regulations and PhD theses will be used to provide essential information. Analyzing such rules and regulations in the Saudi context in particular will be crucial to the present study, facilitating a fundamental understanding of institutional investors' activism and the protection of minority shareholders.

Chapter 2

The Role of Institutional Investors in Corporate Governance and Minority Shareholder Protection

2.1 Introduction

The role of institutional investors in corporate governance and the protection of minority shareholders, once largely of academic interest in developed countries, has come to the fore in emerging and developing countries following the increased separation of ownership and control in publicly-traded companies, raising the issue of whether modern companies should be managed and controlled in different ways in different countries. The agency issue arising from this separation has been the traditional way of understanding the governance issue and has long dominated the corporate governance research agenda. Institutional investors are now considered the most reliable external mechanism of control over corporate governance. Not only do they limit the agency costs that arise between managers and shareholders in developed countries like the UK, but the exploration of this issue is of great significance to the tension between minority shareholders and controlling owners in developing countries such as Saudi Arabia, where it is vital to ensure efficient utilization of corporate resources and to close the gaps between various corporate players, particularly controlling owners, thus increasing the value of the firms concerned. It has been said that the major reasons for the success of institutional investors in capital markets and their advantage in comparison with small investors are the number of shares that they hold,¹ their voting blocks² and the high level of information they gather.³ It is also important to give power to institutional investors as minority shareholders, through legal protection of their rights and by empowering them to use derivative actions to

¹ BJ Bushee, ME Carter and J Gerakos, 'Institutional Investor Preferences for Corporate Governance Mechanisms' (2009) 5 *J Management Accounting Research* <<http://ssrn.com/abstract=1070168>>[Accessed on 05/03/2014].

² *ibid.*

³ Michael Frenkel and Lukas Menkhoff, 'Are Foreign Institutional Investors Good for Emerging Markets?' (2004) 27 *The World Economy* 1280 <<http://ssrn.com/abstract=597016>>[Accessed on 05/03/2014].

prevent managers or controlling owners from stealing the firm's assets or benefiting themselves in other ways.⁴

The main contribution of this chapter is to establish the background to the role of institutional investors in corporate governance and in furthering the protection of minority shareholders in Saudi Arabia (discussed in more detail in chapters 5 and 6). First, it reviews the academic literature on the agency relationship and wider corporate governance as they relate to the problem of the separation of ownership and control in modern corporations, examining the agency models prevailing around the world. The second objective is to offer an overview of research into the effectiveness of the different corporate governance mechanisms in reducing agency costs and ensuring that managers or dominant owners do not expropriate value from shareholders. The third is to consider the protection of minority shareholders and the role that should be given to institutional investors as an external corporate governance mechanism.

The chapter is organised as follows. Section 2.2 outlines the history of modern corporations and the separation of ownership and control, including the Berle-Means theory of the firm, then section 2.3 considers the agency theory and the relationship between shareholders (principals) and managers or dominant controllers (agents). This is followed by a discussion of related agency costs in section 2.4, mainly addressing the specific nature of agency problems and agency costs, and the conflicting relationships between principals and agents. Moreover, corporate governance is defined in section 2.5, before section 2.6 discusses the effectiveness of corporate governance mechanisms and their weaknesses in mitigating agency conflicts. Section 2.7 reviews the protection of minority shareholders and section 2.8 argues for a role in corporate governance to be given to institutional investors, as a supplementary mechanism for controlling managerial and shareholder power. The chapter ends with a summary.

2.2 Separation of Ownership and Control

Bainbridge argues that the Anglo-Saxon conception of the modern firm is the greatest success of capitalism since its development during the late 19th century,⁵ 'contributing

⁴ Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and operation* (OUP 2007) 23.

⁵ Stephen Bainbridge, 'Shareholder Activism and Institutional Investors' (2005) UCLA School of Law, Law-Econ Research Paper 05-20, 4 <<http://ssrn.com/abstract=796227>> [Accessed on 05/03/2014].

both to its prosperity and to the freedom it promotes'.⁶ Indeed, meeting the contemporary demands of technological and financial developments is closely associated with the Anglo-Saxon model of corporate ownership,⁷ which continues to embrace different forms of ownership and management structure around the world. The most distinctive feature of the model is its ability to raise a great amount of capital to finance major investments, as new technologies are continually innovated, requiring heavy investment in a variety of industrial schemes.⁸ The demand for public corporate capital is growing and far exceeds that for any other model of small or medium firms such as partnerships and single proprietorships, which are unable to meet the increases in global economic obligations. Indeed, having access to or attracting as much capital as possible can be said to be a critical matter for publicly-traded companies or the modern model of corporate ownership, stemming from the fact that investors, who as a consequence of globalization have become global providers of funds and seek the maximum residual return, are naturally cautious and have different preferences as to how the funds which they provide ought be employed in the running of modern firms.⁹

There are concerns that those who control the use of these funds may not be motivated to use them in the most desirable way and fears that they would run firms either according to the wishes of investors or incompetently, with substantial influence and control.¹⁰ Jensen and Meckling argue that in the modern model of corporate ownership, when investors provide their funds to managers, who manage the firm's affairs, they want the managers to provide them with a return on their capital.¹¹ However, it is difficult for investors to be assured that managers will not waste the funds they provide or direct them to unattractive projects.¹²

⁶ Barry Norman, 'The Theory of the Corporation' (2003) *Ideas on Liberty* 22 <<http://fee.org/files/docLib/feat5.pdf>>[Accessed on 05/03/2014].

⁷ Malla Bhasa, 'Global Corporate Governance: Debates and Challenges' (2004) 4(2) *Corporate Governance* 7 <<http://ssrn.com/abstract=967916>>[Accessed on 05/03/2014].

⁸ Norman (n6) 22.

⁹ Bhasa (n7) 7.

¹⁰ Stephen Marks, 'The Separation of Ownership and Control', 1999, *Encyclopedia of Law and Economics* 696 <<http://encyclo.findlaw.com/5630book.pdf>>[Accessed on 05/03/2014].

¹¹ Michael Jensen and William Meckling, 'The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3(4) *J Fin Econ* 35 <<http://ssrn.com/abstract=94043>>[Accessed on 05/03/2014].

¹² Marco Becht, Patrick Bolton and Ailsa Röell, 'Corporate Governance and Control' (2002) *Finance Working Paper 02/2002*, 17 <<http://ssrn.com/abstract=343461>>[Accessed on 05/03/2014].

Much of the literature on the role and functioning of the modern firm is based on the assumption of dispersed ownership. This notion originally derives from a landmark work by Berle and Means,¹³ who discussed the impact of divergence in this extraordinary corporate ownership structure in the Anglo-Saxon model and note that although shareholders legally own firms, control is often left to professionally-trained managers.¹⁴ Consequently, they coined the expression ‘the separation of ownership and control’, which indicates that shareholders, while seeking the highest residual return, actually have little or no direct control over everyday operations or long-term policy.¹⁵ These are assigned to professional managers, who make decisions on how the investment capital is spent, how resources are allocated and what actions are undertaken on behalf of the investors.¹⁶

The Berle-Means thesis can be understood more clearly by reference to the structure of economic relations within partnerships or single proprietorships. Where such small firms have shareholders, they are the owners and thus control their affairs and enjoy the profits in full,¹⁷ unlike the situation in modern firms, where the owners have little or no direct control over management. Instead, such owners appoint a board of directors to direct the affairs of the firm on their behalf and the board then delegates everyday operations or long-term policy to professional managers.¹⁸ From an economic perspective, these arrangements mean that the modern firm is a common signatory and the entity that connects owners and managers as a nexus.¹⁹ Therefore, agency theory is said to offer ‘the answer to the mystery of a distinction of ownership and control [which] is a series of market-oriented constraints that serve to align to a substantial extent the interests of those running [firms] with the interests of those owning shares’.²⁰ It is

¹³ Adolph Berle and Gardiner Means, *The Modern Corporation and Private Property* (Contributors M L Weidenbaum, M Jensen, 2nd edn, Transaction Publishers 1991) 4.

¹⁴ Brian Cheffins, ‘Putting Britain on the Roe Map: The Emergence of the Berle-Means Corporation in the United Kingdom’ (2000) Paper presented at the 1999 Tilburg Conference on Convergence and Diversity in Corporate Governance Regimes and Capital Markets 4 <<http://ssrn.com/abstract=218655>>[Accessed on 05/03/2014].

¹⁵ Marks (n10) 692.

¹⁶ Bainbridge (n5) 4.

¹⁷ Marks (n10) 693.

¹⁸ Bainbridge (n5) 4.

¹⁹ John Boatright, ‘Ethics and Corporate Governance: Justifying the Role of Shareholder’ in Norman Bowie (ed) *The Blackwell Guide to Business Ethics* (2001) 2 <http://blackwellreference.com/subscriber/uid=63/tocnode?id=g9780631221234_chunk_g97806312212343>[Accessed on 05/03/2014].

²⁰ Cheffins (n14) 593.

interesting to observe that the agency theory approach to the modern firm,²¹ which financial economists use to account for contractual relationships,²² has also become an accepted theoretical perspective in law-and-economics studies, where it is used to examine the behaviour of firms (contracting constituencies and their relations).²³ Emphasis should be given here to Cheffins' statement that 'Law [scholars] who have chronicled the development of corporate law doctrines have typically neglected the economic trends that led to the rise of the [modern firm]'.²⁴

2.3 Agency Theory

Although developed by financial economists, agency theory is considered a subset of the economic theory of modern firms. In particular, it is said to be concerned with the 'nexus of contracts',²⁵ seeing the firm as a nexus of private contracts between shareholders and managers. This means that the fundamental proposition of the economic approach to the study of the modern firm is that all such firms can be understood as a nexus of contract negotiations resulting from bargaining among all the relevant contracting constituencies, each of which seeks maximum benefit.²⁶ In an ideal world, constituencies regularly sign a complete set of terms and conditions in their contractual relations, which specifies, for example, what the manager does and how the profits are allocated.²⁷ Thus, the nexus of contracts theory assumes such contracts to be incomplete in nature, not completely specifying the constituencies' obligations for every possible and predictable future occurrence; as a result, there may be a serious conflict of interest between them,²⁸ because shareholders may allot substantial so-called 'residual control' rights to managers to make decisions in partly-unpredictable circumstances

²¹ For a critique of agency theory, see Eric Orts, 'Shirking and Sharking: Agency law, Agency Costs, and a Dual Theory of the Firm' (1996) Department of Legal Studies, University of Pennsylvania 1-85 <<http://knowledge.wharton.upenn.edu/paper.cfm?paperid=558>>[Accessed on 05/03/2014].

²² Economically, the agency relation is a contract where the principal engages an agent to perform a service involving decision-making. Jensen and Meckling (n12) 5.

²³ The new economics approach of organizations has come to dominate the study of corporate law. Boatright (n19) 1.

²⁴ Cheffins (n14) 71.

²⁵ Bainbridge (n5) 4.

²⁶ Jensen and Meckling (n12) 9.

²⁷ Oliver Hart, 'Corporate Governance: Some Theory and Implications' (1995) 105(430) *Econ J* 680 <<http://jstor.org/stable/2235027>>[Accessed on 05/03/2014].

²⁸ Scott Baker and Kimberly D Krawiec, 'Incomplete Contracts in a Complete Contract World', Florida State University Law Review, Forthcoming; UNC Legal Studies Research Paper 899160, 1 <<http://ssrn.com/abstract=899160>>[Accessed on 05/03/2014]; Hart (n24)680.

which do not fully complement their interests.²⁹ Shleifer and Vishny point out that the contracting constituencies

would sign a complete contract that specifies exactly what the manager does in all states of the world, and how the profits are allocated. The trouble is, most future contingencies are hard to describe and foresee, and as a result, complete contracts are technologically infeasible. This problem would not be avoided even if the manager is motivated to raise as much funds as he can, and so tries hard to accommodate the financiers by developing a complete contract. ... As a consequence, the manager ends up with substantial residual control rights and therefore discretion to allocate funds as he chooses.³⁰

Indeed, the complexity of the divergence of interests between the modern firm's constituencies and managers was recognised in 1776 by Adam Smith, who asserted in *The Wealth of Nations* that

...[B]eing the managers of other people's money rather 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 a private copartnery frequently watch over their own. Like stewards of a rich man, they... 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 such a company.³¹

Accordingly, it would be impractical for all shareholders in a modern firm, who are usually only interested in profits and increasing the share price, to pursue the strategic and operational management of the firm,³² since they will often not possess the required expertise and skill.³³ Therefore, it is not surprising that the issues associated with the distinction between ownership structure and control in modern firms are intimately linked with the general problem of agency throughout the world.³⁴ Indeed, the dilemma

²⁹ Becht et al (n11) 14.

³⁰ Andrei Shleifer and Robert Vishny, 'A Survey of Corporate Governance' (1997) 52 J Finance 741 <<http://jstor.org/stable/2329497>>[Accessed on 05/03/2014].

³¹ Jensen and Meckling (n11) 1.

³² Joseph McCahery and Erick Vermeulen, 'Corporate Governance and Innovation - Venture Capital, Joint Ventures, Family Businesses' (2006) ECGI - Law Working Paper 65/2006, 6 <<http://ssrn.com/abstract=894785>>[Accessed on 05/03/2014].

³³ *ibid.*

³⁴ Jensen and Meckling (n11) 6.

which arises as a consequence of the separation of ownership and control has been raised as a concern by scholars of the agency relationship, who see a problem between shareholders and managers. The latter can easily expropriate shareholders, because they may pursue objectives attractive to them and may thus create direct and indirect financial benefits for themselves in many particular ways, which are not necessarily beneficial to foreign investors. For instance, Shleifer and Vishny refer to this ‘agency problem’ as ‘the difficulties financiers have in assuring that their funds are not expropriated or wasted on unattractive projects’.³⁵ In particular, Berle and Means highlight principal-agent problems such as

[t]he surrender of control over their wealth by investors [which] has effectively broken the old property relationship and has raised the problem of defining these relationships anew. The direction of industry by persons other than those who have ventured their wealth has raised the question of the motive force and the effective distribution of the returns from business enterprise.³⁶

These conflicts of interest are often referred to as agency problems. Most academic Western scholars have focused primarily on the agency problem between dispersed individual shareholders (principals) and managers (agents) in the US and UK markets.³⁷ They argue that in firms with dispersed corporate ownership, managers hold significant substantial influence and control, giving them an incentive to expropriate foreign investors’ wealth. The individual shareholders’ goals in such firms are to maximize corporate value, while managers prefer to engage in activities that maximize their own returns, rather than those of the investors.³⁸ This can vary from policies that justify paying them a higher salary (for example, by increasing the size of the firm), to the diversion of resources for their personal benefit, or simply refusing to give up their jobs in the face of poor performance.³⁹

Such agency relationships are common in economic and business life throughout the world, not just in the Anglo-American dispersed corporate ownership models, and are considered an element of the more general problem of contracting, which of course

³⁵ Shleifer and Vishny (n30) 741.

³⁶ Berle and Means (n13) 4.

³⁷ Eugene Fama and Michael Jensen, ‘Separation of ownership and control’ (1983) 26 JLE 1-2 <<http://ssrn.com/abstract=94034>>[Accessed on 05/03/2014].

³⁸ Shleifer and Vishny (n30) 742-43.

³⁹ *ibid* 742-43.

extends to the relationship between foreign investors and managers.⁴⁰ La Porta and colleagues allege that the agency problem is most pervasive in emerging and developing capital markets and that the rights of minority investors in those markets are not well protected.⁴¹ Accordingly, in emerging and developing markets like that of Saudi Arabia, the agency problem is likely to arise not between managers and shareholders, as in the US and UK, but between minority investors and controlling owners, who are usually either state bodies or wealthy families.⁴² This issue is addressed in chapter 5.⁴³ In addition, expropriation in emerging and developing capital markets can be seen in many ways:

[M]anagers can set up independent companies that they own personally, and sell the output of the main company they run to the independent firms at below market prices... An even more dramatic alternative is to sell the assets, and not just the output, of the company to other manager-owned businesses at below market prices... In short, straight-out expropriation is a frequent manifestation of the agency problem.⁴⁴

Moreover, in many emerging and developing economies (including Saudi Arabia), ‘pervasive clientelism (“cronyism”) and/or weak judicial systems, and often poorly defined property rights, tend greatly to weaken effective contract enforcement. Poor contract enforcement in turn renders the distinction between “residual” and non-residual claimants of doubtful applicability in practice.’⁴⁵

In such countries, concentration of corporate ownership is a general phenomenon and its dispersion (prevalent in the US and UK) is the exception. The separation of

⁴⁰ Torben Pedersen and Steen Thomsen, ‘European Patterns of Corporate Ownership: A Twelve-Country Study’ (1997) 28 *J International Business Studies* 774
<<http://questia.com/googleScholar.qst;jsessionid=KhGYWGNQVnY7xk2X1GRdgnWYchL8Pbs4LKnyLvyQQgyp817nLNQ4!1048096975!-1899210215?docId=5000592036>>[Accessed on 05/03/2014].

⁴¹ Rafael La Porta, Florencio Lopez de Silanes and Andrei Shleifer, ‘Corporate Ownership Around the World’ (1998) Harvard Institute of Economic Research Paper 1840, 2-5
<<http://ssrn.com/abstract=103130>>.

⁴² Stijn Claessens, Simeon Djankov and Larry Lang, ‘The Separation of Ownership and Control in East Asian Corporations’ (2000) 58 *J Fin Econ* 82
<sciencedirect.com/science/article/pii/S0304405X00000672>[Accessed on 05/03/2014].

⁴³ Section 5.3.

⁴⁴ Shleifer and Vishny (n30) 742.

⁴⁵ OECD, ‘Corporate Governance for Economic Development’ in *Business for Development: Fostering the Private Sector* (OECD 2007) 155 <http://keepeek.com/Digital-Asset-Management/oecd/development/business-for-development/corporate-governance-for-economic-development_9789264034228-6-en>[Accessed on 05/03/2014].

management from ownership control is rare in these countries (including Saudi Arabia), due to ownership structures dominated by the state or rich families, which use corporate pyramid schemes to increase control and participation in management,⁴⁶ addressed in chapter 5.⁴⁷ However, a common feature of the agency relationship between shareholders (principals) and agents (managers/controlling owners) in modern firms, whether in the US, the UK or the rest of the world, is that there may be serious conflicts of interest. Bhuiyan and Biswas give the following examples:

[Perception of risk] The agent is generally assumed to be a risk-avertter and the principal to be a risk-seeker or risk-avertter; [Degree of involvement with the organization] The agent might have a shorter duration with the organization than the principal; [Limit of earnings] The agent's earnings are fixed (in the absence of incentive payments), while the principal is the residual claimant; [Management decision-making] The principal does not directly take part in the management decision-making and control (i.e. ownership is separated from management); [Information asymmetry] There is information asymmetry between the agent and the principal; in fact, the principal is ignorant of many details of the agent's activity.⁴⁸

In particular, agency problems between individual investors and management generally arise from a mixture of asymmetric⁴⁹ or incomplete information⁵⁰ and differences in sensitivity to firm-specific risk.⁵¹ The difficulty is that the agent commonly has better information than the principal about the facts relevant to the firm's performance.⁵² Indeed, the advent of modern firms has created a risk-bearing function for foreign individual investors, while the managerial functions of control are separately performed by constituencies whose interests may conflict.⁵³ Berle and Means acknowledge this conflict of interest between shareholders and managers on one hand

⁴⁶ *ibid* 176.

⁴⁷ Section 5.3.3.1.

⁴⁸ MH Bhuiyan and P Biswas, 'Agency Problem and the Role of Corporate Governance' (2006) 52(25) *Bangladesh Accountant* 111 <<http://ssrn.com/abstract=1250842>>[Accessed on 05/03/2014].

⁴⁹ When managers have information that investors lack. Boatright (n19) 2.

⁵⁰ When certain information is not and perhaps cannot be known to investors. *ibid*2.

⁵¹ Bhuiyan and Biswas (n48) 112.

⁵² Henry Hansmann and Reinier Kraakman, 'Agency Problems and Legal Strategies' in R Kraakman et al (eds) *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP 2004) 1 <<http://ssrn.com/abstract=616003>>[Accessed on 05/03/2014].

⁵³ Eugenio de Nardis, 'Financial Derivatives and the Intrinsic Separation of Ownership and Control' (2009) *Studi e Note di Economia*, Forthcoming 5 <<http://ssrn.com/abstract=1347061>>[Accessed on 05/03/2014].

and minority investors and controlling owners on the other, asking whether there is ‘any justification for the assumption that those in control of a modern corporation will also choose to operate it in the interests of the owners’. They note that

[t]he answer to this question will depend on the degree to which the self-interest of those in control may run parallel to the interests of ownership and, insofar as they differ, on the checks on the use of power which may be established by political, economic, or social conditions... If we are to assume that the desire for personal profit is the prime force motivating control, we must conclude that the interests of control are different from and often radically opposed to those of ownership; that the owners most emphatically will not be served by a profit-seeking controlling group.⁵⁴

Such conflicts of interest in ownership could lead to a drop in corporate value as a result of the behaviour of managers or controlling owners.⁵⁵ Indeed, if the parties to the agency relationship are profit maximizers, especially shareholders who seek the highest residual return for the least cost in order to maximize their own wealth, there is good reason to presume that the managers or controlling owners will not always act in the best interest of these investors.⁵⁶ Instead, they may begin to create direct and indirect financial benefits for themselves in many ways and this divergence of interests will generate what economists describe as agency costs, both in monitoring agents’ performance and in suffering losses from any non-performance.

2.4 Agency Costs

This economic concept has played a great part in scholarly commentary on company law,⁵⁷ where such costs are normally categorised as contracting costs, transactions costs, moral-hazard costs and information costs.⁵⁸ In particular, Fama and Jensen refer to agency costs as ‘the costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests’, noting that they ‘include the value of output

⁵⁴ Berle and Means, *The Modern Corporation and Private Property* (Commerce Clearing House 1932) 141.

⁵⁵ Bhuiyan and Biswas (n48) 114

⁵⁶ Jensen and Meckling (n11) 5.

⁵⁷ Orts (n21) 5.

⁵⁸ Michael Jensen, *A Theory of the Firm: Governance, Residual Claims, and Organizational Forms* (2nd edn, Harvard University Press 2003) 138.

lost because the costs of full enforcement of contracts exceed the benefits'.⁵⁹ Jensen and Meckling divide agency costs into two categories: (1) bonding costs, incurred by managers or controlling owners with the purpose of assuring shareholders that their interests are being pursued;⁶⁰ (2) monitoring costs, are as foreign investors attempt to ensure that managers or controlling owners are acting in their interests.⁶¹ They attempt to explain defensive measures that a principal can take in order to control agency costs. The first suggested approach is to draw up a contract that links the agent's performance with shareholder interests, 'in some situation where it will pay the agent to expend resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions'.⁶²

However, in order for such a contract to be achievable, it would need expressly to state what agents should do to maximize the wealth of the investors. An incomplete contract, as mentioned before, would be an imperfect solution for shareholders if they and the managers or controlling owners were to develop such a contract that would regulate all future circumstances. Long-term incentive contracts could safeguard the interests of such shareholders better than incomplete ones. This is when individual shareholders have agreed to grant managers or controlling owners incentives under most future contingencies that are in line with the shareholders' interests if the managers or controlling owners follow the shareholders' guidelines and do what they want them to do.⁶³ Nevertheless, managers or controlling owners may still want to maximize their own interests by benefiting from the information asymmetry between management and shareholders. For example, Shleifer and Vishny argue that in 'high powered incentive contracts', low stock options could provide a significant opportunity for managers to engage in self-dealing. This is when managers or controlling owners decide terms that will give them some advantage, such as terms related to the firm's share price when managers know that it is likely to rise, rather than looking to the interests of the shareholders.⁶⁴

⁵⁹ Fama and Jensen (n37) 5.

⁶⁰ Jensen and Meckling (n11) 6.

⁶¹ *ibid* 6.

⁶² *ibid* 5.

⁶³ Shleifer and Vishny (n30) 744.

⁶⁴ *ibid* 745.

In many circumstances, managers or controlling owners merely have interests different from those of individual shareholders, whom their decisions may not always benefit. It is true that writing a contract seems to present a solution for the shareholders/owners in order to provide guidelines for the agents to carry out their wishes and it is for investors to employ effective designs of incentive monitoring and contract systems to limit the divergence of long-term incentive contracts, which could work better as monitoring devices than incomplete contracts. However, this is unlikely to be done by average shareholders, who are not organized and have little or no incentive to do so.⁶⁵ Managers or controlling owners would have the chance to conduct private dealing, particularly where long-term incentive contracts had been agreed with inadequate negotiators, such as a small number of shareholders or board members.⁶⁶

A second solution is to monitor the managers or controlling owners by instituting suitable incentives for them and by incurring monitoring costs intended to limit abnormal performance by the agent.⁶⁷ However, it is difficult to initiate this monitoring by any individual shareholders in firms with a dispersed or concentrated ownership structure, who are not organised and do not have the appropriate incentive to do so. Such individual shareholders will also own few shares and the cost of monitoring managers in dispersed firms is very likely to exceed the expected residual returns of dispersed individual shareholders.⁶⁸ Jensen and Meckling argue that ‘even the incurrence of sufficient monitoring and bonding costs does not necessarily ensure that the agent will maximize the [individual shareholders’] utility. Even after effective monitoring and bonding there will be some residual loss arising from the inability to ensure that the [manager or controlling owner] acts fully in the [individual shareholders’] interest, given existing monitoring and bonding devices’.⁶⁹ Indeed, the cost of monitoring is a key factor that is likely to affect investors’ monitoring behaviour to ensure that the manager or controlling owner effectively deploys the firm’s assets to maximize value.⁷⁰ An average shareholder has little or no incentive to monitor and often

⁶⁵ Diane Denis and John McConnell, ‘International Corporate Governance’ (2003) ECGI - Finance Working Paper 05/2003; Tuck-JQFA Contemporary Corporate Governance Issues II Conference 196 <<http://ssrn.com/abstract=320121>>[Accessed on 05/03/2014].

⁶⁶ Shleifer and Vishny (n30) 745.

⁶⁷ Jensen and Meckling (n11) 5.

⁶⁸ Denis and McConnell (n65) 196.

⁶⁹ Bhuiyan and Biswas (n48) 114.

⁷⁰ Stanley Feldman, *Principles of Private Firm Valuation* (Wiley 2005) 10.

faces collective action and free rider problems. These make it prohibitively expensive for small shareholders to act as monitors where they are dispersed in the US and UK corporate model or disorganized in the concentrated corporate model elsewhere in the world and where they cannot coordinate their efforts to share the benefits and costs of monitoring and control of the professional managers whom they have hired to run the firm, or of the controlling owners.⁷¹ As a result, they will tend to let these managers or controlling owners take decisions in a way that benefits them alone, so that the benefits are not shared with other shareholders. The assumption is that individual shareholders will not normally monitor managers or controlling owners. Moreover, the latter parties may be unwilling to respond to allegations of expropriation, knowing that individual shareholders are unlikely to possess the information needed to substantiate claims.⁷²

Indeed, information becomes more costly and difficult to collect from individual shareholders in many developing countries, where disclosure is not mandatory by means of a legal obligation. In such cases the only option available to individual shareholders is to bargain privately for the right to have information on certain key transactions.⁷³ Thus, the limitation of the individual shareholders' ability and incentive to monitor and influence management or controlling owners—as well as their lack of appropriate skills to engage in confidential negotiations with these parties in long-term contracts—including in Saudi Arabia, detailed in chapter 5,⁷⁴ raises the need to establish new large shareholders such as institutional investors to control agency costs through direct bargaining with the management or directors and controlling owners. Such large shareholders would have the power to influence the choice of corporate governance mechanisms or other means of ensuring that managers and directors act in the interests of investors, which is considered necessary to reduce the divergence between shareholders' interests and those of managers and controlling owners. If they assumed monitoring or other costly control activities, all shareholders would benefit, even if they did not bear the monitoring costs. Indeed, Bainbridge declares that shareholders 'care about the value of the residual claim on the [company]. Customers care about the quality and quantity of the goods produced by the [company]. Workers care about

⁷¹ Bushee et al (n1) 5.

⁷² Bainbridge (n5) 6.

⁷³ *ibid.*

⁷⁴ Section 5.2.

salary and conditions of employment. And so on. Under such conditions, efficient decision-making demands an authority-based governance structure.⁷⁵

Consequently, large empirical studies of corporate governance concentrate on agency problems and on investigating which specific mechanisms of corporate governance are effective at reducing agency costs and protecting the interests of shareholders from dishonest managers or controlling owners.⁷⁶ Strong institutional investors are becoming increasingly important. They could take an active role⁷⁷ and have the potential to influence managers' or controlling owners' activities through their large ownership of firms; they are also considered the ideal external governance mechanism to monitor the way in which managers or controlling owners distribute profits to individual fund providers.⁷⁸ On the other hand, legal rights and shareholder protection can play a significant role in reducing agency costs. Examples are rules and procedures that improve disclosure by the firm in favour of shareholders⁷⁹ or protect minority shareholders' rights and facilitate litigation to solve corporate governance problems. The essence of the derivative action lies in empowering institutional investors, who have the resources to exercise the right to enforce corporate claims on behalf of their injured firm and in exceptional circumstances to impose a threat of accountability on dishonest or negligent managers or controlling owners.⁸⁰ A board may often be unwilling to bring an action against the managers where the board members themselves are the wrongdoers, where they are substantially under their controlling influence or where they share personal interests with them. Before considering what role should be given to institutional investors in corporate governance and the protection of minority shareholders, the next section first defines corporate governance and examines the effectiveness and limitation of different internal and external corporate governance mechanisms.

⁷⁵ Bainbridge (n5) 6.

⁷⁶ SL Gillan and L Starks, 'Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective' (2003) Weinberg Center for Corporate Governance Working Paper 2003-01, 2 <<http://ssrn.com/abstract=480983>>[Accessed on 05/03/2014].

⁷⁷ Becht et al (n12) 21.

⁷⁸ Gillan and Starks (n76) 1.

⁷⁹ Brian Cheffins, 'Dividends as a Substitute for Corporate Law: The Separation of Ownership and Control in the United Kingdom' (2006) ECGI - Law Working Paper 69/2006, 6-7 <<http://ssrn.com/abstract=906068>>[Accessed on 05/03/2014].

⁸⁰ Reisberg (n4).

2.5 Corporate Governance

The literature on corporate governance sees it as the decisive answer to reducing agency costs and better protecting the interests of shareholders. Corporate governance is probably the control mechanism most widely used for the efficient employment of corporate resources. It has been described as ‘more than simply a technology. Infused with politics and shaped by history, it is not a variable that a firm can simply elect or contract around. Rather, it is an important constraint that limits and channels corporate evolution, even in very transitional times.’⁸¹ Still, it has been said that corporate governance is an ambiguous term;⁸² the real problem related to such research is the difficulty in clarifying its precise meaning⁸³ and indeed its equivalent in Arabic. Thus, the definitions of corporate governance introduced below are selective examples, some of which refer specifically to the relationship between principal and agent. The first definition to be considered here is that of Sir Adrian Cadbury, Chairman of the Committee on the Financial Aspects of Corporate Governance, which originated the UK Combined Code on Corporate Governance. Cadbury defines corporate governance as ‘the system by which business operations are directed and controlled’⁸⁴ and which holds ‘the balance between economic and social goals, and between individual and communal goals’.⁸⁵ He also defines corporate governance as ‘the system by which business corporations are directed and controlled’.⁸⁶ The OECD defines it as ‘the set of relationships between a company’s management, its board, its shareholders and other stakeholders. It provides the structure through which the company’s objectives are set, and the means of attaining these objectives and monitoring mechanisms are determined.’⁸⁷ The definition offered by Denis and McConnell is ‘the set of mechanisms – both institutional and market-based – that induce the self-interested controllers of a company (those that make decisions regarding how the company will be

⁸¹ John Coffee, ‘The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications’ (1999) Columbia Law School Center for Law and Economic Studies Working Paper 144, 11 <<http://ssrn.com/abstract=142833>> [Accessed on 05/03/2014].

⁸² Dalvinder Singh, *Banking Regulation of UK and US Financial Markets* (Ashgate 2007) 80.

⁸³ Brian Cheffins, ‘Law, Economics and the UK’s System of Corporate Governance: Lessons from History’ (2001) 1 *J Corporate Law Studies* 71 <<http://ssrn.com/abstract=268299>> [Accessed on 05/03/2014].

⁸⁴ Adrian Cadbury, *Corporate Governance and Chairmanship: A Personal View* (OUP 2002) 1.

⁸⁵ *ibid* 38.

⁸⁶ *ibid* 1.

⁸⁷ OECD, *Principles of Corporate Governance* (OECD 2004) 11 <<http://oecd.org/dataoecd/32/18/31557724.pdf>> [Accessed on 05/03/2014].

operated) to make decisions that maximize the value of the company to its owners (the suppliers of capital)'.⁸⁸

It has been argued that the understanding of corporate governance will vary when it is viewed from different perspectives:⁸⁹ from that of the shareholder, corporate governance deals 'with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment',⁹⁰ whereas if

...a broader approach is selected, which includes shareholders as well as stakeholders, corporate governance is: [. . .] the system of checks and balances, both internal and external to companies, which ensure that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity.⁹¹

Whatever definition is chosen, it is clear that corporate governance has increasing significance in the modern world, and it is essential that developed and developing capital markets enhance foreign investment by continuing to improve the legislative and regulatory frameworks that strengthen corporate governance and by adopting the best available rules and standards in this field.

2.5.1 OECD Corporate Governance Principles

Good corporate governance practice plays a significant role in increasing the confidence of shareholders in developed and developing capital markets. The Organization for Economic Cooperation and Development (OECD) first issued in 1999 a set of principles of corporate governance which provide guidelines for its member countries to adopt the best system in compliance with their domestic laws and regulations.⁹² The OECD principles, recognized internationally as a standard for sound corporate governance,⁹³ were revised in 2004 to respond to developments including corporate

⁸⁸ Denis and McConnell (n65) 1-2.

⁸⁹ Marlene Davies and Bernadette Schlitzer, 'The Impracticality of an International "One Size Fits All" Corporate Governance Code Of Best Practice' (2008) 23 *Managerial Auditing Journal* 532 <<http://emeraldinsight.com/Insight/viewContentItem.do;jsessionid=21CBD30C3FF3ADEF723534B5429D32D5?contentType=Article&contentId=1733191>>[Accessed on 05/03/2014].

⁹⁰ Shleifer and Vishny (n30) 737.

⁹¹ Davies and Schlitzer (n89) 532-533.

⁹² *ibid.*

⁹³ G Kirkpatrick and F Jesover, 'The Revised OECD Principles of Corporate Governance and their Relevance to Non-OECD Countries' (2005) 13(2) *Corporate Governance* 1.

scandals that focused the minds of governments on improving governance practice.⁹⁴ The 2004 revision reflects the experience both of OECD countries and of emerging and developing economies, emphasising the need for social and economic sustainability. Publicly-traded companies, especially those with concentrated ownership, can improve value to shareholders by adopting the principles of good governance. Indeed, following such principles helps to bridge the gap between the interests of foreign investors and corporate controllers, which increases investor confidence and reduces agency costs.⁹⁵

In the last few years, there has been a development of corporate governance systems in a number of Gulf Cooperation Council (GCC) countries, detailed in chapter 6,⁹⁶ but it has been said that one major disadvantage of the OECD principles is their weak power of enforcement, making the code a mere reference point for countries that wish to establish or reform their governance systems.⁹⁷ This is because the existing international rules and standards apply in different ways in developed and developing capital markets. Indeed, although corporate governance is believed not to be an area where ‘one size fits all’ in terms of best practice, some of the existing OECD guidance does not take full account of some important aspects of the legal systems of certain countries, where there is a need to interpret the model of corporate governance in relation to their own laws and regulations.⁹⁸ Each country has a unique set of corporate governance procedures corresponding to its legal framework and corporate ownership structure. Firms are administered differently from one country to another because of differing emphases on the relationships between the parties, arising from different ownership structures and legal systems, because they evolved from different economic and political systems. For example, there are two traditional corporate governance systems in the world, the insider and outsider models, each having its own emphasis on certain corporate governance mechanisms.⁹⁹

⁹⁴ *ibid.*

⁹⁵ *ibid.* 4.

⁹⁶ Section 6.3.2.

⁹⁷ Davies and Schlitzer (n89) 533.

⁹⁸ *ibid.* 534.

⁹⁹ A Cuervo, ‘Corporate Governance Mechanisms: A Plea for Less Code of Good Governance and More Market Control’ (2002) 10(2) *Corporate Governance* 84 <<http://ssrn.com/abstract=312105>> [Accessed on 05/03/2014].

Similarly, the financial literature suggests a number of corporate governance monitoring devices to reduce the agency problems in modern companies. For example, Jensen outlines four categories of single corporate governance devices: legal and regulatory mechanisms, internal control mechanisms, external control mechanisms and product market competition.¹⁰⁰ Agrawal and Knoeber identify seven controlling mechanisms of corporate governance: insider shareholdings, institutional shareholdings, shareholding by blockholders, a proportion of outsiders on the board of directors, debt financing, an external labour market for managers and a market of corporate control.¹⁰¹ An alternative set of mechanisms are partial ownership concentration of large shareholders; hostile takeovers and proxy voting; the delegation and concentration of power in the board of directors; alignment of managerial interests with investors through executive compensation contracts and clearly defined fiduciary duties for the Chief Executive Officer (CEO).¹⁰² Denis and McConnell characterise corporate governance control mechanisms as being either internal or external. Internal mechanisms refer to the board of directors and ownership structure, whereas the primary external mechanisms refer to the external market for corporate control (the takeover market) and the legal system.¹⁰³ Cremers and Nair also classify corporate governance mechanisms into two broad types: internal (blockholders and the board of directors) and external (takeovers and the market for corporate control).¹⁰⁴ Judge compares the primary corporate governance mechanisms that guide governance activities and business decisions around the world and argues that the capital market is the key Anglo-American governance mechanism, while this role in Western European and some Asian countries is filled by concentrated ownership patterns via pyramidal ownership structures. However, Scandinavian countries seem to rely on social norms, while Islamic countries appear to be influenced by Shariah law to guide business

¹⁰⁰ M Jensen, 'The modern industrial revolution, exit, and the failure of internal control systems' (1993) 48 *J Finance* 831 <<http://dx.doi.org/10.1111/j.1540-6261.1993.tb04022.x>>[Accessed on 05/03/2014].

¹⁰¹ Anup Agrawal and Charles Knoeber, 'Firm Performance and Mechanism to Control Agency Problem Between Managers and Shareholders' (1996) 31(3) *J Fin Quant Anal* 380 <<http://ssrn.com/abstract=6025>>[Accessed on 05/03/2014].

¹⁰² Becht et al (n12) 1.

¹⁰³ Diane and McConnell (n65) 2.

¹⁰⁴ M Cremers and VB Nair, 'Governance Mechanisms and Equity Prices' (2003) Yale ICF Working Paper 03-15; NYU; Ctr for Law and Business Research Paper 03-09; AFA 2004 San Diego Meetings, 1 <<http://ssrn.com/abstract=412140>>[Accessed on 05/03/2014].

decisions.¹⁰⁵ Much of the literature on finance and corporate law in corporate governance focuses on the collective action problems of shareholders.¹⁰⁶ Accordingly, the following section considers various corporate governance mechanisms and their effectiveness in reducing agency costs and monitoring capabilities to mitigate shareholders' collective action problems.

2.6 Limitations of Internal & External Corporate Governance Devices

The different capital markets are expected to narrow the divergence of interests between the shareholders and managers or controlling owners of a company, by serving as alternative or concurrent monitoring devices. The aim of this discussion is to outline briefly two internal devices: the right to vote and the board of directors. Three key external governance devices are then outlined: the appointment of outside or non-executive directors, external audit and the market for corporate control. The aim of the discussion is a representative rather than comprehensive evaluation of their precise effectiveness in developed countries, serving as a general outline to distinguish the limitations of these internal and external corporate governance mechanisms from those of their Saudi counterparts and to adumbrate the role that might be given to institutional investors as a legitimate external corporate governance device to reduce agency costs, discussed in chapter 6.¹⁰⁷

2.6.1 Voting Rights

Shareholder voting is receiving growing attention as an effective way of reducing agency costs.¹⁰⁸ For example, the OECD encourages its members to ensure that voting rights are given to investors to allow them to voice their discontent.¹⁰⁹ This powerful corporate governance instrument allows the exercise of control over firms, which can be employed to influence their managers. Shareholders are empowered to participate in the

¹⁰⁵ William Judge, 'Corporate Governance Mechanisms Throughout the World', *Corporate Governance: An International Review*, 2010 18(3), 159 < <http://dx.doi.org/10.1111/j.1467-8683.2010.00800.x> > [Accessed on 05/03/2014].

¹⁰⁶ Becht et al (n12) 12.

¹⁰⁷ Section 6.4.

¹⁰⁸ Jeffrey Gordon and Mark Roe (eds) *Convergence and Persistence in Corporate Governance* (Cambridge University Press 2004) 328, 336-8.

¹⁰⁹ OECD, *OECD Principles of Corporate Governance* (2004) II & III <http://valuebasedmanagement.net/articles_oecd_corporate_governance_principles_2004.html> [Accessed on 05/03/2014]. Shareholder coalition formation is one issue emphasized in the OECD's corporate governance principles.

operations of a company such as by voting in general meetings¹¹⁰ or on the board of directors.¹¹¹ Accordingly, directors will generally act in the interests of shareholders, because the latter might otherwise use their power to remove them.¹¹² Nonetheless, shareholders often choose not to participate in general meetings or to vote, a phenomenon known as ‘rational apathy’,¹¹³ even where voting is done by electronic means. Indeed, most developed countries have already undertaken reforms to accommodate the use of the most advanced modern communications¹¹⁴ in order to encourage individual shareholder participation, yet shareholder voting power is severely limited by the free rider problem,¹¹⁵ which means that some individual shareholders have no interest in learning about the companies they have financed, let alone participating in their governance.

Additionally, if voting rights are dispersed widely among a large number of shareholders, no single shareholder will have the incentive to engage in monitoring management or exercising his or her vote, so management will go unmonitored. What is worse, ‘minority shareholders have no real influence even if they vote’.¹¹⁶ In the case of the concentrated model of corporate ownership in countries such as Saudi Arabia, monitoring and voting are likely to be dominated by controlling owners, whose role in affecting the value of their companies in a developing market is likely to be negative, as they do not allow individual and minority investors to participate in running them. Due to weak company law and market defects, such minority shareholders are deprived of their rights compared to those in developed capital markets.¹¹⁷ Some individual shareholders, as argued in chapter 6, do not have the capability and skill to deal with

¹¹⁰ Eilis Ferran, *Company Law and Corporate Finance* (OUP 1999) 118-22.

¹¹¹ This right is not universal; common stock is sometimes non-voting.

¹¹² Reisberg (n4) 25.

¹¹³ On rational apathy theory, see IO Bolodeoku, ‘Corporate Governance in the New Information and Communication Age: An Interrogation of the Rational Apathy Theory’ (2007) 7 *J Corporate Law Studies* 111; Stephen Bainbridge, ‘Investor Activism: Reshaping the Playing Field?’ (2008) UCLA School of Law, Law-Econ Research Paper 08-12 <<http://ssrn.com/abstract=1130969>> [Accessed on 05/03/2014].

¹¹⁴ For example, the ‘communication provisions’ are defined by UK Company Act 2006, s 1143 and ss 1144-1148, together with Schs 4 and 5.

¹¹⁵ Michael Rubach, *Institutional Shareholder Activism: The Changing Face of Corporate Ownership* (Garland 1999) 48.

¹¹⁶ ‘A Modern Regulatory Framework for Company Law in Europe’ Consultative Document of the High Level Group of Company Law Experts, 14 <http://ec.europa.eu/internal_market/company/docs/modern/consult_en.pdf> [Accessed on 05/03/2014].

¹¹⁷ Mark Roe, ‘Corporate Law’s Limits’ (2002) 31 *J Legal Studies*; Columbia Law and Economics Working Paper 186, 1 <<http://ssrn.com/abstract=260582>> [Accessed on 05/03/2014].

voting information and materials, such as using proxy voting or cumulative voting to choose their representatives on the board of directors.¹¹⁸ It has been said that agency costs may be reduced if shareholders improve control by forming voting coalitions.¹¹⁹ However, these are usually temporary and tend to have a specific aim, e.g. the removal of incumbent management.¹²⁰

Significantly, research has established that the operating performance and valuation of firms were not influenced by investors' proposals, which did not appear to bring changes in corporate governance policy.¹²¹ Yet, as noted before, if shareholders remain unresponsive, managers or controlling owners will have the freedom to engage in self-dealing activities, to waste the firm's assets and to maximize their own return, rather than that of shareholders.¹²²

An alternative to institutional investors' activism, which is available to individual shareholders, is to use their voting rights to participate in the annual general meeting (AGM),¹²³ which offers a good opportunity for investors to ask questions of the managers, directors or controlling owners. However, these players may be able to control the type of questions and to limit the content of the information given, thus restricting the value of such investor participation.¹²⁴ It is argued in this circumstance that the corporate law specifying the activities of general meetings 'ignore[s] the potential value of a statutory right to ask questions'. Yet this appears to be the area identified as possibly the greatest source of value of the AGM, both as a device in the service of accountability and as means by which individual shareholders can gain insights not provided in company reports.¹²⁵

¹¹⁸ Section 6.4.1.

¹¹⁹ Rafael Crespi-Cladera and Luc Renneboog 'United We Stand: Corporate Monitoring by Shareholder Coalitions in the UK' (2001) 14 <<http://ssrn.com/abstract=276656>>[Accessed on 05/03/2014].

¹²⁰ *ibid* 4-5.

¹²¹ Jonathan Karpoff, Paul Malatesta and Ralph Walkling, 'Corporate Governance and Shareholder Initiatives: Empirical Evidence' (1996) *J Fin Econ* 365 <<http://ssrn.com/abstract=7551>>[Accessed on 05/03/2014].

¹²² Shleifer and Vishny (n30) 742-743.

¹²³ RR Drury 'The Relative Nature of a Shareholder's Right to Enforce the Company Contract' [1986] *CLJ* 219, 222-223.

¹²⁴ Reisberg (n4) 30.

¹²⁵ Paul Davies and Sarah Worthington, *Gower's and Davies Principles of Modern Company Law* (9th edn, Sweet & Maxwell 2012) 583.

2.6.2 The Board of Directors

For its part, the board is often considered one of the more important internal monitoring mechanisms and sources of corporate governance, which may serve to protect the interests of individual shareholders by taking appropriate action to monitor the work of managers. However, the size of the board and the quality of its decisions and performance are said to be critical: large boards are likely to be less effective than small ones.¹²⁶ A number of studies examine how boards fulfil some of the responsibilities commonly assigned to directors. For example, Weisbach studied the relationship between board composition and turnover of managers in relation to firm performance.¹²⁷ His results show that when boards are dominated by outside directors, CEO earning is more sensitive to firm performance than in firms with insider-dominated boards. Cotter et al found that when a board contained a majority of outside directors, investors received 20% higher returns than similar firms without a majority of outside directors.¹²⁸

The above discussion shows that internal mechanisms such as the board are more concerned with ongoing monitoring of the operations, disclosures and compensation activities of managers, whereas external mechanisms, it is argued below, ensure that managers are brought into line with investors' interests and use the assets of the firm efficiently to maximize its value.

2.6.3 Outside or Non-executive Directors

Outside or non-executive directors constitute an external corporate governance mechanism and can play an effective role in monitoring managers and controlling the owners of the firm by forcing them to take fair decisions. Independent directors can also play a major role in obliging the firm to put into practice the best corporate governance practice that protects the rights of its investors. They may do this in a number of ways, including reviewing the performance of the business, taking the lead where potential conflicts of interest arise, exercising their power to express views and take decisions in

¹²⁶ Jensen, 'The Modern Industrial Revolution' (n100), 831-880.

¹²⁷ Michael Weisbach, 'Outside Directors and CEO Turnover' (1988) 20 J Fin Econ 431-460. <sciencedirect.com/science/article/pii/0304405X88900530>[Accessed on 05/03/2014].

¹²⁸ JF Cotter, A Shivdasani and M Zenner, 'Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers?' (1997) 43, 2 J Fin Econ 195 <sciencedirect.com/science/article/pii/S0304405X96008860>[Accessed on 05/03/2014].

line with investors' interests, and contributing to strategy formulation.¹²⁹ Views are mixed on the extent to which including independent directors on a board is likely to control agency costs. For example, Agrawal and Knoeber found no evidence of a negative relationship between the percentage of outsiders on the board and firm performance.¹³⁰ There are also concerns about the cost of running companies as the role of independent directors is expanded. For instance, some believe that these directors increase the cost of running companies because of their lack of business knowledge and building up an effective line of communication with managers or controlling owners.¹³¹ Conversely, empirical evidence suggests that the appointment of independent directors results in increased share prices; therefore some suppose it to be a positive development.¹³² However, as the role and importance of independent directors increase, there is little clear evidence as to whether their enhanced powers represent a concerted, reliable and achievable instrument of control.¹³³ Indeed, it is doubtful whether having non-executive directors on the board will in itself afford protection to investors in Saudi Arabia, acting as a corporate governance device that will actually reduce agency costs and constitute an effective functional substitute for institutional investors' activism, as discussed in chapter 6.¹³⁴

2.6.4 Independent Auditors and the Market for Corporate Control

While independent auditors and the market for corporate control are also considered key elements of corporate governance, their role too can be limited.¹³⁵ Auditors, for example, are statutorily obligated to provide individual shareholders with autonomous and objective assurance of the reliability of the financial statements and other particular information supplied by the company, 'but [...] they do not have a supervisory role in corporate governance. They may identify only the deficiencies of directors in this regard but they cannot make good those deficiencies'.¹³⁶ Questions also remain about the

¹²⁹ A Agrawal and CR Knoeber, 'Outside Directors, Politics, and Firm Performance' (1998) 1 <<http://ssrn.com/abstract=85310>>[Accessed on 05/03/2014].

¹³⁰ *ibid* 21.

¹³¹ *ibid* 34.

¹³² S Rosenstein and K Wyatt, 'Outside Directors, Board Independence and Shareholders Wealth' (1990) 26 *J Fin Econ* 175 <sciencedirect.com/science/article/B6VBX-45910B6-7/2/3cdceffbbe45104582bd03ca3e02aca24>[Accessed on 05/03/2014].

¹³³ John Birds et al, *Boyle & Birds' Company Law* (6th edn, Jordans 2007) 395-97.

¹³⁴ Section 6.4.3.

¹³⁵ Birds et al (n133).

¹³⁶ *ibid* 398.

effectiveness of takeover as a mechanism of corporate control, as experienced in the USA and UK. Schleifer and Vishny state that takeover may not reduce agency costs, because when bidding managers or insiders overpay for acquisitions that bring them the wealth and benefits of control, they require a liquid capital market to provide finance,¹³⁷ while other commentators within law and economics have ‘entrusted the hostile takeover mechanism to discipline the managers by threatening to oust poor performers by bidders who would consolidate ownership and control’.¹³⁸ Lel and Miller identify the threat of takeover through increased takeover activity and greater monitoring of the management through increased independent foreign institutional ownership as two significant means through which M&A laws increase CEO turnover in poorly performing firms.¹³⁹

But it can be argued that the market for corporate control has no significant role or practical operation in transition economies and developing countries and that its effectiveness is subject to the unpredictability of governance in these countries.¹⁴⁰ Thus, this external corporate governance mechanism may not be effective in Saudi Arabia, where ownership is highly concentrated in the hands of the state and rich families, as discussed in chapter 5, and where it has been argued that the takeover market could not substitute for institutional investors’ activism.¹⁴¹ Although this is hardly a revolution, it seems consistent with the notion that various control mechanisms can complement and may have a role in minimising agency costs, whether in dispersed or concentrated corporate ownership.¹⁴²

2.7 The Protection of Minority Shareholders

A major problem preventing institutional investors from exercising their ownership rights in various emerging and developing countries is that their legal systems confer

¹³⁷ Shleifer and Vishny (n30) 742.

¹³⁸ Moshe Pinto, ‘The Role of Institutional Investors in the Corporate Governance’ (2006) German Working Papers in Law and Economics 1, 2 <bepress.com/gwp/default/vol2006/iss1/art1/> [Accessed on 05/03/2014].

¹³⁹ Ugur Lel and Darius Miller, ‘Does Takeover Activity Cause Managerial Discipline? Evidence From International M&A Laws’ (2013) 33-34. <http://dx.doi.org/10.2139/ssrn.1730316> [Accessed on 05/03/2014].

¹⁴⁰ Shleifer and Vishny (n30) 773.

¹⁴¹ Section 5.3.2.

¹⁴² Joseph McCahery, Laura Starks and Zacharias Sautner, ‘Behind the Scenes: The Corporate Governance Preferences of Institutional Investors’ (2010) AFA 2011 Denver Meetings Paper; Tilburg Law School Research Paper 010/2010, 4 <<http://ssrn.com/abstract=1571046>> [Accessed on 05/03/2014].

limited rights and protection on minority shareholders to deal with the agency problem of controlling shareholders.¹⁴³ An international comparison of corporate governance systems is presented by La Porta et al, whose empirical studies have given the so-called ‘law-and-finance’ theory powerful support by investigating the relationship between legal systems and corporate governance in 49 countries around the world.¹⁴⁴ They found that common law countries had the best legal systems and that their corporate governance rules and standards focused strongly on protecting the rights and interests of shareholders.¹⁴⁵ Empirical studies in law and finance deal primarily with the legal protection of minority investors, demonstrating that laws protecting minority investors matter for financial and economic development. Moreover, the literature illustrates that protecting minority investors is paramount in ensuring the overall strength of a country’s capital market and reassuring investors.¹⁴⁶ It also shows that countries with poor minority investor protection have smaller equity and debt markets, while those with better protection have more developed capital markets and higher growth.¹⁴⁷ With their rights protected, minority investors are indisputably willing to pay more for financial assets such as equity and debt.¹⁴⁸ Empirical studies in law and finance further indicate that companies in countries with stronger minority investors’ rights give higher returns than companies in the same business in countries with weaker minority investors’ rights.¹⁴⁹ There is also evidence that companies located in countries with weaker minority investor protection may obtain less external finance and have poorer market valuations relative to their book assets.¹⁵⁰ This supports the basic thesis that minority investors do not trust managers in these countries to use their assets effectively or to generate high profits.

The law-and-finance literature shows that it is not only the quality of the legal rules that matters; the enforcement of minority investors rights’ is also a key feature in

¹⁴³ Stijn Claessens and Joseph Fan, ‘Corporate Governance in Asia: A Survey’ (2002) 3 *International Review of Finance* 95 <<http://dx.doi.org/10.1111/1468-2443.00034>>[Accessed on 05/03/2014].

¹⁴⁴ R La Porta et al, ‘Law and Finance’ (1998) 106 *J Polit Econ* 1113 <<http://ssrn.com/abstract=139134>>[Accessed on 05/03/2014].

¹⁴⁵ *ibid* 1139.

¹⁴⁶ *ibid* 1152.

¹⁴⁷ Rafael La Porta et al, ‘Investor Protection and Corporate Governance’ 2000, *J Fin Econ* 58, 2 <http://economics.harvard.edu/files/faculty/56_IP_CorpGov.pdf>

¹⁴⁸ Rafael La Porta et al, ‘Legal Determinants of External finance’ (1997) NBER Working Paper w5879 <<http://ssrn.com/abstract=8179>>[Accessed on 05/03/2014].

¹⁴⁹ Rafael La Porta et al, ‘Agency Problems and Dividend Policies around the World’ (2000) 55 *J Finance* 26 <<http://jstor.org/stable/222549>>[Accessed on 05/03/2014].

¹⁵⁰ La Porta et al, ‘Corporate Ownership’ (n41) 36.

creating an effective business atmosphere and good corporate governance. This does not mean that the laws are less important than enforcement, but that laws are required for the judiciary to enforce them.¹⁵¹ Furthermore, effective law enforcement is a prerequisite of any legal system. Early work on law-and-finance theory identifies a strong correlation between a country's legal system and the quality of its enforcement on one hand and the growth, development and stability of its capital market on the other.¹⁵² Accordingly, clearly defined legal protection of minority investors and its strong enforcement in any country will result in high stock market capitalisation as a percentage of GDP, more numerous initial public offerings and a greater number of publicly-traded companies relative to population.¹⁵³

Nevertheless, the main conclusions of the law-and-finance literature are that institutional investors as minority shareholders face different legal systems and protection depending on the country in which they plan to make an investment and that the common law system generally provides a more favourable basis for financial development and economic growth, whilst the civil law tradition is the least favourable in this respect.¹⁵⁴ La Porta et al identify a number of dimensions of shareholders' rights, including voting rights, remedial rights, cumulative voting and pre-emptive rights, proposing an 'anti-director rights index' in order to test the quality of their enforcement.¹⁵⁵ Their research also compares the extent of protection of minority investors in various countries against expropriation by the company's agents and determines whether the company law in each jurisdiction is strong and confers good protection on minority investors. Such law-and-finance literature has been attacked by many economists and other commentators, one of whom describes the dimensions invoked as 'dummy variables' and claims that 'there is not much evidence that common law countries protect financial investors better than civil law countries'.¹⁵⁶ Nonetheless, it can be said that empirical studies have shown that institutional investors' preferences

¹⁵¹ La Porta et al, 'Law and Finance' (n144) 1140.

¹⁵² *ibid* 1145.

¹⁵³ La Porta et al, 'Investor Protection' (n147) 15.

¹⁵⁴ La Porta et al, 'Law and Finance' (n144) 1151.

¹⁵⁵ *ibid* 1127.

¹⁵⁶ Michael Graff, 'Law and Finance: Common Law and Civil Law Countries Compared' (2008) 75(297) *Economica* 20 <<http://ssrn.com/abstract=1079182>>[Accessed on 05/03/2014].

vis-à-vis investor protection at the country level are broadly in line with and underscored by the law-and-finance literature.¹⁵⁷ This issue is explored in chapter 6.

Another critical study indicates that if the lack of protection of minority shareholders is one of the more salient features of English company law, the rule in *Foss v Harbottle* is largely to blame.¹⁵⁸ Yet the credibility of the law-and-finance approach and the effectiveness of its main conclusions are clearly seen in developments made in common law jurisdictions to protect institutional investors as minority shareholders and endorse improvements to corporate governance. The latest positive example of improved corporate governance in common law jurisdictions is the amendment of the derivative action commonly used there. This minority shareholders' remedy, which allows institutional minority investors to pursue an action on behalf of the company against its directors for their misadministration, has been reformed in most common law jurisdictions to a statutory derivative action, designed to provide more modern, flexible and accessible criteria, giving it an important role in effective corporate governance. It has also brought greater clarity and certainty to an area of law once renowned for its complexity. For example, in the UK, one of the most important features of the Companies Act 2006, as discussed in chapter 4, is that it replaces the common law's derivative procedures and those characteristics of the rule of *Foss v Harbottle* that have been applied to such actions, introducing the statutory derivative action.¹⁵⁹

Many other jurisdictions are looking into giving minority investors more protection, by introducing, amending or implementing company laws or codes to enable the statutory derivative action. This indicates that although foreign institutional investors may bring corporate governance changes to emerging and developing economies, enhancing the investment of institutional investors also requires a fundamental response by the country to ensure changes in the regulatory environment and to impose productive governance rules to strengthen the protection of minority investors' rights and interests. Such actions and changes are essential, because if controlling owners are given full discretion to decide their corporate governance strategy, they are likely to

¹⁵⁷ McCahery et al (n142) 36.

¹⁵⁸ JM Garrido García, 'Company Law and Capital Markets Law' (2005) 69 *Rabel J Comparative and International Private Law* 4 n 767 <<http://jstor.org/stable/27878558>>[Accessed on 05/03/2014].

¹⁵⁹ Birds et al (n133) 682.

write ineffective rules, making it impossible for minority shareholders to be fully engaged and participate in negotiations.

Additionally, even if controlling owners have the right incentives to design an efficient corporate strategy at first, they may want to break it or change it to their private advantage. Therefore, controlling owners in a concentrated ownership environment may not be able to build a credible reputation for treating outside investors well if minority investors do not take an active interest in their companies and participate in making important decisions.¹⁶⁰ Improved minority shareholder protection in Saudi Arabia, as discussed in chapter 6, may then require the intervention and activism of institutional shareholders as well as the essential regulatory environment. A system where derivative action is considered an important remedy must be legally available to institutional investors as minority shareholders, allowing them to challenge controlling corporate owners.¹⁶¹ Meanwhile, the next section considers what role institutional investors have in corporate governance and what institutional shareholders can achieve as an external corporate governance mechanism in the light of the limited consequence of different internal and external corporate governance mechanisms to reduce agency costs in modern companies.

2.8 The Role of Institutional Investors in Corporate Governance

The central question to be asked here is: ‘Which mode of corporate governance – a director primacy model or a shareholder-centric model – holds the greatest promise for enhancing firm value?’¹⁶² As discussed earlier, principal-agent problems are likely to persist as long as modern corporations exist, whether with dispersed or concentrated ownership. However, a wide range of corporate governance mechanisms may be used in different legal systems to limit them significantly. These internal and external devices are important control mechanisms, reducing agency costs and serving the interests of investors and corporate managers or controlling owners, but most are imperfect for one reason or another.¹⁶³ Indeed, there are serious limitations and constraints on the

¹⁶⁰ La Porta et al, ‘Investor Protection’ (n147) 4.

¹⁶¹ Section 6.5.4.1

¹⁶² Lawrence Mitchell, ‘The Legitimate Rights of Public Shareholders’ (2009) GWU Legal Studies Research Paper 461, 5 <<http://ssrn.com/abstract=1352025>>[Accessed on 05/03/2014].

¹⁶³ Roe (n117) 15.

effectiveness of similar devices that may not work to reduce agency costs in Saudi Arabia, as discussed in chapter 6, while each control mechanism has its limitations. The monitoring and supervision of management are also difficult and expensive tasks; although investors could decide to take an active role in monitoring management, they are discouraged from doing so because the benefits to them will depend on the size of their shareholding; thus, an individual investor has little or no incentive to exert monitoring pressure, being better off taking a free ride. Individual shareholders tend to prefer trading to making their voices heard: if they are not satisfied with company performance or management behaviour, they simply sell their shares and thus rid themselves of the problem.¹⁶⁴

Recently, institutional investors have been considered an increasingly important external control mechanism affecting governance around the world, having the potential to influence managers' and directors' activities through their large ownership stakes. This role of institutional investors in corporate governance came to the forefront as an endogenous response not only to the financial crisis of 2008 and recent calls to subject institutional investors to stewardship regimes; indeed, since the 1980s, various scholars have argued that institutional investors play an important role in corporate governance and could become an important constraint on agency costs. For example, Shleifer and Vishny argue that institutional shareholders would have incentives to monitor corporate performance, since they have greater benefits from monitoring. Their easy access to company information, coupled with their concentrated voting power, should enable them to monitor performance more actively and so to discipline corporate managers.¹⁶⁵ There is also empirical evidence that monitoring by large shareholders may strengthen corporate governance and improve corporate performance. For example, '...institutional investors can provide a strong stimulus to the development of securities markets. They can ... modernize capital markets, enhance transparency and information disclosure, and strengthen corporate governance',¹⁶⁶ while there is evidence that the performance of publicly-traded companies improves after institutional investors purchase shares in them and that their presence 'leads to more informative prices, and consequently lower

¹⁶⁴ Bhuiyan and Biswas (n48) 114.

¹⁶⁵ Bernard Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice' (1992) 39 *UCLA Law Review* 887 <<http://ssrn.com/abstract=1132082>>[Accessed on 05/03/2014].

¹⁶⁶ Dimitri Vittas, 'Institutional Investors and Securities Markets: Which Comes First?' (June 1998) *World Bank Policy Research Working Paper* 2032, 18 <<http://ssrn.com/abstract=597209>>[Accessed on 05/03/2014].

monitoring costs for all investors. Thus, the outcome should be better monitoring of managers and better corporate governance.’¹⁶⁷

The evidence is mixed on the role of institutional investors in corporate governance in an environment of concentrated ownership: the Asian financial crisis of 1997 indicated that corporate governance mechanisms can have limited effectiveness in systems with a weak presence of institutions and poor property rights,¹⁶⁸ while Vittas claims that ‘some of the beneficial effects of institutional investors are taking place faster in developing countries because of the experience gained in advanced countries and because of the transfer of financial expertise that electronic technology and globalization make possible in modern times.’¹⁶⁹ Globally, institutional ownership was found to have ‘a direct effect on corporate governance outcomes, functioning as a disciplinary mechanism in terminating poorly performing CEOs. Furthermore, increases in institutional ownership lead to increases in firm valuation, suggesting that institutional investment not only affects governance mechanisms, but also has real effects on firm value and board decisions.’¹⁷⁰ Similarly, a study in Korea found that ‘the institutional investors’ role in corporate governance reform is becoming increasingly important – they are essential tools in the reform machinery.’¹⁷¹ This is also the case in Saudi Arabia, as will become clear in chapters 5 and 6; although the presence of institutional investors is less significant in the Saudi capital market, they are still an important element helping to facilitate different internal and external corporate governance devices. In addition, Mizuno recently examined the relationships of institutional investors with corporate governance and of institutional investors’ shareholdings with firm performance, reporting that corporate governance in Japan had

¹⁶⁷ Gillan and Starks (n76) 35.

¹⁶⁸ Claessens and Fan (n143) 71.

¹⁶⁹ Vittas (n166) 18.

¹⁷⁰ Reena Aggarwal et al, ‘Does Governance Travel Around the World? Evidence from Institutional Investors’ (2010) *J Fin Econ* 148

<<http://sciencedirect.com/science/article/pii/S0304405X10002540>>[Accessed on 05/03/2014].

¹⁷¹ JF Solomon, A Solomon and C-Y Park, ‘The Evolving Role of Institutional Investors in South Korean Corporate Governance: Some Empirical Evidence’ (2002) *10 Corporate Governance* 222
<<http://ssrn.com/abstract=314292>>.

been enhanced by institutional investors.¹⁷² A recent OECD report on the role of institutional investors in promoting good corporate governance practices states:

While the issues surrounding institutional investors are particularly important for those markets with diffused ownership and a large institutional shareholder base, they are also crucial in most jurisdictions within and outside the OECD area characterised by concentrated ownership [including the] Middle East/North Africa (MENA). Nevertheless, a number of reports note that actual practices have often fallen short of the potential, with institutions too often taking a passive role and failing, or not being able, to exercise their ownership rights in an active and informed manner.¹⁷³

Finally, it can be said that the role of institutional investors in corporate governance in many emerging and developing capital markets is more positive than many local institutional investors. For example, foreign institutional investors were positively associated with firms' efforts to achieve better corporate governance in the Korean capital market,¹⁷⁴ while an empirical study in China found that compared with domestic funds, '[t]he dramatic growth of the [qualified foreign institutional investors] scheme may by itself force improvement in the area of corporate governance in China.'¹⁷⁵

2.9 Chapter Summary

This chapter has reviewed theoretical and empirical studies of the impact of corporate ownership, with particular attention to the agency problem. Several major themes emerge from the existing literature. Shareholder passivity, inherent in the dispersed ownership structure of modern companies, results in control of the company passing to its management, bringing into focus the concerns of separating ownership and control prefigured by Berle and Means.¹⁷⁶ The complexity of the divergence of interests among the modern firm's constituencies and the issues associated with the distinction between

¹⁷² M Mizuno, 'Institutional Investors, Corporate Governance and Firm Performance in Japan' (2010) 15 *Pacific Economic Review* 653 <<http://dx.doi.org/10.1111/j.1468-0106.2010.00521.x>>[Accessed on 05/03/2014].

¹⁷³ OECD, 'The Role of Institutional Investors in Promoting Good Corporate Governance' in *Corporate Governance* (OECD 2011) 21 <<http://oecd.org/daf/corporateaffairs/corporategovernanceprinciples/49081553.pdf>>[Accessed on 05/03/2014].

¹⁷⁴ Joon Kim et al, 'Foreign Investors and Corporate Governance in Korea' (2010) 18 *Pacific-Basin Finance Journal* 401 <sciencedirect.com/science/article/pii/S0927538X10000296>[Accessed on 05/03/2014].

¹⁷⁵ Ningyue Liu et al, 'Domestic and Foreign Institutional Investor Behavior in China' (2011) 22 *Euro J Fin* <<http://tandfonline.com/doi/ref/10.1080/1351847X.2012.671778#tabModule>>[Accessed on 05/03/2014].

¹⁷⁶ Berle and Means (n13) 4.

ownership structure and control in modern firms are intimately linked with the general problem of agency everywhere. Much literature on the role and functioning of the modern firm is based on the assumption of dispersed ownership, but in transition, emerging and developing markets corporate ownership remains generally concentrated and its dispersion (prevalent in the US and UK) is the exception. Although large empirical studies of corporate governance concentrate on agency problems and on investigating which specific mechanisms of corporate governance are effective at reducing agency costs and protecting the interests of shareholders from dishonest managers or controlling owners, direct intervention by individual shareholders is presumed to be unlikely, whether in dispersed or concentrated ownership structures. In short, the various corporate governance mechanisms are not effective enough at reducing agency costs and protecting the interests of shareholders from dishonest managers or controlling owners.

Meanwhile, attention should be paid to the importance of the legal system in protecting the rights and interests of minority shareholders, and the power of managers and controlling owners in concentrated ownership structures should be taken into consideration, alongside the notion that legal rights can play a significant role in reducing agency costs, protecting minority shareholders' rights and facilitating litigation to solve corporate governance problems. This chapter has further attempted to address the question of whether the role of institutional shareholders in corporate governance needs to be reinforced, thus helping to reduce agency costs. It has argued that institutional shareholders, as a source of corporate discipline, are likely to have a stronger role in corporate governance than alternative mechanisms such as non-executive directors, which have exercised imperfect control and failed to build a comprehensive picture of monitoring. The above discussion has not covered all aspects of the role of institutional investors in activism, as the space for doing so is limited. Attention turns in the following chapter to the growing importance of institutional shareholders and their links with the development of global capital markets.

Chapter 3

Classes of Institutional Shareholders and Determinants of their Activism

3.1 Introduction

The previous chapter discussed the agency relationship and corporate governance challenges arising in both developed and emerging economies. Following that analysis, this chapter considers aspects of institutional shareholders' behaviour, especially the cost-benefit considerations and other rationales that influence their decision to become active monitors engaged with the governance of publicly-traded companies. The chapter defines the concept and categorizes the different classes of institutional investors. It provides an analysis of institutional investors' characteristics and of their influence on corporate governance, then seeks an understanding of how they operate in the corporate environment and of their role in corporate governance. In particular, it discusses the ways in which institutional shareholders seek to exercise a corporate governance function, exploring their interventions and the influence that they have over managers and controlling owners in reducing agency costs.

Following this introduction, section 3.2 discusses the innovation and rise of institutional investors in the global capital markets. Section 3.3 offers definitions of the institutional investors and section 3.4 discusses the diverse main types of institutional shareholders around the world. Section 3.5 focuses on institutional shareholders' activism and discusses the determinants of the efficiency of the distinctive functions of institutional investors that affect their tendency to engage in activism, such as their investment approach (voice/exit), investment behaviour and conflicts of interest.

3.2 The Rise of Institutional Investors

Many observers and academic commentators have noted the potential implications of the rising global importance of institutional investors. Their evolution, particularly under the slogan of 'corporate governance reform', has come to be one of the central issues in the international corporate governance debate, as a consequence of the substantial financial resources which such investors have enjoyed since 1990, a development which was necessary to meet the increasing dimensions of economies of scale, as Vittas points out:

Institutional investors can act as a countervailing force to the dominant position of commercial banks and thus promote competition and efficiency in the financial system. They can also stimulate financial innovation, modernize capital markets, enhance transparency and information disclosure, and strengthen corporate governance.¹

One of the most remarkable changes in global finance since the 1990s is the rise of ‘institutionalisation’,² which can be understood as a large and ‘successful innovation’,³ widely promoting competition and efficiency in financial markets. Historically, this innovation arose in the USA in the twentieth century as a new wave of ownership was substituted for individual diffused ownership.⁴ This transformation of institutional shareholders has now spread to many emerging and developing markets;⁵ in 1980 there were probably just ten countries where institutional investors controlled assets greater than 50% of gross domestic product (GDP),⁶ but since then, institutional shareholders have increased their ownership dramatically in the capital market to become well-functioning professional investors with a high level of investment assets. The OECD estimates that the total institutional assets of its member countries in 2005 were more than ‘US\$ 40.3 trillion, equivalent to 162.6 per cent of GDP where the US holds the highest share, with half of the market share, followed by Japan and the UK with respectively 18% and 8.4% of the area’.⁷

This innovation is the result of many factors, such as a major but gradual change in the ownership structure of companies from ownership by individual investors with a

¹ Dimitri Vittas, ‘Institutional Investors and Securities Markets: Which Comes First?’ (1998) World Bank Policy Research Working Paper 2032, 6 <<http://ssrn.com/abstract=597209>>[Accessed on 05/03/2014].

² *ibid.*

³ Lukas Menkhoff, ‘Institutional Investors: The External Costs of a Successful Innovation’ (2002) 36 *J Economic Issues* 907 <<http://jstor.org/stable/4227841>>[Accessed on 05/03/2014].

⁴ Anju Seth, ‘Review of James Hawley and Andrew Williams (2000) “The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic”’ (2001) 26 *Academy of Management Review* 668 <<http://jstor.org/stable/3560249>>[Accessed on 05/03/2014].

⁵ SL Gillan and L Starks, ‘Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective’ (2003) Weinberg Center for Corporate Governance Working Paper 2003-01, 2 <<http://ssrn.com/abstract=480983>>[Accessed on 05/03/2014].

⁶ Wafik Grais and Dimitri Vittas, ‘Institutional Investors, Contractual Savings and Capital Market Development in Egypt, Jordan, Morocco, and Tunisia’ in S Neaime, NA Colton (eds), *Money and Finance in the Middle East: Missed Opportunities or Future Prospects?* (Research in Middle East Economics vol 6 Emerald 2005) <<http://emeraldinsight.com/books.htm?issn=1094-5334&volume=6&chapterid=1757897&show=abstract>>[Accessed on 05/03/2014].

⁷ E Gonnard, EJ Kim and I Ynesta, ‘Recent Trends in Institutional Investors Statistics’ (2008) 3 *Financial Market Trends* <oe.cd.org/finance/financialmarkets/42143444.pdf>[Accessed on 05/03/2014].

large number of common shares to institutional investors, who are now the key owners in capital markets.⁸ In the USA, for example, the increase in the level of institutional holdings has been associated with a decline in individual ownership ‘from 79% in 1966 to around 50% in 1993. Similar figures have been observed in Japan, where the percentage of individual owners of shares has decreased since 1953 from around 53% to 20% in 1993’.⁹ In Germany, individual share ownership declined during the same period from 75 percent to less than 25 percent,¹⁰ while in the UK it declined from 54 percent in 1962 to 10.2 percent in 2008.¹¹ Today, most individuals prefer to invest through investment vehicles or collective investment schemes such as mutual funds. For example, ownership by US individuals of institutional mutual funds increased from \$899 billion in mid-1989 to \$10.0 trillion in mid-2009, while the number of US individuals who owned mutual funds rose from 23.2 million to 50.4 million over the same period. Thus, as of mid-year 2009, 43 percent of US individuals owned mutual funds, representing 87.1 million individual fund shareholders.¹² Institutional investors are set to become the key owners in financial markets, promoting competition and efficiency. They can also encourage financial improvement, advance capital markets, enhance transparency and information disclosure, and reinforce corporate governance standards.¹³

This rapid growth, according to Davis and Steil, came as a consequence of various supply and demand factors that have made investing via institutions attractive to households. Supply-side factors suggest that institutions have offered their services relatively more efficiently than banks and direct holdings, thus fulfilling the functions of the financial system more effectively, while demand-side factors stem from households’ enhanced needs for the types of financial functions that institutional investors are able to fulfil.¹⁴ Other factors have been listed as follows:

⁸ Richard Briston and Richard Dobbins, *The Growth and Impact of Institutional investors: A report to the Research Committee of the Institute of Chartered Accountants in England and Wales* (Institute of Chartered Accountants in England and Wales, 1978) 11.

⁹ Allen Franklin and Douglas Gale, *Comparing Financial Systems* (MIT Press 2001) 58-67.

¹⁰ Menkhoff (n3) 909.

¹¹ Office for National Statistics (ONS), *Share Ownership: A Report on Ownership of Shares 2008* (ONS 2010) 6 <<http://statistics.gov.uk/StatBase/Product.asp?vlnk=930>>[Accessed on 05/03/2014].

¹² Investment Company Institute (ICI), *A Survey on the Profile of Mutual Fund Shareholders* (2009) 1 <http://ici.org/research#investor_research>[Accessed on 05/03/2014].

¹³ Vittas (n1) 6.

¹⁴ EP Davis and B Steil, *Institutional Investors* (MIT Press 2001) 29.

- 1- The ageing of the populations... [in some countries] has produced a rising need for retirement products... . At the same time, the baby boom cohort is causing looming fiscal problems in countries relying predominantly on pay-as-you-go ... state pension provisions systems.
- 2- Technological progress in communication and information processing has enhanced the capacity of the financial services industry to provide financial intermediation and risk management services by handling vast information flows at very high speed and at very low costs, giving rise to a new breed of sophisticated investment products...
- 3- Deregulation of the banking and securities industries since the beginning of the 1980s has heightened competition between and among banks and other financial institutions. Abolition of cross-border capital flow restrictions has further increased competition.
- 4- Disintermediation from banks occurring via reduced demand for bank deposits and traditional savings vehicles has resulted in a shift in favor of more performance-oriented instruments like money market funds and equity mutual funds.¹⁵

3.3 Definition of Institutional Shareholders

The term ‘institutional investors’ has been defined in a number of ways.¹⁶ Some of these are explanatory, whereas others follow a more analytical approach. Thus, Davis and Steil describe institutional investors as specialized financial institutions or organizations that collect and manage savings or financial assets collectively on behalf of dispersed beneficial owners towards a specific objective in terms of acceptable risk, return maximization and maturity of claims.¹⁷ Similarly, Sullivan and Mackenzie define them as financial intermediaries such as pension funds, insurance companies and investment managers, and investment managers in pension funds, mutual funds and other pooled investment vehicles. Their role in the economy is to act on behalf of others, say pensioners or individual investors, who have their pensions and savings invested in these funds.¹⁸ A list of all institutional investors investing in the capital markets would include public/private pension funds, investment funds such as mutual funds, banks, industrial/commercial companies, universities, colleges, charities, unions and other non-

¹⁵ Hans Blommestein and Norbert Fubke, *Institutional Investors in the Financial Landscape* (OECD 1998) 15-16.

¹⁶ Nor has ‘institution’ been clearly defined. Lance Davis and Douglas North, ‘Institutional Change and American Economic Growth: A First Step Towards a Theory of Institutional Innovation’ (1970) 30 *J Economic History* 132 <<http://jstor.org/stable/2116728>>[Accessed on 05/03/2014].

¹⁷ Davis and Steil (n14) 12.

¹⁸ Rory Sullivan and Craig Mackenzie (eds), *Responsible Investment* (Greenleaf 2006) 15.

profit and profit-making organisations. For the purpose of this thesis, the discussion in the following section is limited to specific classes of institutional investors whose influence is growing in global capital markets and whose incentive to engage in monitoring is considerable, while excluding those whose role in the capital market has diminished during recent years,¹⁹ as well as commercial banks, which are not the perfect model of institutions to monitor corporate performance in Saudi Arabia.²⁰

3.4 The Role of Institutional Shareholders in Corporate Governance

When Berle and Means recognised long ago that shareholders in publicly-traded companies were powerless,²¹ they understood, as discussed in chapter 2, that corporate ownership was substantially dispersed among a large percentage of inattentive investors. This was one of the signal facts of corporate governance in the twentieth century. This Anglo-Saxon ownership model²² was a result of the technological innovation that reflected the new economic scale of many publicly-traded companies, which was an ‘increase to the point that no individual, family or group of managers had sufficient wealth to own a controlling interest. As a consequence, [publicly-traded companies] became large and ownership there was diffuse’.²³ Since that time, almost all Western corporate governance scholars have based their studies on the Berle-Means diffuse ownership model, focusing on how firms control the agency problem caused by separation of ownership and control.²⁴ This trend in favour of the diffuse ownership structure has apparently transformed and shifted, shown by the sizeable growth of global institutional investors with huge assets, which are becoming the prominent

¹⁹ For example, although bank trust departments in the USA and, correspondingly, investment trusts in the UK were once considered important institutional investors, their share of capital market equity has shrivelled since 1980. James Hawley and Andrew Williams, *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic* (University of Pennsylvania Press 2000) 59; Briston and Dobbins (n8) 14.

²⁰ Saudi regulations restrict local bank ownership of corporate equity, as discussed in chapter 5, Section 5.2.3.

²¹ Iman Anabtawi and Lynn Stout, ‘Fiduciary Duties for Activist Shareholders’ (2008) Law-Econ Research Paper 08-02, 60 *Stanford Law Review* 27 <<http://ssrn.com/abstract=1089606>> [Accessed on 05/03/2014].

²² Brian Cheffins, ‘Does Law Matter? The Separation of Ownership and Control in the United Kingdom’ (2000) ESRC Centre for Business Research, University of Cambridge, Working Paper 172.2, 3 <<http://ssrn.com/abstract=245560>> [Accessed on 05/03/2014].

²³ CG Holderness, ‘A Survey of Blockholders and Corporate Control’ (2003) FRBNY Economic Policy Review 51 <<http://ny.frb.org/research/epr/03v09n1/0304hold.pdf>> [Accessed on 05/03/2014].

²⁴ Brian Cheffins and Steven Bank, ‘Is Berle and Means Really a Myth?’ (2009) UCLA School of Law, Law-Econ Research Paper 09-05, 52 <<http://ssrn.com/abstract=1352605>> [Accessed on 05/03/2014].

shareholders in corporations. In fact, most recent corporate governance debates in English-speaking countries have addressed only the empowerment of shareholders. For instance, Holderness recently found that ‘most public corporations in the US have large percentage shareholders, and the ownership concentration of US corporations is similar to the ownership concentration of corporations elsewhere’.²⁵ Given the unique problem posed by the regulatory barriers facing many types of institutional investors, many observers expected that the role of most types of institutional investors in the capital markets would grow progressively weaker over many years. In fact, many large institutional investors have recently made remarkable shifts, as activist shareholders are healthy for the economy. Although some are far from active investors, the activism of the institutional investor is becoming the norm throughout the world.

3.4.1 Types of Institutional Shareholder

As there is limited literature covering many countries, this thesis retains a focus on Anglo-Saxon countries, where the evolution of institutional investors’ activism is most relevant. Many types of institutional investors play a major role in the capital markets of OECD countries.²⁶ In particular, a large body of scholarly research covers a number of prominent institutional investors, which are a growing force in developed countries and play a dominant role in their capital markets. For example, pension funds and insurance companies have been the dominant investors in the UK capital market since the latter half of the 20th century. Mutual funds have recently become the dominant investors in the US capital market,²⁷ accounting for almost 60 percent of world mutual funds since 1995.²⁸ Although most of these institutional investors and other pooled assets and investment vehicles have common features in terms of size and large shares in capital markets, while individuals are the main owners to benefit among most of these institutional investors,²⁹ they do not inevitably represent a homogeneous group, since they have many differences in terms of contractual relations, performance strategies,

²⁵ Clifford Holderness, ‘The Myth of Diffuse Ownership in the United States’ (2009) 22 *Review of Financial Studies* 1378 <<http://ssrn.com/abstract=1365685>>[Accessed on 05/03/2014].

²⁶ Major forms of institutional investors in OECD countries include investment funds, insurance companies and pension funds. Gonnard et al (n7).

²⁷ Ruth Aguilera et al, ‘Corporate Governance and Social Responsibility: a Comparative Analysis of the UK and the US’ (2006) 14(3) *Corporate Governance* 149 <<http://ssrn.com/abstract=898963>>[Accessed on 05/03/2014].

²⁸ Graciela Kaminsky, Richard Lyons and Sergio Schmukler, ‘Mutual Fund Investment in Emerging Markets: An Overview’ (2001) 15 *World Bank Economic Review* 325 <<http://home.gwu.edu/~graciela/HOME-PAGE/RESEARCH-WORK/WORKING-PAPERS/mutual-fund-overview.pdf>>.

²⁹ Hawley and Williams (n19) 67.

liabilities to their beneficiaries or investors and fiduciary responsibilities.³⁰ Nevertheless, among other institutional investors, there are particular types whose shares have increased rapidly and which have the potential to influence corporate governance practices in global markets. They generally comprise various pension plans, insurance companies, investment management funds such as mutual funds,³¹ hedge funds and sovereign wealth funds.³² Therefore, the characteristics of each of these types are summarised in the following subsections.

3.4.1.1 Pension funds

Pension plans or funds are the first and largest driving force towards the globalisation of financial markets. Generally, this class of institutional investors is divided into two groups: private and public pension funds.³³ Both types provide a means of pooling many individual savings. The pension funds' sponsors or trustees distribute these pooled savings among investment plans in order to generate stable growth over the long term and provide for pensioners' future benefits. Therefore, it is fair to say that maturity influences the portfolio distribution of such institutions, which, with many mutual funds,³⁴ have recently been the most active institutional investors in global capital markets in non-financial matters such as environment and social issues.³⁵

3.4.1.2 Insurance companies

Insurance companies are the second largest driving force towards the globalisation of financial markets and the second most important class of equity ownership in global capital markets after pension funds.³⁶ Indeed, life and health insurance companies are similar to pension funds in providing long-term insurance products to potential

³⁰ Mark Roe, *Strong Managers, Weak Owners: the Political Roots of American Corporate Finance* (Princeton University Press 1994)14.

³¹ *ibid.* See also Hawley and Williams (n 19) 67.

³² A sovereign wealth fund is a government investment vehicle 'funded by foreign exchange assets, and which manages those assets separately from the official reserves of the monetary authorities (the Central Bank) and reserve-related functions of the Finance Ministry'. US Treasury, cited by Roland Beck and Michael Fidora, 'Sovereign Wealth Funds – Before and Since the Crisis' (2009) 10 *European Business Organization Law Review* 353-67 <http://journals.cambridge.org/abstract_S156675290900353X >[Accessed on 05/03/2014].

³³ Briston and Dobbins (n8)15.

³⁴ *ibid.* See also Hawley and Williams (n19) 60.

³⁵ KAD Camara, 'Classifying Institutional Investors' (2004) 235 <<http://ssrn.com/abstract=573441>>[Accessed on 05/03/2014].

³⁶ Hawley and Williams (n19) 59.

policyholders such as universal life coverage, universal health insurance coverage and permanent life insurance.³⁷ By contrast, casualty and property insurance companies are more dependent on short-term investment horizons to deal with cash flow shortages arising from paying for major disasters and court cases.³⁸ Although insurance companies own many shares in capital markets, they have long been criticised as ‘giants without power’ in the USA and inactive as institutional investors in exercising influence on corporate governance practices.³⁹ However, the case is totally different in the UK, Germany and Japan, where insurance companies are in step with most other institutional investors in exercising corporate activism.⁴⁰

3.4.1.3 Sovereign wealth funds

Sovereign wealth funds, constituting a growing investment sector in global markets since the 1950s,⁴¹ are designed and structured by governments to attain their economic objectives by investing financial assets mostly in foreign capital markets.⁴² Such funds have recently been recognised as one of the major sources of capital flows to global capital markets. Indeed, these funds have recently become visible in a number of mature emerging markets and some developed markets, as their estimated investment assets account for between 2 and 3 trillion US dollars, compared with total global financial assets of US\$190 trillion.⁴³ Therefore, many commentators envisage that such funds will eventually become one of the major players in global capital markets, similar to pension and mutual funds, in terms of their influence on corporate governance practices.⁴⁴ A number of legal characteristics of sovereign wealth funds distinguish them from public pension funds. ‘In particular, the absence of explicit liabilities or the stretched-out maturity of liabilities favours the pursuit of long-term investment strategies ...making sovereign wealth funds more similar to private mutual funds’.⁴⁵ Although sovereign funds have become globally important contributors of foreign direct investment (FDI), non-financial motives, including political ones, still affect their

³⁷ Davis and Steil (n14) 16.

³⁸ *ibid.*

³⁹ Hawley and Williams (n19) 59.

⁴⁰ Roe (n30) 62.

⁴¹ Beck and Fidora (n32) 353-67.

⁴² International Working Group of Sovereign Wealth Funds, ‘Generally Accepted Principles and Practices: Santiago Principles (2008) 3 <iwg-swf.org/pubs/gapplist.htm> [Accessed on 05/03/2014].

⁴³ *ibid.*, citing The International Monetary Fund, *Global Financial Stability Report* (2007) 139.

⁴⁴ Beck and Fidora (n32) 353-67.

⁴⁵ *ibid.*

investment decisions.⁴⁶ A recent empirical study indicates that these commonly differ from those of rational institutional investors, which prefer to maximize financial returns; political relations are considered an important factor for sovereign funds, which are more likely to invest in countries with which they have weaker political relations.⁴⁷

3.4.1.4 Mutual funds

Mutual funds comprise one of the most important channels of capital flows in the global capital markets after pension funds, in terms of their influence on corporate governance practices. They are a vehicle for investing on behalf of different clients, including other local and foreign institutional investors, as well as households and wealthy individuals. They have gained investment credibility among investors during the last few decades because they are managed by many specialist and skilled managers who can offer expertise to meet their investment objectives and hence offer liquidity throughout the year at current market prices, ‘either via direct redemption of holdings (open-end funds) or via the ability to trade shares in the funds exchanges (closed-end funds)’.⁴⁸ In addition, these professional managers are better able to collect investment information and data and to evaluate and select the investment opportunities than the fund owners.⁴⁹ Mutual funds can be classified as either active or indexed. Active funds operate by using professional and skilled managers who have the experience to choose among different investment opportunities, rather than exercising corporate governance activities, whereas indexed funds operate mainly ‘to match the return of an antecedently selected group of securities, such as the S&P 500, as cheaply as possible’.⁵⁰ Davis and Steil describe mutual funds as specialised and different from any other type of funds in that their investment goals are straightforward.⁵¹ Thus, each mutual fund is different from the others because each has its own investment strategy.⁵² For example, mutual funds are either active or passive. The former approach entails an attempt to seek out

⁴⁶ United Nations Conference on Trade and Development, ‘World Investment Report 2012’, ch 1, 13 <http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/WIR2012_WebFlyer.aspx>[Accessed on 05/03/2014].

⁴⁷ April Knill et al ‘Bilateral Political Relations and Sovereign Wealth Fund Investment’ (2012) 18 J Corp Fin 121 <<http://sciencedirect.com/science/article/pii/S0929119911001192>>[Accessed on 05/03/2014].

⁴⁸ Davis and Steil (n14) 16-17.

⁴⁹ Roe (n30) 102-103.

⁵⁰ Camara (n35) 230.

⁵¹ Roe (n30) 64.

⁵² *ibid.*

and purchase misvalued securities, with the implicit assumption that the market is inefficient and that not all relevant information is present in the price of securities. Passive or index funds, by contrast, assume that the market is efficient and hence that returns are maximised by ‘holding the market’.⁵³

3.4.1.5 Hedge funds

Hedge funds are another special kind of (closed-end) mutual fund, subject to less restrictive fiduciary constraints than traditional mutual funds.⁵⁴ These institutional investors, whose number has again increased dramatically recently, stand as a new product in the global capital markets amongst other major customary institutional investors and as one of the driving forces towards the globalisation of financial markets.⁵⁵ According to Davis and Steil, there are two types of hedge funds: macro funds, whose investment objectives are to benefit financially from change and development in the global economy,⁵⁶ and relative value funds, which tend to obtain their financial earnings from a different investment approach called ‘arbitrage strategies’, focusing on divergences in market price.⁵⁷ Moreover, hedge funds are different from major customary institutional investors in that they are more competent and flexible in exercising influence on corporate governance practices in the global capital market without having any limitation or regulatory environment that poses an impediment, as is the case with other institutional investors such as pension funds and mutual funds.⁵⁸ This is not because they are characterised as private pooled investment vehicles similar to venture capital and private equity funds. Indeed, hedge funds are substantially different from these investment vehicles, as they do not commonly pay close attention to private capital markets or have the exclusive objective of investing in private firms.⁵⁹ Ultimately, hedge funds can be perceived as a ‘new middle ground

⁵³ *ibid* 58.

⁵⁴ Davis and Steil (n14) 65.

⁵⁵ Jan Loeys and Laurent Fransolet, *Have Hedge Funds Eroded Market Opportunities?* (JP Morgan 2004) 5 <w.edge-fund.com/LoeysFransolet2004.pdf>[Accessed on 05/03/2014].

⁵⁶ Davis and Steil (n14) 65.

⁵⁷ *ibid* 18-65.

⁵⁸ Alon Brav et al, ‘Hedge Fund Activism, Corporate Governance, and Firm Performance’ (2008) 63 *J Finance* 1730 <<http://ssrn.com/abstract=948907>>[Accessed on 05/03/2014].

⁵⁹ *ibid*.

between internal monitoring by large shareholders and external monitoring by corporate raiders'.⁶⁰

3.5 Institutional Shareholder Activism

3.5.1 Introduction

Activism in its broadest definition is the use of a powerful ownership position to influence directly the company management's decision-making or performance.⁶¹ This powerful influence of institutional shareholders depends mainly on a reasonable situation within the investee companies, which induces them to choose between different direct or indirect forms of action.⁶² The traditional method of shareholder activism is the use of the position as owner to actively influence company policy and practice.⁶³ Shareholders do this by exercising direct influence and using formal rights attached to ordinary shares, such as filing resolutions at an AGM, voting against management or divesting from a company, to influence or challenge the way a corporation operates or 'utilise [s] their unique rights to facilitate change'.⁶⁴ However, institutional shareholders may use their powerful positions to wield indirect influence, through private negotiations, the use of proxy voting, media campaigns and shareholder proposals.⁶⁵ Some may exercise these direct and indirect influences both to focus on financial returns and to pursue non-financial objectives such as those represented by corporate social or human rights performance measures. Alternatively, the theoretical and empirical possibility for institutional investors to sell their shares, also commonly referred to as 'exit',⁶⁶ is now said to be favoured by many institutional shareholders, so

⁶⁰ *ibid* 1774.

⁶¹ GL Clark and T Hebb, 'Pension Fund Corporate Engagement: The Fifth Stage of Capitalism' (2005) 59 *Industrial Relations* 144 <<http://ssrn.com/abstract=789724>>[Accessed on 05/03/2014].

⁶² Joseph McCahery, Laura Starks and Zacharias Sautner, 'Behind the Scenes: The Corporate Governance Preferences of Institutional Investors' 2010, AFA 2011 Denver Meetings Paper 19 <<http://ssrn.com/abstract=1571046>>[Accessed on 05/03/2014].

⁶³ Emma Sjöström, 'Shareholder Activism for Corporate Social Responsibility: What Do We Know?' (2008) 16 *Sustainable Development* 142 <<http://dx.doi.org/10.1002/sd.361>>[Accessed on 05/03/2014].

⁶⁴ Russell Sparkes and Christopher Cowton, 'The Maturing of Socially Responsible Investment: A Review of the Developing Link with Corporate Social Responsibility' (2004) 52 *J Business Ethics* 51 <<http://dx.doi.org/10.1023/B%3ABUSI.0000033106.43260.99>>[Accessed on 05/03/2014].

⁶⁵ Lori Ryan and Marguerite Schneider, 'The Antecedents of Institutional Investors' Activism' (2002) 27 *Academy of Management Review* 554 <<http://jstor.org/stable/4134403>>[Accessed on 05/03/2014].

⁶⁶ Alex Edmans and Gustavo Manso, 'Governance Through Trading and Intervention: A Theory of Multiple Blockholders' (2010) *Journal Review of Financial Studies* 2 <<http://rfs.oxfordjournals.org/content/early/2010/12/13/rfs.hhq145.full.pdf+html> >[Accessed on 05/03/2014].

that it may eventually become more effective in influencing managers than the traditional methods of activism.⁶⁷ Therefore, in an effort to determine the level of activist behaviour among institutional shareholders, this section explores how they use these alternative activism routines by distinguishing their willingness and approaches with respect to their costs and their effectiveness. It also examines the effectiveness of their characteristic functions, arising from their tendency to adopt activism and consequently reduce agency costs.

⁶⁷ McCahery et al (n62) 20.

3.5.2 Traditional Shareholders' Activism (Voice)

This section seeks to identify the characteristics of institutional investors that lead towards activism. Thus, it will not debate social and environmental responsibility at length, but will observe that such issues have gained the widespread attention of institutional investors and government regulators. This started only in the last decade or so, when institutional investors began to shift part of their strategic investment programmes to focus on corporate social responsibility (CSR).⁶⁸ The movement towards activism for corporate social and environmental responsibility has recently been mapped by many academics. For example, Sparkes and Cowton state that social responsibility 'has become an investment philosophy adopted by a growing number of large institutional investors... [and] [t]here are signs in recent years that institutional investors are beginning to take [socially responsible investment] seriously'.⁶⁹ Carrol assumes that CSR 'has a bright future because at its core, it addresses and captures the most important concerns of the public regarding business and society relationships'.⁷⁰ Sjöström's evaluation of academic articles and working papers up to 2008 found that although socially responsible investment had shown rapid growth in many countries, revealing an increasing alertness of investors to social, environmental and governance issues, research into institutional investors' activism in the area of corporate social and environmental responsibility was still new to many countries.⁷¹

It should be emphasised that institutional investors do not limit themselves to increasing the social responsibility of investee companies but also seek a financial return. It would be unrealistic to expect them not to be concerned with maximising their profits when taking long-term investment decisions. Nonetheless, while not denying that most are in search of profits, one would expect them, in at least some investment decisions, to sacrifice wealth to obtain something else of value by considering other imperative issues that are not purely financial.⁷² Such responsibilities need not impact negatively on the financial demand factor or investee companies' profitability. Indeed,

⁶⁸ Cynthia Williams and Ruth Aguilera, 'Corporate Social Responsibility in a Comparative Perspective' in A Crane et al (eds), *The Oxford Handbook of Corporate Social Responsibility* (Oxford University Press, 2008) 1.

⁶⁹ Sparkes and Cowton (n64) 45.

⁷⁰ AB Carroll, 'Corporate Social Responsibility: Evolution of a Definitional Construct' (1999) 38 *Business & Society* 292 <<http://bas.sagepub.com/content/38/3/268>>[Accessed on 05/03/2014].

⁷¹ Sjöström (n63) 141-145.

⁷² Camara (n35) 223.

some academics aver that ethical or social and environmental portfolios are by nature subsets of the market portfolio,⁷³ hence,

...there are three hypotheses about the comparative returns of socially [and environmentally] responsible portfolios as replacements for normal or conventional portfolios. The first is that socially responsible investing does not add or destroy value in terms of risk-adjusted returns, because corporate social responsibility is not priced. The second hypothesis is that socially responsible portfolios deliver lower expected returns compared to regular portfolios, because socially responsible investors are able to influence the value of socially responsible companies upwards by driving down their expected returns and cost of capital. Finally, the third hypothesis posits that the expected returns on stocks of socially responsible firms are higher than the returns on conventional stocks... [and] this could occur when markets do not price social responsibility correctly.⁷⁴

On the other hand, while social and environmental responsibility are not indispensable aspects of investee companies' contractual relations,⁷⁵ belief is growing that institutional investors, particularly large ones, can be trusted to act positively to focus on the social and environmental effects of their investments.⁷⁶ Indeed, many types of institutional investors are beginning to act responsibly by eliminating from their lists any potential investment that could harm society or the environment; alternatively, they utilise their ownership abilities to express anxiety by monitoring the behaviour of investee companies on CSR issues. Sparkes believes that the distinction between responsible institutional investors and ordinary investors who look only for financial gain is that the former combine two indispensable ambitions: pursuing long-term investment horizons and engaging in social and environmental activities.⁷⁷ A recent empirical study also found that firm size and prior profitability in civil and common law

⁷³ Rob Bauer, Kees Koedijk and Rog r Otten, 'International Evidence on Ethical Mutual Fund Performance and Investment Style' (2005) 29 J Bank Fin 1752 <<http://arno.unimaas.nl/show.cgi?fid=15670>>[Accessed on 05/03/2014].

⁷⁴ *ibid.*

⁷⁵ Ian Lee, 'Corporate Law, Profit Maximization and the Responsible Shareholder' (2005) Stanford J Law Bus Fin 14-16 <<http://ssrn.com/abstract=692862>>[Accessed on 05/03/2014].

⁷⁶ Craig Mackenzie and Rory Sullivan, *The Scope for Investor Action on Corporate Social and Environmental Impacts* (Greenleaf 2006) 13 <greenleaf-publishing.com/productdetail.kmod?productid=80>[Accessed on 05/03/2014].

⁷⁷ Russell Sparkes, 'Ethical Investment: Whose Ethics, Which Investment?' (2001) 10 Business Ethics 197-201.

countries were positively associated with institutional investors' eagerness to engage in social activities and address economic inequality.⁷⁸

Thus, institutional investors' activism in terms of social and environmental responsibility can be traced back not only to institutional investors' evolving attitudes but also to regulatory improvements in many developed countries, such as the amendment to the UK Pensions Act of 1995, after which pension funds had to reveal the extent to which they included environmental, social and governance issues in their investment decision-making practice, and the Sarbanes-Oxley Act in the USA, which required companies to produce a written ethical policy.⁷⁹ In Sweden, national pension funds must integrate an environmental and ethical vision into their investment strategies or programmes. Finally, in Germany the Renewable Energy Act has enhanced tax advantages for funds investing in wind energy.⁸⁰ In developing countries, the view might be different, depending on each government's attitude to social and environment responsibility issues; some refuse to enforce social or environmental standards, in order to facilitate FDI,⁸¹ while others believe in the need to improve these standards but do not wish to discourage the influx of foreign capital and institutional investment.⁸² In similar situations, discussed in chapter 6, many institutional shareholders in Saudi Arabia have not been encouraged to expand their investment policies to improve social and environment standards.

3.5.3 Exit as Alternative to Voice

It has been argued that the improvement of corporate governance standards increases liquidity in the capital market,⁸³ which in turn can improve the sharing of financial risks by influencing investors' trading decisions, owing to a reduction in the transaction costs

⁷⁸ William Judge, Ajai Gaur and Maureen Muller-Kahle, 'Antecedents of Shareholder Activism in Target Firms: Evidence from a Multi-Countries Study' (2010) 18 *Corporate Governance* 270.

⁷⁹ Luc Renneboog, Jenke Ter Horst and Chendi Zhang, 'Socially Responsible Investments: Institutional Aspects, Performance, and Investor Behavior' (2008) 32 *J Bank Fin* 1727 <[sciencedirect.com/science/article/B6VCY-4RKMJ1P-1/2/b4aa54b9d4f83904b03f42bbfac551b9S](http://www.sciencedirect.com/science/article/B6VCY-4RKMJ1P-1/2/b4aa54b9d4f83904b03f42bbfac551b9S)>[Accessed on 05/03/2014].

⁸⁰ *ibid.*

⁸¹ Williams and Aguilera (n68) 3-5.

⁸² *ibid.* 5.

⁸³ KH Chung, J Elder and J-C Kim, 'Corporate Governance and Liquidity' (2010) 45(2) *J Financial and Quantitative Analysis* 22 <<http://dx.doi.org/10.1017/S0022109010000104>>[Accessed on 05/03/2014].

associated with making portfolio changes.⁸⁴ A capital market with more liquidity is considered less costly for institutional shareholders to obtain additional shares or large shares; such liquidity could also help to persuade institutional shareholders to be more active in monitoring company management and increase their earnings,⁸⁵ as the cost of monitoring is covered by informed trading, which achieves more efficient corporate governance.⁸⁶ However, a recent empirical study examines whether liquidity has any impact on the occurrence of institutional shareholders' activism. Its main conclusion is that liquidity is imperative for the monitoring decision and encourages institutional shareholders to take an active role in the governance of the investee companies,⁸⁷ because

[i]n a liquid market a potential activist can profit from trading on [non-public] information of his future value-enhancing intervention and thereby cover monitoring costs. Also, for [institutional investors] that face the risk of having to liquidate their positions, liquidity may encourage activism because a more informative price allows an activist to sell shares at a price that reflects value improvements.⁸⁸

Thus, it has been argued that exit may perhaps eliminate or curtail the influence of shareholders to monitor managers, as it may increase the attractiveness of the option of effortlessly selling their existing shares, making them less aggressive in trying to change the unwanted behaviour of the investee company by initiating an action that appears to be inconsistent with traditional activism. Coffee therefore argues that institutional shareholders who are actively trading and prefer to exit will have less interest in voicing concerns and will poorly monitor the firm's performance.⁸⁹ Bhidé adds that liquidity is considered destructive, as it allows institutional shareholders

⁸⁴ Prasun Agarwal, 'Institutional Ownership and Stock Liquidity' (2007) 1 <<http://ssrn.com/abstract=1029395>>[Accessed on 05/03/2014].

⁸⁵ Jun Uno and Naoki Kamiyama, 'Ownership Structure, Liquidity, and Firm Value: Effects of the Investment Horizon' (2009) 22nd Australasian Finance and Banking Conference <<http://ssrn.com/abstract=1455995>>[Accessed on 05/03/2014].

⁸⁶ Ernst Maug, 'Large Shareholders as Monitoring: Is There a Trade-Off between Liquidity and Control?' (1998) LIII J Finance 65-88.

⁸⁷ Oyvind Norli, Charlotte Ostergaard and Ibolya Schindele 'Liquidity and Shareholder Activism' (2010) EFA 2009 Bergen Meetings Paper 25 <<http://ssrn.com/abstract=1344407>>[Accessed on 05/03/2014].

⁸⁸ *ibid.*

⁸⁹ John Coffee, 'Liquidity Versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 Columbia Law Review 1366 <<http://jstor.org/stable/1123064>>[Accessed on 05/03/2014].

simply to sell existing shares instead of encouraging them to intervene and pursue their desired objectives.⁹⁰

However, a recent survey of the actual views of institutional investors on issues related to investor protection and corporate governance mechanisms found that the most frequently mentioned and admired action, which 80% of institutional investors may be willing to take, is simply selling their existing shares.⁹¹ This raises the question of why exit is so widely favoured by institutional shareholders, despite having long been seen as a “white flag” on the battlefield of corporate governance.⁹² Indeed, it should be recognized that there is a significant development reflected by many recent theoretical and empirical studies, which cast new light on its role, showing that trading or exit is considered an alternative to traditional forms of shareholder activism. It may perhaps have a function in improving the effectiveness of activism on the part of activist institutional shareholders, as it can be used as a threat to discipline the management of the investee company⁹³ or to help restrain managerial misconduct.⁹⁴

For example, the threat to sell existing shares can significantly enhance the firm’s value by persuading managers to focus on long-term investment.⁹⁵ Correspondingly, the possibility of selling existing large holdings may affect the company’s share price and accordingly threaten managers by its potential effect on their compensation, which is often responsive to the share price.⁹⁶ Related empirical work has examined how the efficacy of the large shareholder’s threat depends on the nature of the agency problem and the information arrangements, showing that the threat and ability of institutional shareholders to sell their existing shares as regards the non-public information they have actually reduces agency costs by encouraging managers to focus on real investment to

⁹⁰ Amar Bhidé, ‘The Hidden Costs of Stock Market Liquidity’ (1993) 34 *J Fin Econ* 45-46 <<http://sciencedirect.com/science/article/pii/0304405X9390039E>>[Accessed on 05/03/2014].

⁹¹ McCahery et al (n62) 30.

⁹² Brandon Chen, ‘Board Monitoring and the Wall Street Rule’ (23rd Australasian Finance and Banking Conference 2010) <<http://ssrn.com/abstract=1659436>>[Accessed on 05/03/2014].

⁹³ AR Admati and P Pfleiderer, ‘The “Wall Street Walk” and Shareholder Activism: Exit as a Form of Voice’ (2009) 22 *Review of Financial Studies*, 2 <<http://rfs.oxfordjournals.org/content/early/2009/05/18/rfs.hhp037.full.pdf+html>>[Accessed on 05/03/2014].

⁹⁴ Bengt Holmstrom and Jean Tirole, ‘Market Liquidity and Performance Monitoring’ (1993) 101 *J Political Economy* 679 <<http://jstor.org/stable/2138744>>[Accessed on 05/03/2014].

⁹⁵ Alex Edmans, ‘Blockholder Trading, Market Efficiency, and Managerial Myopia’ (2011) 64 *J Finance* 4 <<http://ssrn.com/abstract=946669>>[Accessed on 05/03/2014].

⁹⁶ Admati and Pfleiderer (n93) 2.

maximize share values and consequently solve the agency problem between shareholders and managers.⁹⁷

In a different approach, the liquidity of shares has been found to be positively associated with corporate value, especially when there are multiple blockholders,⁹⁸ in particular because their trading has an impact on managerial compensation.⁹⁹ Indeed, Edmans and Manso assume that since most companies in reality consist of multiple blockholders,¹⁰⁰ their trading on non-public information, while reducing the effectiveness of direct interference (voice), can still produce quite different effects by enhancing the effectiveness and increasing the power of exit as a second governance mechanism, by ‘[moving] the [share] price towards its fundamental value, thus [causing] it to more closely reflect the effort exerted by the manager to enhance firm value’.¹⁰¹ In similar vein, Gallagher et al state that the threat of exit may verbalize more convincingly than the traditional shareholder activism (voice).¹⁰² Actually, ‘[the] high levels of short-term trading activity, inclusive of purely “churning” trades by institutional investors, are not evidence of “actively doing nothing” ... [but to a certain extent] it is fundamental to value-enhancing pressure placed on firm management’.¹⁰³ Moreover, it has been said that the threat of exit as a form of activism does not necessarily dismiss the role of traditional shareholders’ activism; in fact, it may perhaps enhance their efficiency.¹⁰⁴ For example, Brandon recently found a positive association between exit and a strong independent board, arguing that such threats of exit provide strong independent directors with additional information that may help them to monitor more efficiently by improving price informativeness.¹⁰⁵

⁹⁷ *ibid*2.

⁹⁸ Sreedhar Bharath, Sudarshan Jayaraman and Venky Nagar, ‘Exit as Governance: An Empirical Analysis’ (2010) *J Finance*, forthcoming <<http://ssrn.com/abstract=1572940>>[Accessed on 05/03/2014].

⁹⁹ Gavin Smith and Peter Swan, ‘Will the Real Monitors Please Stand Up? Institutional Investors and CEO Compensation’ (2008) Working Paper, University of New South Wales, 29-30 <<http://ssrn.com/abstract=1096998>>[Accessed on 05/03/2014].

¹⁰⁰ Edmans and Manso (n66) 2.

¹⁰¹ *ibid*2.

¹⁰² David Gallagher et al, ‘Blockholder Intervention Versus Threat of Exit’ (2009) Working Paper, University of New South Wales 1 <http://firm.net.au/resources/pdfs-papers-slides/RD_Swan_2009.pdf>[Accessed on 05/03/2014].

¹⁰³ *ibid*.

¹⁰⁴ Admati and Pfleiderer (n93) 32.

¹⁰⁵ Chen (n92) 31-32.

In summary, mixed results emerge from a review of the literature on the possible influences of institutional shareholders on governance, either directly through the traditional means of activism (voice) or alternatively by selling shares (exit). It remains unclear which of these would be the most desirable action to take. Therefore, there is a need to explore activism from a different angle, identifying institutional shareholders' characteristics, which may give a clearer picture of their affinity for activism and help to determine which among them are most likely to be the most activist. This is important, because '[g]aining a comprehensive vision of the institutional investor characteristics that shape investors' propensity toward activism would enable researchers to refine their studies and perhaps arrive at more conclusive findings'.¹⁰⁶ The next section therefore turns to institutional shareholders' characteristics, with a focus on capturing aspects that may provide the key to understanding their tendency towards activism; more precisely, aspects that distinguish them from individual shareholders and which are necessary to give them the confidence to undertake activism.

3.5.4 Determinants of Institutional Shareholder Behaviour

Each type of institutional investor has different objectives and strategies, and the importance of each type also varies significantly across countries and regions. Yet they share a number of interesting and unique features, making them distinct from individual investors and a valuable tool to promote activism. One of the main common characteristics of the institutional investor is that 'it cares not only about the governance and performance of the individual companies that compose its investment portfolio, but [...also] about the performance of the economy as a whole'.¹⁰⁷ Another common feature of institutional investors is the ability to expand their investments and facilitate risk pooling and information gathering better than individual investors could achieve through direct holding of ownership. Additionally, direct holding of ownership broadens the risk of investment among individual or small investors, who are prone to uncertainty. Davis and Steil emphasise this advantageous feature:

[Institutional shareholders] provide a form of risk pooling for small investors, thus providing a better trade-off of risk and return than is generally possible via direct holdings. This entails, on the asset side, putting a premium on

¹⁰⁶ Ryan and Schneider (n65) 554.

¹⁰⁷ Hawley and Williams (n19) 21.

diversification, both by holding a spread of domestic securities (which may be both debt and equity) and by international investment.¹⁰⁸

However, this does not imply that institutional investors work synchronically towards activism; their difference relates primarily to the liability side of their operations, their investment objectives and the nature of their relationships with those who invest with them. Many of these characteristics of institutional investors are important to note, as they reflect an affinity with activism which is greater than individuals could achieve. Most of these characteristics have been gleaned from institutional investors' schemes and are presented in the financial and law literature.¹⁰⁹ For example, Ryan and Schneider attempt to identify those characteristics of institutional shareholders which may indicate a tendency to exercise activism.¹¹⁰ They report that fund size and the investment time horizon were among characteristics that would determine whether an institution would be active. Hence, the following subsections principally describe particular characteristics of institutional investors, without attempting to be comprehensive.¹¹¹

3.5.4.1 *Institutional size*

The investment function varies with the size of institutional investors, which is considered one of the generic aspects that undoubtedly affect institutions' leanings towards activism. Many of these large holdings, particularly for large institutional shareholders, may confer greater advantages from activism, because institutions with large holdings can 'build better information channels to the firms' top and help firms in related industries organize simultaneous investments in complex components'.¹¹² Earlier empirical evidence also suggests that large investors give institutional shareholders economies of scale in monitoring portfolio companies,¹¹³ as Davis explains:

[T]he ability to transact in large volumes typically involves lower proportionate commission charges. Furthermore, investors share the costly services of expert

¹⁰⁸ *ibid* 12.

¹⁰⁹ See, for example, and Schneider (n65); Davis and Steil (n14) 14.

¹¹⁰ Ryan and Schneider (n65).

¹¹¹ *ibid*.

¹¹² Davis and Steil (n14) 13.

¹¹³ *ibid*; A Admati, P. Pfleiderer and J. Zechner, 'Large Shareholder Activism, Risk Sharing, and Financial Market Equilibrium (1994) 102 J Political Economy 1097 <<http://jstor.org/stable/2138781>>.

investment managers and thereby save in advisory fees. Size also enables [institutional shareholders] to invest in large indivisible investments (although there is a tension with desire for diversification). Moreover, size may establish countervailing power, yielding lower transactions costs and custodial fees. This countervailing power may also ensure fair treatment by capital market intermediaries on the one hand and, on the other, improved control over companies in which they invest..., thus reducing the incidence of adverse incentive problems.¹¹⁴

Ryan and Schneider agree with this justification and with the assumption that shareholder activism will be linked with institutional size.¹¹⁵

3.5.4.2 Long-term versus short-term investment approaches

Among institutional investors, whether they engage in voice or exit depends on their investment policies and behaviour.¹¹⁶ For instance, some institutional shareholders like pension funds and insurance companies are unleveraged passive investors with a long-term approach to investment obligations or liability to their beneficiaries, which makes liquidity less important to them and leads them to take a long-term investment approach to their savings plans in order to practise activism.¹¹⁷ Unlike pension and insurance companies, mutual fund investment managers and investment companies sometimes have mixed obligations or liability to their investors.¹¹⁸ They may need to cope with beneficiaries or investors who may withdraw from the investment at any time, leading the managers of such investment funds or companies to place more emphasis on developing a short-term investment approach,¹¹⁹ resulting from 'their own reward systems, which emphasize quarterly performance... [perhaps] coupled with the potential difficulty of selling large blocks of stock without a loss'.¹²⁰ However, adopting such a short-term investment approach would put pressure on the management of the

¹¹⁴ EP Davis, 'Institutional Investors, Financial Market Efficiency, and Financial Stability' (2001) 9 <<http://philipdavis.com/Institutional-investors-and-capital-markets1.pdf>>[Accessed on 05/03/2014].

¹¹⁵ Ryan and Schneider (n65) 560.

¹¹⁶ Agarwal (n84) 4.

¹¹⁷ Kai Li, Jarrad Harford and Xia Chen, 'Monitoring: Which Institutions Matter?' J Financial Economics (forthcoming) 3 <<http://ssrn.com/abstract=930185>>[Accessed on 05/03/2014].

¹¹⁸ Roe (n30)199-200. See also Daniel Levinthal and Jennifer Myatt, 'Co-Evolution of Capabilities and Industry: The Evolution of Mutual Fund Processing' (1994) 15 Strategic Management Journal 45-62 <<http://3.interscience.wiley.com/journal/113456347/abstract>>[Accessed on 05/03/2014].

¹¹⁹ Davis and Steil (n14) 13.

¹²⁰ Richard Johnson and Daniel Greening, 'The Effects of Corporate Governance and Institutional Ownership Types on Corporate Social Performance' (1999) 42 Academy of Management Journal 566 <<http://jstor.org/stable/256977>>[Accessed on 05/03/2014].

investee companies to operate and make decisions in order to realise fast gains, rather than to attain long-term earnings and economic value, and consequently sustain steady investment performance.¹²¹ Such pressure on the managers of the investee companies will make them less successful in choosing the right investment if they are concerned only to attain short-term earnings. This irrational fear is identified by Graham et al, who found that 78% of executives would sacrifice long-term value to meet short-term earnings targets.¹²² They would do so to

(i) build credibility with the capital market; (ii) maintain or increase stock price; (iii) improve the external reputation of the management team; and (iv) convey future growth prospects. Failure to hit earnings benchmarks creates uncertainty about a firm's prospects, and raises the possibility of hidden, deeper problems at the firm.¹²³

Besides, this pressure on the investee company could 'lead to the adoption of more aggressive trading strategies (such as market timing and technical analysis) at the expense of buy-and-hold investment strategies based on [the expense of long economic value and] firm fundamentals'.¹²⁴

Nonetheless, the movement of invested assets to and from mutual funds has been found to be hypersensitive to performance only for the best-performing funds.¹²⁵ This implies that most individual investors are wealthy and that having bought units in mutual funds they hold their investments for a long time, irrespective of changes in fund performance during the year.¹²⁶ It is important to recognise that many mutual fund investment managers consequently take a long-term investment approach,¹²⁷ so as to have a steady return from the companies where they hold shares, in order to maximise

¹²¹ Brian Bushee, 'Do Institutional Investors Prefer Near-Term Earnings over Long-Run Value?' (1999) University of Pennsylvania Working Paper 1 <<http://ssrn.com/abstract=161739>> [Accessed on 05/03/2014].

¹²² John Graham et al, 'The Economic Implications of Corporate Financial Reporting' (2005) 40 J Account Econ 1, 5. <<http://dx.doi.org/10.1016/j.jacceco.2005.01.002>> [Accessed on 05/03/2014].

¹²³ *ibid* 66.

¹²⁴ Bushee (n121) 6.

¹²⁵ Camara (n35) 230.

¹²⁶ Bhide (n90) 44.

¹²⁷ Sathya Debasish, 'Investigating Performance of Equity-based Mutual Fund Schemes in Indian Scenario' (2009) 2 KCA J Bus Man 1 <<http://ajol.info/index.php/kjbm/article/view/52160/40786>> [Accessed on 05/03/2014]; Shakir Ullah and Dima Jamali, 'Institutional Investors and Corporate Social Responsibility: The Role of Islamic Financial Institutions' (2010) 6 Int Rev Bus Res Papers 621 <<http://bizresearchpapers.com/44.Shakir.pdf>> [Accessed on 05/03/2014]; Ryan and Schneider (n65) 567.

profits and meet their obligations to their beneficiaries.¹²⁸ Therefore, like pension funds and insurance companies, they are encouraged to be involved in corporate strategic management rather than to sell their shares.¹²⁹ Moreover, it has been argued that one of the most recent phenomena in the activism behaviour of institutional investors in the capital market is the pressure which they place on the managers of investee companies to meet social and environment standards.¹³⁰ Cox et al found that long-term institutional investment was correlated with corporate social performance,¹³¹ while a long-term focus ‘may well deliver better corporate social responsibility performance as well as shareholder value’.¹³² This suggests that the alternatives of short-term or long-term investment are not straightforwardly limited to traditional financial factors, but should be extended to other aspects of being a responsible investor,

...because such responsibilities are of concern not only to government regulatory bodies¹³³ but to most [institutional investors] in order to ensure long-term returns to [beneficiaries] and therefore fulfill rather than detract from their fiduciary duty. Such increases in demand for social and environmental standards lower risk and uncertainty over the long run and hence have the potential to pay off for these investors over time.¹³⁴

Conversely, Gillan and Starks find little evidence of improvement in the long-term financial operations or performance of targeted companies,¹³⁵ but institutional investors with a long-term investment approach still seem to be able to engage in healthier activism than institutions with a short-term approach.¹³⁶ Thus, hedge funds are not, as many commentators have argued, entirely focused on short-term investments.¹³⁷ There is recent empirical evidence that hedge fund managers are more likely to emphasize

¹²⁸ Aguilera et al (n27)147-158; Ullah and Jamali (n127).

¹²⁹ Clark and Hebb (n61); Ullah and Jamali (n127).

¹³⁰ Ullah and Jamali (n127).

¹³¹ Paul Cox, Stephen Brammer and Andrew Millington, ‘An Empirical Examination of institutional Investor Preferences for Corporate Social Performance’ (2004) 52 J Bus Ethics 39.

¹³² Craig Mackenzie, ‘Boards, Incentives and Corporate Social Responsibility: The Case for a Change of Emphasis’ (2007) 15 Corporate Governance 939.

¹³³ UK pension funds and insurance companies are beginning to exert control over the companies in their portfolios and play an active role in challenging corporate, social and environmental standards. Ullah and Jamali (n127).

¹³⁸ Clark and Hebb (n61) 157-158.

¹³⁵ Stuart Gillan and Laura Starks, ‘The Evolution of Shareholder Activism in the United States’ (2007) 4 <<http://ssrn.com/abstract=959670>>[Accessed on 05/03/2014].

¹³⁶ Christopher Brown, ‘Rise of the Institutional Equity Funds: Implications for Managerialism’ (1998) 32 J Econ Issues 806 <<http://jstor.org/stable/4227353>>[Accessed on 05/03/2014].

¹³⁷ Alon Brav et al (n58).

long-term performance in most of their investment decisions and to instruct the investee companies to realize this investment approach, in a similar way to pension funds, life insurance companies, many mutual funds and sovereign funds.¹³⁸ They are also likely to be more active than others. Alternative investments (hedge funds, commodities, real estate, infrastructure, emerging market assets, private equity) have gained importance of late among traditional institutional investors such as life insurance companies and pension funds, although those investments still represent only a small proportion of their total assets under management. This evidence is broadly confirmed in surveys, market intelligence and interviews with institutional investors.

3.5.4.3 Institutional investors and conflicts of interest

Generally speaking, institutional investors' trustees or sponsors are themselves fiduciary agents of the dispersed beneficial owners, the pensioners or investors of the collective investment schemes. Hence another characteristic of most types of institutional investors which may render them more active than dispersed beneficial owners is that they are like corporations inasmuch as they are run by professional and skilled managers. Indeed, most institutional shareholders delegate investment management to external professionals or to firms such as insurance companies or bank trusts,¹³⁹ which save on behalf of the fund officers or trustees and fiduciaries, based on a fiduciary relationship.¹⁴⁰ These investment or portfolio firms traditionally involve the portfolio manager, who may be professional and skilled in the collection and analysis of relevant investment information, in investment asset allocations and in evaluating corporate behaviour and performance measurement,¹⁴¹ so their monitoring costs will be lower than those of less professional and skilled retail, independent or small investors. However, institutional shareholders can sometimes take care of their own investment asset or portfolio management by employing professional investment managers as an

¹³⁸ *ibid* 1732.

¹³⁹ 'While investment terms or objectives are agreed with clients, fund managers have the primary responsibility for day-to-day investment decisions.' Sullivan and Mackenzie (n18) 15.

¹⁴⁰ The law on fiduciary duties has two components: reasonable care and loyalty, i.e. putting the client's interests above one's own and acting 'solely for the benefit of the client'. WG Droms, 'Fiduciary Responsibilities of Investment Managers and Trustees' (1992) 48 *Financial Analysts J* 60 <<http://jstor.org/stable/4479561?cookieSet=1>>[Accessed on 05/03/2014].

¹⁴¹ Davis and Steil (n14) 225.

alternative to external investment or portfolio managers.¹⁴² Accordingly, whether investment management is delegated entirely or partially to external professionals has implications for the fund's activism level.

The decision to delegate portfolio management to external managers has advantages, as they

...are likely to hold many of the same [shares] across the [assets] they manage, giving them a greater incentive and greater power to intervene than the internal manager of a single fund. Similarly, divesting... instead of becoming activist is more costly for a portfolio manager who has placed the [shares] in several of his or her funds' portfolios, since selling across the board could depress prices.¹⁴³

The delegation of investment decisions to external professional managers is also more likely to encourage the fund trustee or sponsor to be active without any conflict of interest or threat of corporate insider trading.¹⁴⁴ Menkhoff argues that delegating fund management to professional institutional shareholders has three additional advantages:

First, professionals are better informed and thus able to realize a superior investment performance. Second, professionals can—due to larger funds and lower transaction costs—diversify their portfolios more broadly. Third, economies of scale should make the costs of investment management lower, in particular for [beneficiaries] aiming to be reasonably well informed.¹⁴⁵

Thus, external professional investment managers essentially pledge to offer the institutional shareholders whose assets they manage the benefit of their long investment experience and their ability to collect and analyse the daily flow of information in order to originate and implement appropriate investment decisions,¹⁴⁶ in the best interests of the institutional shareholders. However, the assertions of the external investment or portfolio managers may not always be indisputable. In fact, such a relationship is considered another manifestation of the third agency problem, which arises between the shareholders as principals and the corporate manager as agent,¹⁴⁷ when the external

¹⁴² E.g. in Saudi Arabia, local pension funds employ internal investment portfolio managers, mainly to manage local investments.

¹⁴³ Ryan and Schneider (n65) 563.

¹⁴⁴ *ibid.*

¹⁴⁵ Menkhoff (n3) 911.

¹⁴⁶ Niclas Hellman, 'Can We Expect Institutional Investors to Improve Corporate Governance?' (2005) 21 *Scand J Mgmt* 306.

¹⁴⁷ Also between institutional investors' sponsors or fund trustees as agents and fiduciaries as principals.

professionals use tools or engage in investment behaviour that may not be within the client's parameters in order to serve their own interests, which intrinsically generates a conflict of interest and does not show reasonable care of the investment, but a breach of their duty of loyalty to their clients.

This does not suggest that fund managers always look after their own interests only and not those of their beneficiaries, nor does it necessarily create significant agency conflicts between beneficiaries and trustees and/or between trustees and fund managers, because the structure of their investment mandates usually emphasizes non-absolute targets for returns and volatility, so agency concerns are also contracted out, relying on the premise of market efficiency. The assumption is that in actual performance, institutional shareholders have an acute understanding of their investment strategy or status and can develop their investment agenda better than dispersed beneficial owners, so it is possible for them to eliminate any conflict of interest and monitor the performance of investment or portfolio managers or agents. This may require such managers/agents to make their investment arrangements in accordance with certain techniques, but with limited influence over their investment activities. However, the agent's acceptance of institutional shareholders' methods logically implies that the agent, as a prudent skilled specialist, will apply these coherently and prudently within the framework of modern portfolio theory. In addition, this influence may be established for internal investment managers controlled completely by the institutional shareholders, not the employed investment or portfolio managers. In fact, it depends on the nature of the interest that the external professional investment managers have, which could be inconsistent with the institutional shareholders' interests. This illustrates

a clear tendency to restrict the freedom of [professional investment managers] by specifying investment styles to follow and benchmarks for the portfolio's performance. Such mechanisms can be seen as an attempt to alleviate the agency problems in investment management. But while it is possible to limit the freedom of the portfolio manager to some extent, it remains intrinsically inconsistent with the concept of investment management to completely specify the actions of the agent in advance. The financial service of asset management

cannot effectively benefit the investor without the portfolio manager enjoying some margin of discretion.¹⁴⁸

Interestingly, the complexity of this difficulty depends on what sort of interests the external professional investment managers could come into conflict with. Conflicts of interest may be identifiable in many ways in the relationship between the institutional shareholders and their external financial intermediaries. For instance, they may occur because professional investment managers sometimes represent more than one client, or because certain interests might conflict with other institutional shareholder objectives, or because professional investment managers also offer other financial services to the same clients, or because professional investment managers invest in their own accounts or have personal interests in the consequences of the transactions of clients.¹⁴⁹

The conflicts of interest which are characteristic of institutional investors can thus be seen to impair their activism behaviour in multiple ways. The detailed implications for the situation in Saudi Arabia are discussed in chapter 6. Meanwhile, let it be noted that the concept of fiduciary duty applicable to trusts in common-law countries has a significant role in solving these problems.¹⁵⁰ Yet the specific nature of the fiduciary relationship between institutional shareholders and investment or portfolio managers has, since its inception, had a function beyond the relations of private shareholders and managers or the normal principal-agent relationship. It has long caused confusion over how investment managers should manage assets in their customers' best interests; enforcing such fiduciary duties causes many difficulties, as it does not fit with modern financial practice or services. Indeed, fiduciary law seems not to be particularly valid, as it

...does not fit well with the much more complicated financial services of today, the large scale at which financial services that require loyalty are nowadays organized, or with the tendency to create multifunctional financial institutions that combine almost all financial services under one roof.¹⁵¹

¹⁴⁸ Marc Kruithof, 'Conflicts of Interest in Institutional Asset Management: Is the EU Regulatory Approach Adequate?' (2005) Ghent University Financial Law Institute Working Paper 2005-07, 12 <<http://ssrn.com/abstract=871178>>[Accessed on 05/03/2014].

¹⁴⁹ *ibid* 7, 13-14.

¹⁵⁰ *ibid* 24. Other jurisdictions have similar rules to address conflicts of interest.

¹⁵¹ *ibid* 27.

Thus, the recent development of financial markets and business practice has shown many improvements that may result from the increased concentration of ownership by institutional investors in response to the general problem of conflicts of interest. Kruihof lists some of these improvements:

First, the industry has been moving away from the traditional single [investment] manager that controls a broad based portfolio towards very specialized mandates focused on narrowly defined asset classes and clearly defined investment styles and strategies. Performance is being evaluated based on general or specialized market indices ... [which make it] more difficult for managers to deliberately hurt the client's interests by choosing suboptimal investment decisions without being caught. ... Second, most [professional investment] management contracts include disclaimers trying to limit the potential liability of the financial firm. Not only are such clauses designed to inform the client in advance of any potential conflict of interest, thereby shielding the firm from any future claim based on such a conflict, but they also in effect aim to limit the duties the portfolio manager owes his client. Under the most broad of such exonerating clauses, the manager only promises to spend a reasonable amount of effort trying to generate an investment result that conforms with the industry standards, without being required to take the best decision for the investment interests of the client at every turn.¹⁵²

It is also important to recognise that the question of who holds the professional investment managers accountable to their clients or owners may no longer be the acute problem it used to be.¹⁵³ For example, interaction with boards and management is no longer an option for institutional shareholders. To this effect, a significant regulatory improvement will be made by the UK Law Commission in its final report, due in June 2014, to codify the legal concept of fiduciary responsibilities in investment intermediaries and to address uncertainties and misunderstandings on the part of the investment chain, urging longer-term thinking in the investment world and recommending the application of fiduciary standards to those working in financial

¹⁵² *ibid* 51.

¹⁵³ Ruth Sullivan, 'UK Debates Fiduciary Duty Confusions' *Financial Times* (London 2012), <<http://ft.com/intl/cms/s/0/26663138-cc1e-11e1-aac1-00144feabdc0.html#axzz2TH4Jj8FK>> [Accessed on 05/03/2014]

markets for long-term trust-based relationships that support engagement in pursuit of sustainable value creation.¹⁵⁴

They should exercise their influence by using several possible legal instruments that may have a dynamic and positive impact on corporate decision-making. Furthermore, this engagement with the directors and managers should not be exercised by investment and asset managers alone. Today, institutional shareholders themselves are facing a changed global business environment, as they are expected to engage directly in monitoring management closely and pressing for change by exercising ownership rights. They should do so in a way that is coherent with their investment policy, which protects the financial value of their investments and which is most likely to enable the directors and managers of the investee company to achieve their long-term strategic objectives. Investors' goals should be the company's goals.

3.6 Chapter Summary

The most remarkable recent change in Anglo-American capital markets has been the innovation of the institutional shareholder as a pooling investment vehicle, replacing the ownership of individual investors of companies with a large number of common shares owned by institutional investors of different types. This chapter has discussed how they have become a key factor in promoting competition and efficiency, modernizing capital markets, enhancing transparency and information disclosure and reinforcing corporate governance standards. Although regulatory barriers impede their increasing ownership of publicly-traded companies, many large institutional shareholders have exercised significant influence as activist shareholders. It has been pointed out that such activism among institutional shareholders has recently become the rule rather than the exception in capital markets around the world and that it now plays a central role in corporate governance, heavily influencing corporate affairs and decision-making. In this connection, perhaps a more important finding of this chapter has been that one of the most recent phenomena in the activism of institutional investors in the capital market is

¹⁵⁴ The Law Commission, 'Fiduciary Duty of Investment Intermediaries – Response to Questions', Paper No. 215, <http://lawcommission.justice.gov.uk/docs/cp215_fiduciary_duties_response_form.pdf>, [Accessed on 05/03/2014]

the pressure which they place on managers and directors of investee companies to meet social and environment standards. The chapter has also identified the characteristics that shape institutional shareholders' propensity toward activism, arguing that while the likelihood of them exercising various investment policies depends on their size, it is their approach to investment obligations or liability to their beneficiaries that helps to determine which among them are likely to be the most activist. Hence, recent developments in capital markets and business practice have brought many improvements, resulting partly from the increased concentration of ownership by institutional investors in response to the general problem of conflicts of interest, which play a role in impeding the current efforts of institutional investors to exercise influence over companies and to hold them accountable for good governance. In the Saudi context, it will be argued in chapters 5 and 6 that institutional shareholders' activism has an important role in the development of the capital market. The regulatory framework contains several obstacles to diminishing potential conflicts of interest and improvements are needed to encourage institutional investors to function effectively as corporate governance monitors and to increase their ownership of publicly-traded companies. Meanwhile, a significant regulatory improvement has been made in the UK, for example, to increase the stewardship behaviour of institutional investors and to encourage them to play a greater role in corporate governance. The next chapter discusses these regulatory developments with the intention of assessing their ability to enhance the quality of engagement between institutional investors and investee companies, considering their unique position of influence towards a longer-term investment approach and the protection of minority shareholders in the UK.

Chapter 4

Institutional Shareholders' Activism and the Protection of Minority Shareholders in the UK

4.1 Introduction

It can be said that the UK has developed the basis for a distinctive corporate governance regulatory framework which, as mentioned in chapter 1,¹ has built a strong investment environment and boosted business trust, making the UK a favoured location for international portfolio diversification. This strengthening of the investment environment and of trust has been validated as a means of delivering a high standard of corporate governance practice that encourages efforts to enhance institutional shareholder activism by providing clear guidelines for distinguishing acting in concert from corporate governance activism and offering a high level of minority shareholder protection in publicly-traded companies, making such guidelines globally popular amongst policymakers.² Therefore, with the recent development of institutional shareholder activism and protection of minority shareholders in Saudi Arabia, the UK's experience of corporate governance best practice provides an excellent opportunity to draw lessons contributing significantly to addressing the weakness of existing corporate governance practices, as discussed in the following chapters. Such reforms might well imitate UK investment trusts by protecting and safeguarding the interests of minority shareholders and create a favourable investment environment by encouraging engagement by institutional investors in Saudi Arabia.

Many factors and innovations can be said to have helped to develop and strengthen the UK's corporate governance framework, such as its entry into the European Community in 1972, which prompted a change in the approach to corporate governance. The introduction of legislation was necessary in order to implement Community

¹ Section 1.6.

² Paolo Santella, Enrico Baffi, Carlo Drago and Dino Lattuca, 'A Comparative Analysis of the Legal Obstacles to Institutional Investor Activism in Europe and in the US' (2009) Working paper 29 <<http://ssrn.com/abstract=1137491>>[Accessed on 05/03/2014].

directives and to underpin the duties of loyalty owed by directors.³ The EU has implemented harmonisation and integration programmes to facilitate cross-border investment, a single European market and the harmonisation of EU company law,⁴ making inevitable greater consideration by the UK of models popular in other EU countries, which tend to be more stakeholder-orientated. Although harmonisation in this area has been resisted, membership of the EU has fuelled the debate and moved the UK's political spectrum away from a traditional and purist approach towards shareholder primacy. Another innovation encouraging institutional investors to inject money into shares in the UK capital market was the changing of tax rules, which placed more new money in their hands. These changes, designed to dissuade individual investors from buying shares directly in the UK capital market,⁵ altered individual investors' conventional wisdom by changing their habits to saving money with institutional investors, since these entities were eligible for lower tax rates than individuals and had better access to company information.⁶ It has been asserted in this regard that such tax rules 'contributed to a "wall of money" in institutional hands that had to be invested and created demand by default for shares'.⁷ This gave institutional investors, particularly insurance companies and pension fund owners, the potential for a shift toward control-oriented corporate governance, which led them by 1991 to become the most important class of investors in the UK capital market.⁸

Other important factors also resulted in a move away from the more traditional shareholder primacy approach. The growth of institutional investors—including pension funds, insurance companies and other investment vehicles—gave great influence to these institutions, which themselves must demonstrate corporate responsibility. It is also more likely that some of them would be interested in long-term rather than short-term growth and therefore assess performance over a longer timeframe. The increasing number of shares in the hands of institutional shareholders, especially pension funds

³ M Arden, 'Reforming the Companies Acts – The Way Ahead' [2002] JBL 579.

⁴ S Kiarie, 'At Crossroads: Shareholder Value, Stakeholder Value and Enlightened Shareholder Value: Which Road Should the United Kingdom Take?' [2006] ICCLR 329, 337.

⁵ B Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford University Press 2010) 346.

⁶ F Allen, A Bernardo and I Welch, 'A Theory of Dividends Based on Tax Clienteles' (2000) 55 J Finance 2499. See also A Shleifer & R Vishny, 'Large Shareholders and Corporate Control' (1986) 94 J Political Economy 461.

⁷ Cheffins (n5).

⁸ *ibid* 344.

and insurance companies, was an imperative development in the UK's corporate governance system, as they became the dominant players in publicly-traded companies following the Second World War. Their shares in such companies rose from 9% in 1957 to 33% in 1975, due to various factors, which helped to change the investment behaviour of institutional shareholders towards the capital market as an alternative investment in the UK. In fact, reforms to UK company law and the soft regulations that have been shaped the UK corporate governance scheme have been driven by the powerful presence in the UK capital market of institutional shareholders.⁹

Arguably, company law is essential to provide the minority shareholders with the appropriate protection and to strengthen the position of institutional investors as minority shareholders. Thus, the effectiveness of minority shareholder protection in the UK has come under greater scrutiny than ever before since the ratification of the Companies Act 2006. This confirms the view that the rules protecting shareholders within the Act seem to give more confidence to the strategic plans of investment vehicles such as hedge funds and a large number of foreign institutional investors to inject more money into the UK capital market.¹⁰ This would persuade them to invest more financial assets by buying additional minority shares in UK publicly-traded companies, thus filling the gap left by pension funds and insurance companies. Investment levels for hedge funds grew from 0.6% in 1993 to 10% in 2006, and for foreign institutional investors from 16% in 1993 to 40% in 2006. Almost instantly, foreign institutional investors began to dominate shareholding in UK publicly-traded companies.¹¹

Against this backdrop, this chapter will discuss recent developments in the UK corporate governance regime concerning the activism of institutional investors and the protection of minority shareholders. It covers two main areas: the legal regulation of enlightened shareholder value as mandated by statute and the self-regulatory system of the corporate governance code. As Chapter 6 makes clear, this combination of statute and self-regulation has significant implications for the formulation of proposed reforms in

⁹ *ibid*390.

¹⁰ James Kirkbride, Steve Letza and Clive Smallman, 'Minority shareholders and corporate governance' (2009) 51(4) *International Journal of Law and Management* 208-214.

<doi:http://dx.doi.org/10.1108/17542430910974031> [Accessed on 05/03/2014].

¹¹ *ibid* 390.

Saudi Arabia. In detail, section 4.2 focuses on shareholders' general rights and the protection of minority shareholders (derivative action), then attention turns in section 4.3 to the general duties of directors under the Companies Act 2006, paying particular attention to section 172, representing the UK's new approach to corporate governance: enlightened shareholder value. Section 4.4 summarizes and discusses directors' duties, then section 4.5 addresses the role of institutional investors in corporate governance in the UK since the Cadbury Report of 1992, the recent Corporate Governance Code of 2012 and the Stewardship Code of 2012 respectively. Section 4.6 reviews the influence of trade organisations on institutional investors' activism in the UK and the chapter ends with a summary.

4.2 The Protection of Shareholders in the UK

4.2.1 Shareholders' Rights

UK legal provisions create a clear system of power for the board of directors and discipline in the hands of shareholders as monitors of the company's affairs, holding directors accountable. For example, under the Companies Act 2006, shareholders enjoy various rights, many of which are discussed in chapter 6 in the Saudi context. Generally, shareholders' rights under UK law fall into four groups: decision-making rights in order to limit the power of the board of directors; appointment and removal rights; shareholding rights and intervention rights.¹² Decision-making rights include the power of shareholders to approve changes to the constitution¹³ and to decide on particular actions such as the award of long-term service contracts to directors,¹⁴ substantial property transaction with directors¹⁵ and loans and quasi-loans to directors.¹⁶ As to appointment and removal rights, these give shareholders the power to remove directors at the AGM.¹⁷ Finally, shareholding rights and intervention rights include pre-emption rights when the company issues new shares,¹⁸ the right to submit proposals to the

¹² I MacNeil, 'Activism and Collaboration among Shareholders in UK Listed Companies' (2010) 5(4) *Capital Markets Law Journal* 422 <<http://cmlj.oxfordjournals.org/content/5/4/419.full>>[Accessed on 05/03/2014].

¹³ CA 2006 s 21.

¹⁴ *ibid* s 188-9.

¹⁵ *ibid* s 190-6.

¹⁶ *ibid* s 197-214.

¹⁷ *ibid* s 168.

¹⁸ *ibid* s 549.

AGM¹⁹ and the right to appoint proxies.²⁰ In respect of directors' duties, as discussed in section 4.3, shareholders are expected to take action where they deem that the directors have breached these. How minority shareholders are able to bring a derivative suit against directors is discussed in the following section. First, it is necessary to introduce old case law principles, since they have been found to represent the spirit and foundation of the new Act, in order to see how the Act will play a primary role in protecting shareholders from the abuse of power by directors.²¹

4.2.2 Common Law Rules and Shareholders' Remedies

One of the judicial ways to strengthen the position of institutional investors as minority shareholders against directors is what has become known as a shareholders' derivative suit. As in common law, in a country where case law principles are well developed and where shareholders are said to be better protected, judicial intervention is believed to be an indispensable factor of the common law approach to corporate governance.²²

Shareholders may also bring a personal legal action against the company in order to protect their interests or to enforce their rights in the company's constitution,²³ or bring an action to protect the interests of the company as a whole where the directors commit a wrong against the company or breach their duties. However, such remedies are not widely open to shareholders under common law and restrictions have resulted from certain court decisions. The next two subsections examine the availability of these two legal actions to aggrieved shareholders under common law.

4.2.2.1 The rule in *Foss v Harbottle*²⁴

According to the rule in *Foss v Harbottle*, shareholders are prohibited from bringing an action to court where a wrong is done to a company.²⁵ Lord Davey's statement in

¹⁹ *ibid* s 314.

²⁰ *ibid* s 324.

²¹ Len Sealy and Sarah Worthington, *Cases and Materials in Company Law* (8th edn, Oxford University Press 2008), 6.

²² Rafael La Porta et al, 'Investors Protection and Corporate Governance' (2000) 58 *J Financial Economics* 9
<<http://leedsfaculty.colorado.edu/bhagat/InvestorProtectionCorporateGovernance.pdf>> [Accessed on 05/03/2014].

²³ The attention in this section is on the history of the derivative action and the recent developments under the Companies Act 2006.

²⁴ (1843) 2 Hare 461, 67 ER 198.

*Burland v Earle*²⁶ stipulates that ‘a court has no jurisdiction to interfere with the internal management of companies acting within their powers. The company must sue to redress a wrong done to it’. Jenkins LJ’s judgment in *Edwards v Halliwell*²⁷ characterised the rule in *Foss v Harbottle* as follows:

First, the proper plaintiff in an action in respect of a wrong alleged to be done to a company or association of persons is prima facie the company or the association of persons itself. Secondly, where the alleged wrong is a transaction which might be made binding on the company or association and on all its members by a simple majority of the members, no individual member of the company is allowed to maintain an action in respect of that matter for the simple reason that, if a mere majority of the members of the company or association is in favour of what had been done, then cadit quaestio. No wrong had been done to the company or association and there is nothing in respect of which anyone could sue. If, on the other hand, a simple majority of members of the company or association is against what has been done, then there is no valid reason why the company or association itself should not sue.

In *Prudential Assurance Co Ltd v Newman Industries Ltd*²⁸ the Court of Appeal held that Jenkins LJ’s judgment in *Edwards v Halliwell*²⁹ stated ‘the classic definition of the rule in *Foss v Harbottle*’. Accordingly, the rule in *Foss v Harbottle* is explained as follows:

Proper plaintiff principle. If the company is allegedly wronged, then the company, as a separate person, is considered the proper plaintiff to enforce the rights belonging to it.³⁰

Internal management principle. Individual shareholders or a minority of shareholders are not permitted by the court to litigate in matters regarding the internal affairs of the company; it is only the majority of shareholders who decide on behalf of the company whether to bring the action before the court.³¹ This principle is considered the foundation of the rule in *Foss v Harbottle*, ‘because the internal management principle is based on the idea that matters of internal management are conclusively settled by

²⁵ D French, S Mayson and C Ryan, *Mayson, French & Ryan on Company Law* (24th edn, Oxford University Press 2007) 516.

²⁶ [1902] AC 83, 71 LJPC 1.

²⁷ [1950] 2 All ER 1064.

²⁸ (No.2) [1982] Ch 204, the Court of Appeal, 210-11.

²⁹ [1950] 2 All ER 1064.

³⁰ Sealy and Worthington (n21) 502.

³¹ J Birds et al, *Boyle & Birds’ Company Law* (8th edn, Jordans 2011) 674.

majority decision and so not reviewable by the courts and the proper plaintiff principle is based on supposed common law rules that the majority in a general meeting have the right to decide on whether or not to litigate in the company's name.³²

Ratifiability principle. If a minority of shareholders claims that the directors of the company have acted in a wrongful manner, the claim may not be pursued in a case where the illegal conduct could be ratified by the majority of shareholders in the general meeting. The ratifiability principle was acknowledged by Wigram V-C in *Bagshaw v Eastern Union Railway Co*³³ in the following form:

...if the act, though it be the act of the directors only, be one which a general meeting of the company could sanction, a bill by some of the shareholders, on behalf of themselves and others, to impeach that act cannot be sustained, because a general meeting of the company might immediately confirm and give validity to the act of which the bill complains.

Mellish LJ in *McDougall v Gardiner*³⁴ 'observed the futility of ignoring the majority power to ratify',³⁵ while Jenkins LJ in *Edwards v Halliwell*³⁶ stated that the ratifiability principle is a very important factor in the ruling in *Foss V Harbottle*.³⁷

It has been said that the rule in *Foss v Harbottle* has eliminated the chances of shareholders filing unreasonable suits and prevents them from litigating for any wrongs done to their company or for any internal irregularities in the operation of the company.³⁸ Thus, the reason for the rule appears to be the court's desire not to hear any allegations by individual shareholders concerning the affairs of their company, in order to avoid multiple claims. Mellish LJ elucidated this clearly in *Macdougall v Gardiner*³⁹ as follows:

Looking to the nature of these companies at the way in which their articles are formed, and that they are not all lawyers who attend these meetings. Nothing can be more likely than that there should be something more or less irregular done at them – some directors may have been irregularly appointed, some directors

³² French et al (n25) 518.

³³ (1849) 7 Hare 114, 130.

³⁴ (1875) 1 Ch D 13, 25.

³⁵ Birds et al (n31) 675.

³⁶ [1950] 2 All ER 1064.

³⁷ French et al (n25) 520.

³⁸ JH Farrar & BM Haningan, *Farrar's Company Law* (4th edn, 1998) 431.

³⁹ (1875) 1 Ch D 13, 25.

irregularly turned out, or something or other may have been done which ought not to have been done according to the proper construction of the articles. Now, if that gives a right to every member of the company to file a bill to have the question decided, then if there happens to be a cantankerous member, or one member who loves litigation, everything of this kind will be litigated; whereas, if the bill must be filed in the name of the company, then, unless there is a majority who really wish for litigation, the litigation will not go on. Therefore, holding that such suits must be brought in the name of the company does certainly greatly tend to stop litigation.⁴⁰

4.2.2.2 Common law exceptions to the rule in *Foss v Harbottle*

The rule in *Foss v Harbottle* has no application if the act complained of is either ultra vires or unlawful,⁴¹ or one which could be done only by some special majority of shareholders.⁴² Thus, the term ‘*fraud on minority*’ under common law is found to be the only true exception to the rule in *Foss v Harbottle*.⁴³ The definition of fraud not only has its ordinary meaning under common law, but extends to include other unlawful acts such as the breach of directors’ duties, the abuse of their power, where those in control of the company have obtained some unreasonable advantage at the expense of the company, or if those in control of the company have acted in a fraudulent manner by giving themselves corporate property.⁴⁴ The term ‘fraud’ includes situations such as Lord Davey exemplified in *Burland v Earle*⁴⁵ ‘...where the majority is endeavouring, directly or indirectly, to appropriate to themselves money, property or advantages which belong to the company or in which other shareholders are entitled to participate’. Consequently, the shareholder or minority shareholders, when they attempt to bring a derivative action on behalf of the company to redress such fraudulent acts, must show the court that the company was not capable of bringing such action in its own name,⁴⁶ or the court must be willing to ignore the company’s decision not to sue.⁴⁷

Griffin argues that it is not easy for the court to determine whether the action should be defined as a derivative or personal action. In situations where the unlawful act conflicts with the terms of the memorandum and the articles, or where a company is

⁴⁰ French et al (n25) 519.

⁴¹ Birds et al (n31) 675.

⁴² *ibid.*

⁴³ Farrar & Haningan (n38) 433.

⁴⁴ S Griffin, *Company Law: Fundamental Principles* (Longman 2000) 329.

⁴⁵ [1902] AC 83 (PC), 93.

⁴⁶ *ibid.*

⁴⁷ French et al (n25) 522.

supposed to pass a resolution by a simple majority vote instead of a prescribed special resolution, the minority shareholders may be able to bring a derivative action and/or personal action.⁴⁸ Yet, under the ‘no reflective loss principle,’ shareholders or minority shareholders have no right to sue in their personal capacity where the loss in this litigation merely reflects the loss suffered by the company.⁴⁹ Nevertheless, if the company is not capable of suing for misconduct that affects shareholders or minority shareholders personally and indirectly, they may be capable of recovering the personal losses arising from the same misconduct.⁵⁰

4.2.3 Companies Act 2006 Section 260(1) on Derivative Action

Where a wrong has been done to the company, minority shareholders, as an exception to the rule in *Foss v Harbottle*, may bring a derivative claim on behalf of the company under the Civil Procedure Rules 1998. Such a claim may now be brought only under Part 11 of the Companies Act 2006 or in pursuance of a court order in unfair prejudice proceedings under section 994 of the Act,⁵¹ which replaces common law derivative procedures and those of *Foss v Harbottle* that have been applied to such claims.⁵² Thus, a derivative claim is now defined under section 260(1) of the Companies Act 2006 as a proceeding by a member of a company who may bring an action, but only with regard to a course of action to protect the interests of the company,⁵³ and ask the court for relief on behalf of the company. Such a case of action arises from an actual or proposed act or omission by a director or another member, or both,⁵⁴ which involves negligence, a default, a breach of duty or a breach of trust by a director of the company.⁵⁵ French notes that under the old common law, shareholders were ‘not allowed to sue with regard to a director’s negligence, if it did not benefit the director personally’.⁵⁶ On the other hand, the shareholder of a company must show his or her evidence when applying for the court’s permission to continue the derivative claim.⁵⁷ Yet, if the court comes to the

⁴⁸ Griffin (n44) 333.

⁴⁹ Paul Davies and Sara Worthington, *Gower & Davies: Principles of Modern Company Law*, (9th edn, Sweet & Maxwell 2012) 625.

⁵⁰ Sealy and Worthington (n21) 547.

⁵¹ CA 2006 Section 269(2).

⁵² Birds et al (n31) 682.

⁵³ CA 2006, part 11 ch 2 s 265.

⁵⁴ *ibid* s 260(3); s 265(4).

⁵⁵ *ibid* s 260.

⁵⁶ French et al (n25) 523.

⁵⁷ CA 2006 s 261(1).

decision that the submitted application and supporting evidence are not adequate and do not disclose a prima facie case, the court must dismiss the application⁵⁸ and make any significant order it feels applicable.⁵⁹ However, the court may give direction to the company to present such evidence⁶⁰ and may defer the proceedings until the evidence is provided by the company.⁶¹ Accordingly, in recalling the trial, the court may take the approach that the claimant will be given permission to continue the claim on such terms as it thinks fit.⁶² Otherwise, the court will dismiss the claim or suspend the proceedings on the application and give such direction as it sees fit.⁶³

The derivative claim, under the Companies Act 2006, as an alternative to the old common law procedures, can be permitted or rejected after passing the court test set out under section 263.⁶⁴ If a derivative claim arises from an act or omission that is yet to occur, the court must come to a decision whether to permit it to continue, taking into account whether the act or omission might be approved by the company before it occurs, or ratified eventually, and whether, in this situation, one of these is likely to occur.⁶⁵ If the court comes to the decision that the act or omission has been approved by the company, it must refuse permission for the claim to proceed.⁶⁶ If a derivative claim arises from an act or omission that has already occurred, the court's decision whether to permit it to proceed must take into account whether the act or omission could be ratified by the company, and whether, in the situation, it would be likely to be ratified.⁶⁷ If the court is satisfied that it has been approved by the company, it must refuse permission.⁶⁸

It has been argued that the US is better at dealing with shareholders' derivative suits than UK.⁶⁹ In the UK, a derivative suit seems to be an insignificant part of the corporate law landscape, because of the obstructive limitations and restrictions on its use

⁵⁸ *ibid* (2)(a).

⁵⁹ *ibid* (2)(b).

⁶⁰ *ibid* (3)(a).

⁶¹ *ibid* (3)(b).

⁶² *ibid* (4)(a).

⁶³ *ibid* (4)(b, c).

⁶⁴ *Davies and Worthington* (n49) 621.

⁶⁵ CA 2006 s 63(3)(c).

⁶⁶ *ibid* (2)(b).

⁶⁷ *ibid* (3)(d).

⁶⁸ *ibid* (2)(c).

⁶⁹ G Miller, 'Property Rights and Corporate Governance: Some Points of Contrast between the United States and England' (1998) *Columbia Business Law Review* 75-76. Also see A Alcock, J Birds and S Gale, *Companies Act 2006: The New Law* (Jordans 2009) 163-65.

mentioned above and because of the rules on attorneys' fees, which in the UK block the emergence of an entrepreneurial class of attorney specialising in class action and derivative litigation.⁷⁰ As Charkham notes, 'the directors of UK companies are seldom sued and on the whole do not fear litigation. This is partly because there are few causes which apply and partly because the machinery is not available'.⁷¹ Nevertheless, recent cases suggest that this has changed. For example, *Robin Stainer v. Gerard Lee (1) Enrique Elliott (2) Eldington Holdings Ltd*⁷² may reflect a new view of minority shareholders that the threat alone of a derivative action may be adequate for them to achieve their intention of changing the behaviour of directors and managers. In addition, what the new Companies Act 2006 has done in other areas of protecting minority shareholders, without going too deeply into detail, is to make changes which may affect the exercise of such claims, particularly in reference to directors' duties,⁷³ conflicts of interest⁷⁴ and the model of litigation in takeover cases.⁷⁵

Thus, Miller argues that the litigation system in the UK generally lacks a strong interest group in favour of such a claim. The UK legal profession, as a natural constituency in favour of derivative litigation, is not greatly enthused because of the obstructive rules on fees. Without the contingent fee as an incentive, UK lawyers would not obtain significant benefit, even if the substantive limitations on derivative litigation were alleviated; while there has always been a strong constituency in the UK in favour of limiting derivative litigation, there is no constituency of comparable strength in favour of liberalising derivative action as a remedy for shareholders, notwithstanding changes under the Companies Act 2006.⁷⁶

⁷⁰ *ibid.*

⁷¹ J Charkham, *Keeping Better Company: Corporate Governance Ten Years on* (OUP 2005) 364.

⁷² *Robin Stainer v Gerard Lee (1) Enrique Elliott (2) Eldington Holdings Ltd (3)* [2010] EWHC 1539 (Ch). See also *Franbar Holdings Ltd v Patel and Ors* [2008] EWHC 1534 (Ch); *Stimpson & Ors v Southern Landlords Association* [2009] EWHC 2072 (Ch); *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch).

⁷³ CA 2006 s 170.

⁷⁴ *ibid* s 175.

⁷⁵ *ibid* ss 942-965.

⁷⁶ Miller (n69) 75-76.

4.3 Directors' Duties under the UK Companies Act 2006

Prior to the ratification of the Companies Act 2006, the laws pertaining to directors' duties were predominantly governed by the principles of fiduciary duty and the common law of negligence.⁷⁷ Nonetheless, it is important to understand that there is indisputable and infrequent interaction between the Act and common law, even though the statutory structure is best understood as an avowal or acknowledgment of a director's general obligations, and thus as a tactic to compress case law principles to a diminutive and comprehensible codification. To be more precise, sections 171-177 of the Act stipulate seven general duties, while section 170(3) states expressly that these 'general duties are based on certain common law rules and equitable principles as they apply in relation to directors and have effect in place of those rules and principles as regards the duties owed to a company by a director'. This implies that the spirit of the Act is derived from the common law rules or equitable principles that were developed by judges through case law.⁷⁸ The question is whether the case law should be disregarded or whether the statutory wording of directors' duties should be interpreted and applied in the light of common law rules and equitable principles.

That said, the statutory code for directors' duties was recommended⁷⁹ in order to enable the rules to be acknowledged by the directors, who should be able to understand more easily what their obligations are, aside from making the development of the duties more predictable, and to reform the equitable principles relating to conflicts of duty and interests perceived as disproportionately harsh.⁸⁰ It should be noted, though, that one danger of codification exists in the possibility of losing the adaptability and flexibility of common law in exchange for fixed statutory wording.⁸¹ Section 170(4) of the Companies Act 2006 attempts to avoid this by stating: 'The general duties shall be interpreted and applied in the same way as common law rules or equitable principles, and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties'. This means that although the statutory wording has replaced all previous common law rules or equitable principles, these rules

⁷⁷ French et al (n25) 470.

⁷⁸ Davies and Worthington (n49), 478-479

⁷⁹ CLRSG, *Modern Company Law for a Competitive Economy: Final Report* (URN 01/942) (2001) DTI.

⁸⁰ Birds et al (n31) 606.

⁸¹ French et al (n25) 470.

or principles might be more noteworthy and meaningful in the event that statutory principles are vague or their origin ambiguous.⁸²

4.3.1 The Statutory Structure of Directors' Duties

Generally speaking, every duty concerning directors can be summarised as follows: a duty to act within the terms of his powers;⁸³ to promote the success of the company as the director sees it in good faith;⁸⁴ to exercise independent judgment;⁸⁵ to exercise reasonable care, skill and diligence;⁸⁶ to avoid conflicts of interest;⁸⁷ not to accept benefits, such as bribes and secret commissions;⁸⁸ and to declare interests in transactions and arrangements.⁸⁹

In addition, the statement of director's duties is made in Chapter 2, Part 10 of the Companies Act 2006, headed 'General Duties of Directors'. The scope of the statutory structure is set out in section 170 as follows: '(1) The general duties specified in sections 171 to 177 are owed by a director of a company to the company.' This means that a director does not, by virtue only of being a director, owe any fiduciary duty to the members of the company, to its creditors, or to fellow directors, but to the company only.⁹⁰ Indeed, directors in the Saudi context are seen also to have the duty to promote the success of the company itself, but not in the interests of any specific group.⁹¹

Thus, it is essential in the next section to discuss section 172 CA 2006 on enlightened shareholder value, which complements other institutional measures encouraging good governance for the benefit of shareholders and other stakeholders alike.

⁸² P Davies and J Rickford, 'Introduction to the New UK Companies Act' (2008) 5 ECFR 48, 63
<http://heinonline.org/HOL/Page?handle=hein.journals/ecomflr5&div=7&g_sent=1&collection=journals#58> [Accessed on 05/03/2014].

⁸³ CA 2006 s 171.

⁸⁴ *ibid* s 172.

⁸⁵ *ibid* s 173.

⁸⁶ *ibid* s 174.

⁸⁷ *ibid* s 175.

⁸⁸ *ibid* s 176.

⁸⁹ *ibid* s 177.

⁹⁰ French et al (n25) 472.

⁹¹ See section 6.5.2

4.3.2 S172: Duty to Promote the Success of the Company (Enlightened Shareholder Value)

A 2005 White Paper stated that one aim of the UK government was to ‘embed in statute the concept of Enlightened Shareholder Value by making clear that directors must promote the success of the company for the benefit of its shareholders, and this can only be achieved by taking due account of both the long term and short term, and wider factors such as employees, effects on the environment, suppliers and customers’.⁹² The new approach to directors’ duties represented by enlightened shareholder value was said to be at the centre of what would become the Companies Act 2006, which ‘enshrines in statute what the law review called “enlightened shareholder value”. It recognises that directors will be more likely to achieve long-term sustainable success for the benefit of their shareholders if their companies pay attention to a wider range of matters’.⁹³ This is considered the central obligation of a director.⁹⁴ The following is therefore an evaluation of the approach adopted within s 172, rather than just a short outline; s 172 provides that:

- (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to
 - (a) the likely consequences of any decision in the long term,
 - (b) the interests of the company’s employees,
 - (c) the need to foster the company’s business relationships with suppliers, customers and others,
 - (d) the impact of the company’s operations on the community and the environment,
 - (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
 - (f) the need to act fairly between members of the company.
- (2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

⁹² DTI, *Company Law Reform* (March 2005) 5.

⁹³ HC Deb 7 June 2006, col 125.

⁹⁴ French et al (n25) 478.

(3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

Although the traditional approach of corporate governance has been to view the interests of the company as the interests of the shareholders, present and future, s 172 still refers to the interests of the members, and therefore maintains primacy of the interests of shareholders. The statutory duty provides that directors must ‘have regard’ to the factors listed in subsection 1(a-f). The section is not designed to open the doors to the judicial review of directors’ decision-making,⁹⁵ and the then Minister for Industry and the Regions explained in the parliamentary debate on the section that:

We believe it is essential for the weight given to any factor to be for a matter for a director’s good faith judgment. Importantly, the decision is not subject to the reasonableness test that appears in other legislation [...]. That is in sharp contrast to, for example, decisions on public law, to which courts often apply such a test.⁹⁶

Lord Goldsmith, in the House of Lords, asserted that the government’s intention was that the duty to have regard to these factors should be subordinate to the overriding duty to act in what the director ‘considers, in good faith would be most likely to promote’ the company’s success.⁹⁷ He continued:

We want the director to give such consideration to the factors identified as is necessary for the decision that he has to take, and no more than that. We do not intend a director to be required to do more than good faith and the duty of skill and care would require, nor do we want it to be possible for a director acting in good faith to be held liable for a process failure where it could not have affected the outcome.⁹⁸

Accordingly, although the duty is formulated in such a way as to place a duty on directors to ‘have regard to’ the factors, this is a secondary requirement, which is subordinate to the general duty to promote the success of the company, and there is no

⁹⁵ Davies and Worthington (n49) 513.

⁹⁶ HC Deb 11 July 2006, cols 591-2.

⁹⁷ HL Deb 9 May 2006, col 845.

⁹⁸ *ibid* col 846.

specific guidance on the weight or priority to be given to the various factors, which is left to the individual director to decide.

4.4 Evaluation of Directors' Duties

It is evident from section 4.3 that the provisions on directors' duties contained in the Companies Act 2006 largely codify existing duties, with the effect of maintaining the traditional approach to corporate governance, in that the directors owe duties solely to the company and that these duties are enforceable by the company alone, although this may be through a shareholder derivative action. In this way, the Act has largely maintained the shareholder primacy model of corporate governance, although one of the duties in particular has evolved through the codification process, to encompass in section 172 the new corporate governance model of enlightened shareholder value. As mentioned earlier, it was realised that it was desirable from the common law point of view to have a more descriptive code, and in the case of what is now section 172, a decision was made not only to codify but also to reform the law, by adopting the enlightened shareholder value approach.

However, academic commentators have identified some problems with the approach, and in particular the way it has been implemented. Section 172 requires that directors take decisions which they believe in good faith to promote the success of the company. Critics have argued that this subjective test permits directors too much leeway to take whatever decisions they want, being able simply to pass them off as being in good faith. One commentator presumes that this subjective test makes the monitoring of directors practically impossible.⁹⁹ Furthermore, Keay concludes that the section grants 'unfettered discretion' to the directors, provided they act in a way that they themselves consider to be beneficial.¹⁰⁰ No objective standards against which the good faith decisions of the directors can be judged are provided in the Act or in accompanying guidance. Some more optimistic writers have noted that the wording of section 170, which states that 'regard shall be had to the corresponding common law rules and

⁹⁹ Sohia Wesley-Key, 'Companies Act 2006: Are Cracks Showing in the Glass Ceiling?', Unpublished PhD thesis (University of Sussex. Sussex Law School. Graduate Centre for Legal Studies), 73<
<http://capitadiscovery.co.uk/sussex-ac/items/900436?outdated=true>>.

¹⁰⁰ Andrew Keay, 'Section 172(1) of the Companies Act 2006: An Interpretation and Assessment' [2007] Comp Law 106, 107,< <http://law.leeds.ac.uk/people/staff/keay/publications>>, accessed on 05/03/2014.

equitable principles in interpreting and applying the general duties’, may serve to incorporate the decision of *Charterbridge Corp Ltd v Lloyds Bank Ltd*,¹⁰¹ in which it was alleged that in considering the actions of directors, the question of whether an honest and intelligent man in the position of the director could have reasonably believed that the action was for the benefit of the members should be included. However, section 172 is a ‘new’ duty in that it contains a completely new approach, distinct from its common law predecessor, and it is by no means clear that the courts will interpret it to involve any objective standard at all. Indeed, to do so would appear to go against the very nature of the section. Fisher argues that the lack of objective standards makes the director’s position ‘virtually unassailable’,¹⁰² but that despite the criticism that this may raise, it ‘may reflect judicial unwillingness to become embroiled in assessing business strategy’.¹⁰³ The new model therefore continues the traditional approach of leaving directors to determine the best way to achieve success, and indeed just what ‘success’ is, rather than for the courts to become involved in business strategy.

Another problem regarding the potential for lack of clarity in the section is the paucity of a clear definition of the phrase ‘have regard to’. As Fisher notes, the phrase:

Is not explained so it is unclear whether directors should consider stakeholder interests per se, or only as far as they benefit shareholders. For example, it fails to indicate whether directors can pick from all options with an equal chance of success or if they must opt for the one most beneficial to shareholders.¹⁰⁴

Furthermore, as the list of factors to be considered is not exhaustive, confusion remains as to what ‘other factors’ a director must consider. When considering the list, there is no guidance as to how much weight the directors are to give to each of the competing interests, or how to prioritize the factors to consider.¹⁰⁵ As noted earlier, during the ratification of the Act it was made clear that the interests of other stakeholders and the consideration of the factors listed were to be secondary to the superseding duty towards the shareholders. Still, some contend that even the interests of shareholders are hard to

¹⁰¹ [1969] 3 All ER 1185.

¹⁰² D Fisher, ‘The Enlightened Shareholder- Leaving Stakeholders in the Dark: Will Section 172(1) of the Companies Act 2006 Make Directors Consider the Impact of their Decisions on Third Parties?’ (2009) ICCLR 10, 15.

¹⁰³ *ibid.*

¹⁰⁴ *ibid* 15.

¹⁰⁵ L Linklater, ‘Promoting Success: The Companies Act 2006’ [2007] Comp Law 129.

define, leading to further confusion on the interpretation of the section and increased scope for directors to act with ‘unfettered discretion’. One commentator explains:

It is usually assumed that the only benefit the members of a company derive from it is the return on their investments. However, this is not necessarily easy to define. Do the directors have to ensure the company pays the highest possible annual dividends, or that the market price for its shares is as high as possible, or should they ensure the long-term growth and stability of the company? How risky should the shareholders’ investment be?¹⁰⁶

Even if the director is happy to comply fully with the spirit of the section and desires to take actions which he regards as being in good faith and likely to promote the success of the company for the benefit of its members, how is that director to demonstrate this? A director must show that he has ‘had regard to’ the various factors, but this is surely problematic.¹⁰⁷ The accompanying guidance provides that ‘it will not be sufficient to pay lip service to the factors’.¹⁰⁸ This has led some commentators to assert that board minutes will have to become much more detailed in order to demonstrate that each of the factors was indeed considered and noted.¹⁰⁹ Nonetheless, there is a danger in this course of action that this would merely become a formality to be complied with by a simple note in the minutes and thus effectively meaningless. There is also a danger that other considerations may be neglected and commercial efficiency would be hindered by over-concern to provide a detailed record of consideration of the factors.¹¹⁰

An even greater problem with the new formulation of the duty is the lack of effective enforcement provision. Although the interests of stakeholders are to be considered, there is no positive duty towards them that they can enforce. Nor is there any means by which they can challenge whether or not a director has actually had regard to their interests. Correspondingly, if a stakeholder group feels that the director has failed in his duty to have regard to the interests of that stakeholder group, there is no entitlement to challenge the director or require him to prove that he did consider their interests.

¹⁰⁶ French et al (n25) 467.

¹⁰⁷ B Perry and L Gregory, ‘The European Panorama: Directors’ Economic and Social Responsibilities’ [2009] ICCLR 25, 29.

¹⁰⁸ Key (n100) 108.

¹⁰⁹ R Davidson, ‘The Companies Act 2006: Directors’ Duties and Promoting the Company’s Success’ (2007) 11 JIBFL 631.

¹¹⁰ Perry and Gregory (n107) 29.

This is similar to the effect of section 309 of the Companies Act 1985, which provided ‘protection’ for the stakeholder group of employees. It established that directors should have regard to the interests of employees, stating that ‘the matters to which the directors of a company are to have regard in performance of their functions include the interests of the company’s employees in general, as well as the interests of its members’.¹¹¹ However, section 309 did not have the effect of providing a duty which was directly enforceable by employees themselves. Thus, it may be argued that the only protection the section offered was not to employees, but to directors, as against shareholder complaints that they had not considered employees. Yet, even in ‘considering’ the interests of employees, there was no duty upon directors to even consult with those employees to establish their interests.¹¹²

Some claimed that lacking an effective enforcement mechanism, section 309 was a ‘lame duck, and next to useless’.¹¹³ As the section was of no use to employees themselves, it was very rarely used, meaning that no case law was developed around it. Despite this great difficulty with the section, one distinguished commentator, it been has argued that section 172 will actually provide even less protection to employees than that offered by the inadequate section 309.¹¹⁴ Although the interests of employees are perceived as holding high importance in the theories underpinning a more stakeholder-centred approach, Lord Wedderburn argues that the effect of section 172, which ‘lumps together’ all interests other than shareholder interests, is to provide ‘the weakest possible statutory provision’.¹¹⁵ He contends that as employees’ interests are just one of a list of factors to be considered, these interests disappear into that list. Directors are to take account of the company’s relationships with its employees alongside other groups, which provide supplies and custom.¹¹⁶ This confirms, in Lord Wedderburn’s opinion, that employees are considered just another supplier, rather than a distinct and special category.¹¹⁷

¹¹¹ C Wynn-Evans, ‘The Companies Act 2006 and the Interests of Employees’ (2007) 36(2) ILJ 188. <<http://ilj.oxfordjournals.org/content/36/2/188.full.pdf+html>>, [accessed on 05/03/2014].

¹¹² L Miles, G Proctor, ‘Duty, Accountability and the Company Law Review’ [1999] Comp Law 233.

¹¹³ Keay (n100) 109.

¹¹⁴ Lord Wedderburn Charlton, ‘Employees, Partnerships and Company Law’ (2002) 31(2) Ind Law J. 106 <<http://ilj.oxfordjournals.org/content/31/2/99.abstract>> [Accessed on 05/03/2014].

¹¹⁵ *ibid* 109.

¹¹⁶ *ibid* 110.

¹¹⁷ *ibid* 99.

Even if a director is technically in breach of section 172, such a breach is likely to be very difficult to establish, because of the subjective nature of the duty. Furthermore, there may be no one who is capable of or willing to bring an action for breach.¹¹⁸ In this case, the duty will be enforceable only by the company itself, possibly through a derivative action brought by shareholders. However, a derivative action may be difficult to pursue, as mentioned in the previous section, if it is against the wishes of the majority and is likely to be cost-prohibitive for shareholders if they are seeking to protect shareholders' interests. Shareholders are unlikely to pursue an action if the decision taken by the director has resulted in increased shareholder benefit. Moreover, it may be very difficult to show that the company has suffered any loss as a direct result of a decision which failed to have regard to stakeholder interests. The problem of enforcement has led Attenborough to assert

...that the directors are more likely to ensure, in order to protect themselves from the real threat, that they get the best possible deal for shareholders, even if it means disregarding the interests of others (and possibly breaching s 172(1) in a technical sense), because if they do not then the shareholders are the only ones who can pursue them for breach.¹¹⁹

Conversely, others are concerned that the section will actually increase directors' vulnerability to litigation, with shareholders subjecting them to tactical litigation for the benefit of pressure groups.¹²⁰

As a result of these problems, commentators have generally been fairly negative in their opinions of the implementation of enlightened shareholder value through section 172. For example, one commentator has stated that 'the proponents of opposite sides of the debate as to the extent to which company law should impose corporate social responsibility have been left dissatisfied by the enactment of s 172',¹²¹ while another has noted that

the Companies Act 2006 has attempted to establish a midway point between a shareholder and stakeholder approach [...]. The reality of the situation, however,

¹¹⁸ Fisher (n102) 15.

¹¹⁹ Attenborough (n105) 312, 317.

¹²⁰ N Fagan and C Bates, 'The Long Road to Reform: A Directors' Lot Under the Company Law Reform Bill' (2006) 4 JIBFL 16.

¹²¹ Linklater (n105) 129.

is rather more depressing – with the emphasis of benefit remaining with the shareholders and no remedy for other constituencies it is impossible to agree with any commentator who states that directors’ duties in relation to s.172 will actually change. Consequently, it must be concluded that s.172 and the ‘enlightened shareholder value’ approach are shareholder orientated, do not support a stakeholder approach, and will not do so until the directors are obliged to subordinate the interests of the shareholders.¹²²

It may therefore be concluded that the enactment of section 172 of the Companies Act will not have a significant effect on corporate governance in the UK, except perhaps in encouraging through ‘soft’ methods the consideration of wider interests by directors. Nonetheless, it may be noted that directors were already free to look at stakeholder interests prior to the enactment, and the social pressures to do so were already in operation.

The shareholder primacy approach has not been able to prevent major corporate collapses, and has come under increasing public and political pressure, making clear that it is no longer in line with contemporary thinking and theorising on corporate governance. However, there are several reasons why the implementation of a full stakeholder theory approach would not be desirable in the UK. Firstly, directors would have to balance a wide range of supposedly equally important interests, and any hierarchical structure for these interests would be insufficient in practice, as there is such a wide divergence of interests and priorities amongst companies. Secondly, representations could not practically be made by all potential stakeholder groups at the point of every decision to be made by directors, which would make it very difficult to establish what the interests to be considered were and would also present problems surrounding ‘proof’ of consideration. Stakeholders would then be free to argue tactically that directors did not consider their interests, or that their interests were misinterpreted, resulting in the reconsideration of many decisions, a slowing down of business decision-making, inefficiency and corporate deadlock. Finally, such an approach, being fundamentally different from the traditional corporate governance ideology in the UK, would require extensive reform, which might take decades to implement successfully and would cause uncertainty and unease in the meantime. This would strengthen the hands of institutional investors, who have the power to enforce

¹²² Wesley-Key (n99) 128.

corporate decision-making and corporate social responsibility through investment choice and who have become increasingly demanding in their strategic investment plans.

Indeed, efficiency cannot be declared an effective result that lives up to satisfactory standards of ethics. Profit maximizing, as a measure of efficiency, is not intrinsically right and seeking maximum profit does not always run together with ethical behaviour.¹²³ Chasing the greatest profit, even under conditions of efficiency, may still be achieved by mistreating employees, producing insufficient or malfunctioning products or contaminating the environment. Profit maximizing strategies could be considered unethical and although companies rarely profit in the long term from adopting such behaviour, they might sometimes believe it advantageous to do so. In such circumstances, the mission for the activist institutional investor is to punish the poor performance of directors, to dissuade such unethical behaviour and to encourage decision-making which promotes social justice and distributional equity.¹²⁴ Fisher notes a recent change in emphasis:

Traditionally, the law has not interfered with the way in which directors should manage their companies but the Government hopes that the enlightenment measures will correct a perceived tendency towards short-term investment and also encourage a more inclusive corporate environment. It seems that after the banking crisis of 2007-2008 a combination of the Corporate Governance Code and the law which preceded the Companies Act 2006 is no longer considered adequate to deal with the proper regulation of the shareholder value system.¹²⁵

Thus, the UK's corporate governance framework now comprehensively embraces a less formal body of soft rules, providing significant support for institutional shareholder activism and the role that these large investors should play in corporate governance. There is much to say in the next section about the role of institutional investors in corporate governance in the UK and the way that the UK's corporate governance framework has been extensively designed to build an activist environment among institutional investors.

¹²³ Peter Taylor, 'Enlightened Shareholder Value and the Companies Act 2006', published PhD thesis (Birkbeck College 2010), 203 <<http://lccge.bbk.ac.uk/publications-and-resources/docs/PhDThesisPNTaylorJune2010.pdf>> [Accessed on 05/03/2014].

¹²⁴ *ibid*

¹²⁵ Fisher (n102) 15.

4.5 The Role of Institutional Investors in Corporate Governance and Institutional Activism in the UK

4.5.1 Introduction

The undertaking to produce a code of best practice for corporate governance in the UK properly began in the early 1990s, particularly in 1992 with the Cadbury Report on the Financial Aspects of Corporate Governance.¹²⁶ Since then, a series of committees have been convened and many have reported, each issuing a different set of recommendations, mainly focused on solving the agency problem inherent in the shareholder primacy model and thus emphasising the need to increase the effectiveness of the board's accountability to shareholders regarding the company's affairs.¹²⁷ A number of these reports also made recommendations that addressed the role of institutional investors in corporate governance and their activism. It is the intention of this section to outline some of these recommendations and to explore the development of principles and guidance in the Combined Codes since the Cadbury Code of 1992, with particular focus on the Myners Review of 2001, which introduced many important improvements to the position of institutional investors in corporate governance and strengthened their activism in the UK. It then discusses the recent trends in UK corporate governance after the Walker Review of 2009, which inspired the UK Corporate Governance Code of 2010 and recent revised version of 2012, focusing on the behaviour of boards of directors in publicly-traded companies, and the Stewardship Code of 2010 and its recent revised version, concentrating in its turn on the role of institutional investors in corporate governance and on their activism. These UK self-regulatory measures are significant in formulating proposals for activism among Saudi institutional investors, as discussed in chapters 6 and 7.

4.5.2 Cadbury Committee 1992

The Cadbury Code is considered to be the first important piece of soft law to adopt the self-regulation approach to best practice in contributing to the UK corporate governance regime. It paved the way for the evolution of this field and its influence has been clearly seen outside the UK: it has been embraced in the OECD Principles of Corporate

¹²⁶ Brian Cheffins, 'The Stewardship Code's Achilles' Heel' (2010) 73(6) *Modern Law Review* 1008 <<http://dx.doi.org/10.1111/j.1468-2230.2010.00828.x>>[Accessed on 05/03/2014].

¹²⁷ John Armour, Simon Deakin and Suzanne Konzelmann, 'Shareholder Primacy and the Trajectory of UK Corporate Governance' (2003) 41(3) *British J Industrial Relations* 9 <<http://dx.doi.org/10.1111/1467-8543.00286>>[Accessed on 05/03/2014].

Governance and in the notion of best practice around the world.¹²⁸ The Cadbury Committee was appointed to address various issues arising from corporate scandals in the late 1980s and early 1990s.¹²⁹ Among its recommendations on governance are some concerning the effectiveness of measures to ensure the accountability of board members. It recognised for the first time the importance of non-executive and independent directors, of the remuneration and audit subcommittees as corporate governance devices and of the separation of the roles of chairman and CEO.¹³⁰ Thus, although the Cadbury Code does not clearly specify the role that should be taken by institutional investors in corporate governance, the report does underline the importance of this role as a consequence of their huge shareholding in the capital market. For example, it encourages them to use their voting power to influence the standards of corporate governance in the companies in which they invest.¹³¹ Although the Code is voluntary, the committee's recommendations were incorporated into the London Stock Exchange Listing Rules on a comply-or-explain basis, whereby listed companies are not obligated to comply with the Code's provisions but where each is required to publish a statement of compliance in its annual report to shareholders or provide an explanation of any non-compliance.¹³²

4.5.3 Hampel Committee 1998

After Cadbury, the Greenbury Committee of 1995 was primarily concerned with directors' remuneration. The Hampel Committee then combined the Cadbury and Greenbury recommendations to produce the Combined Code of 1998. Unlike those of Cadbury, the Hampel recommendations clearly emphasised the role of institutional investors in corporate governance by voting in the companies in which they invest. Hampel also recommended that pension fund trustees should encourage fund managers to take a long view in managing their investments and that institutional investors should act responsibly towards their beneficiaries by making information available to clients

¹²⁸ Ian Jones and Michael Pollitt, 'Understanding How Issues in Corporate Governance Develop: Cadbury Report to Higgs Review' (2004) 12(2) *Corporate Governance* 164
<<http://dx.doi.org/10.1111/j.1467-8683.2004.00355.x>>[Accessed on 05/03/2014].

¹²⁹ Financial Reporting Council, *The UK Approach to Corporate Governance* (FRC 2010) 4.

¹³⁰ Jones and Pollitt (n128) 164.

¹³¹ *ibid.*

¹³² *ibid*165.

and owners upon request.¹³³ In effect, the Hampel recommendations on institutions became an integral part of the Combined Code of 2003 and were incorporated into section 2, which contains principles and provisions mainly applicable to institutional investors, identifying specific issues that should be addressed by institutional investors, such as voting, dialogue with companies and the evaluation of the investee company's governance arrangements.¹³⁴

4.5.4 Higgs Review 2003

Further examination of corporate governance in the UK came after major corporate scandals in the USA affecting companies such as Enron and WorldCom, beginning in 2001. The US government responded to this crisis by introducing the Sarbanes-Oxley legislation and new stock exchange listing rules in 2002.¹³⁵ The UK government then responded to these corporate collapses and to the new US legislation by establishing the Higgs Review on the role and effectiveness of non-executive directors in order to determine the extent to which the US measures should apply to UK and other foreign-owned companies.¹³⁶ Although the Higgs Review focused primarily on the role and effectiveness of non-executive directors, it added a progressive aspect to the role of institutional investors in corporate governance and produced new recommendations that were incorporated under the revised Combined Code of 2003, issued, at the Review's recommendation, by the Financial Reporting Council.¹³⁷ The Combined Code of 2003 gives the board the responsibility of entering into dialogue with institutional shareholders and conversely encourages these shareholders to engage in dialogue with the company. It further encourages institutional shareholders to apply the statement of principles on institutional shareholders and agents issued by the Institutional Investors' Committee (IIC).¹³⁸

¹³³ R Hampel, 'Committee on Corporate Governance: Final Report' (1998) 61-2.
<<http://ecgi.org/codes/documents/hampel29.pdf>>[Accessed on 05/03/2014].

¹³⁴ UK Combined Code (2000) <http://ecgi.org/codes/documents/combined_code.pdf>[Accessed on 05/03/2014].

¹³⁵ S Lütz, D Eberle and D Lauter, 'Varieties of Private Self-Regulation in European Capitalism: Corporate Governance Codes in the UK and Germany' (2011) 9 *Socio-Economic Review*, 322
<<http://ser.oxfordjournals.org/content/9/2/315.full>>[Accessed on 05/03/2014].

¹³⁶ Jones and Pollitt (n128) 164-5.

¹³⁷ Cheffins (n126).

¹³⁸ UK Combined Code (2003), Principles DI and E1
<http://ecgi.org/codes/documents/combined_code_final.pdf>[Accessed on 05/03/2014].

4.5.5 Myners Review

Before the Higgs Review, the Myners Review of 2001 had specifically focused on institutional investors in the UK. It was established as a result of government concerns regarding the passive attitude of institutional investors, particularly pension funds, and the investment behaviour of their managers, as well as other practices of institutional investors. According to Smerdon, the government was concerned with

... the institutions generally for failing to live up to their responsibilities by using their votes, as the dismal proxy return demonstrated... [Concern was also expressed] and still continues, to the effect that there are structural conflicts of interest within institutional shareholders themselves in the sense that they are both trustees for the savings of millions of people who entrust their saving to them, but they and the fund managers which they appoint invest those savings in companies to which they also try to sell financial products and services and which in that sense are their clients. ... [Another concern] has been that fund managers appointed by the institutions have to adopt a short approach in order to get returns for their client institutions or face the sack: activism, it is said, in an attempt to achieve the performance required of fund managers, induces short thinking by managers of the companies in which the fund managers invest. Finally there is [concern as to] the governance of the institutions themselves....¹³⁹

Accordingly, the Review made recommendations for effective investment decision-making that involved changes in the legal and regulatory framework and in the practices of institutional investors.¹⁴⁰ For example, the Myners principles codify the model of best practice for institutional investors in the UK and apply a similar comply-or-explain approach as with the UK Combined Code, where institutional investors either comply with the Myners principles or explain any non-compliance:

As with the Combined Code, compliance with them would not mean strict reproduction of a specific organisational structure. The review hopes that its proposals will positively encourage diversity in investment approaches. However, the principles constitute a framework for good practice. If an institution's current arrangements do not fall within this framework, the review

¹³⁹ Richard Smerdon, *A Practical Guide to Corporate Governance* (3rd edn, Sweet & Maxwell 2007) 6.

¹⁴⁰ MacNeil (n12) 417.

believes it should have to explain why it has chosen to adopt an alternative approach.¹⁴¹

Following his 2001 review, Myners made an important series of recommendations in 2004, 2005 and 2007 in reports to the Shareholder Voting Working Group on the impediments to voting shares.¹⁴² These reports were concerned with the effectiveness of the corporate voting and reporting systems in the UK and outlined comprehensive and practical action plans to improve these. They also introduced electronic proxy voting and enhanced voting procedures for institutional investors at company meetings, in order to improve the effectiveness of relations between institutional investors, their voting agencies and other participants in the voting process. Specifically, in his 2004 review Myners directs his recommendations to bodies such as institutional investors, publicly-traded companies, investment managers and proxy voting agencies. For example, he recommends that institutional investors should ensure that their agreements with the various participants who are accountable to them, such as voting agencies, 'include specific service standards for voting, establish a chain of responsibility for voting and an information flow which enables all parties to meet their responsibilities and require those responsible to report back on the discharge of their obligations.'¹⁴³

4.5.6 Walker Review 2009

Whereas the Myners principles stated in the Review of 2001 marked significant changes in the legal and regulatory framework and in the practices of institutional investors in the UK, after the financial crisis that originated in 2007-2008 there were wide academic and professional debates on the role of institutional investors in corporate governance and their passive attitudes. Cheffins reports that

In 2008 and early 2009 Britain was side-swiped by a global banking crisis that resulted in the UK government owning dominant stakes in a couple of Britain's largest banks, HBOS/Lloyd's TSB and the Royal Bank of Scotland, and the nationalization of the assets of a couple of smaller failed banks, Northern Rock

¹⁴¹ Paul Myners, *Institutional Investment in the United Kingdom: A final Review* (2001). London: HM Treasury, 147 <http://archive.treasury.gov.uk/pdf/2001/myners_report.pdf>[Accessed on 05/03/2014].

¹⁴² Paul Myners, *Review of the Impediments to Voting UK Shares*, London: Shareholder Voting Working Group, 2004. <<http://archive.manifest.co.uk/myners/04-0204%20Final%20SVWG%20Report.pdf>>[Accessed on 05/03/2014].

¹⁴³ *ibid.*

and Bradford & Bingley. Institutional shareholders were quickly identified as one of the culprits, in the sense they allegedly did nothing meaningful to prevent wayward bank executives from going off the rails.¹⁴⁴

In view of this, the UK Government commissioned Sir David Walker to review and investigate the governance of banks and other financial institutions and to make recommendations. Although the main purpose of establishing the Walker Review was to respond to the role of the institutional investors in the governance of banks and other financial institutions, the Review clearly states that its recommendations are also applicable to the role of institutional investors in corporate governance.¹⁴⁵ It recommended that the Financial Reporting Council (FRC) should encourage and monitor active engagement by institutional investors in corporate governance and that its remit should include responsibility for the Combined Code.¹⁴⁶ In particular, it recommended the removal of the content of section E addressed to institutional investors, since the Combined Code 2003 and the separate Stewardship Code now reflected the principles of best practice in stewardship by institutional investors and fund managers. The Combined Code was renamed the Corporate Governance Code and now mainly focused on the governance of publicly-traded companies.¹⁴⁷ In addition, the Review recommended that UK and foreign institutional investors authorised by the Financial Services Authority (FSA) should indicate on their websites their commitment to the Stewardship principles, that these should apply to institutional investors on a comply-or-explain basis and that the FSA should require disclosure of such commitment.¹⁴⁸

4.5.7 UK Corporate Governance Code

The UK Corporate Governance Code was first issued by the FRC in 2010 and the most recent version was issued in 2012. One of the Code's key features is that it presents an integral set of broad principles and specific provisions to promote better behaviour

¹⁴⁴ Cheffins (n126) 1009.

¹⁴⁵ David Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations' (2009) 6. <http://webarchive.nationalarchives.gov.uk/+http://hm-treasury.gov.uk/d/walker_review_261109.pdf>[Accessed on 05/03/2014].

¹⁴⁶ *ibid* recommendation 16.

¹⁴⁷ *ibid*.

¹⁴⁸ *ibid* recommendations 17-19.

among directors of publicly-traded companies.¹⁴⁹ Another is that the FRC declares that the Code is consistent with the new approach to corporate governance in the UK, that of enlightened shareholder value, and that directors should consider the long-term success of the company in making decisions.¹⁵⁰ The Code's principles and provisions are not mandatory and it continues to operate on the comply-or-explain basis, which has become the hallmark of UK corporate governance since the Cadbury Code 1992.¹⁵¹ Its main principles are intended to strengthen the responsibilities of the directors of FTSE 350 companies and to increase their accountability to shareholders in such matters as the role of directors as leaders, board composition, directors' remuneration, the accountability and audit committee, and auditors. Thus, there are new principles which are not covered in previous revised Combined Codes since 2003, such as the need for the board to have a balance of skills, experience, independence and knowledge of the company to enable directors to discharge their duties and responsibilities effectively.¹⁵² Another of the principles that strengthens and improves the relations between the board and shareholders is that all directors of FTSE 350 companies should be subject to annual election by shareholders,¹⁵³ which the FRC asserts will improve accountability and encourage stronger engagement between the board and shareholders, including institutional investors.¹⁵⁴

4.5.8 The Stewardship Code

The FRC considers the Stewardship Code 2010 and its most recent (2012) version to constitute a companion piece to the UK Corporate Governance Code.¹⁵⁵ One of the main goals of the Stewardship Code is to strengthen the engagement of institutional investors in the companies in which they invest. Tomorrow's Company, in a report to the FRC, states:

¹⁴⁹ FRC, 'Revisions to the UK Corporate Governance Code (Formerly the Combined Code)' (2010) 1 <<http://frc.org.uk/getattachment/675640ed-23ff-42a5-a157-09dc4da7ef51/May-2010-Report-on-Code-Consultation.aspx>>[Accessed on 05/03/2014].

¹⁵⁰ FRC, 'The UK Corporate Governance Code' (2012) 1 <<http://frc.org.uk/getattachment/a7f0aa3a-57dd-4341-b3e8-ffa99899e154/UK-Corporate-Governance-Code-September-2012.aspx>>[Accessed on 05/03/2014].

¹⁵¹ *ibid* 4.

¹⁵² *ibid* principle B1.

¹⁵³ *ibid* principle B7.

¹⁵⁴ FRC, Revisions (n149) 3.

¹⁵⁵ FRC, CGC 2012 (n150).

The concept of stewardship has a long tradition. It describes any situation in which people are looking after assets on behalf of others. For example, it is often used to describe the responsibility which human beings have to look after the natural assets of our environment. In the context of a company or of businesses more generally ... stewardship is the process through which shareholders, directors and others seek to influence companies in the direction of long-term, sustainable performance that derives from contributing to human progress and the well-being of the environment and society.¹⁵⁶

The principles of the Code were originally delivered by the Institutional Shareholders' Committee, which became known as the Institutional Investor Committee (IIC) in 2011, and reflect the committee principles of 2009.¹⁵⁷ It was one of the Walker Review recommendations to the FRC that 'The Code on the Responsibilities of Institutional Investors prepared by the Institutional Shareholders' Committee should be ratified by the FRC and become the Stewardship Code.'¹⁵⁸ These main principles are applicable to asset owners including pension funds, insurance companies, investment trusts and other collective investment vehicles in the UK, which should:

1. publicly disclose their policy on how they will discharge their stewardship responsibilities.
2. have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed.
3. monitor their investee companies.
4. establish clear guidelines on when and how they will escalate their stewardship activities.
5. be willing to act collectively with other investors where appropriate.
6. have a clear policy on voting and disclosure of voting activity.
7. report periodically on their stewardship and voting activities.¹⁵⁹

The Stewardship Code principles and guidance were not mandatory and as recommended by Sir David Walker, it was decided to apply the comply-or-explain approach that characterized the Corporate Governance Code, but this was found to be

¹⁵⁶ Tomorrow's Company, 'FRC Consultation on a Stewardship Code for Institutional Investors' (2010) 5 <<http://frc.org.uk/Our-Work/Publications/Corporate-Governance/Consultation-on-a-Stewardship-Code-for-Institution/Responses-to-January-2010-consultation-on-a-Steward/Tomorrow's-Company.aspx>>[Accessed on 05/03/2014].

¹⁵⁷ FRC, 'The UK Stewardship Code' (2012) 1 <<http://frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx>>[Accessed on 05/03/2014].

¹⁵⁸ Walker (n148) principle 17.

¹⁵⁹ FRC, 'Stewardship Code' (n157) 5.

inappropriate, as it ‘creates risks that those to whom the Code applies will fail to treat compliance as a priority and will offer little or no explanation to justify non-compliance.’¹⁶⁰ One of the critical points of the Stewardship Code is that it would not have a great impact on UK corporate governance, being applicable only to UK institutional investors and not to foreign institutional investors or hedge funds, which have recently become major shareholders in the UK capital market. For example, Cheffins argues:

The fact the Stewardship Code focuses primarily on UK-based asset managers and on “mainstream” domestic institutional investors who own less than one-third of the shares in UK quoted companies suggests adoption of the Stewardship Code is unlikely to have a transformative impact on corporate governance. ... Perhaps mandatory legislation will be proposed requiring asset managers to disclose in detail the extent to which each of their funds follows stewardship principles. Another possibility is that a compulsory levy, payable in part by companies and in part by institutional investors, could be imposed to support shareholder engagement.¹⁶¹

In similar vein, Reisberg argues that there are major concerns for the success of the Code and that the FRC should be aware that ‘non-UK investors collectively now hold upwards of 40 percent of the country’s equity market.’¹⁶² Another concern is that ‘in respect of managing conflicts of interest, it is arguable that the Stewardship Code has actually taken a step backward ... [it] focuses only on “managing” conflicts, with no requirement to minimise or avoid them. Conflicts of interest are pervasive in the investment industry and, without stronger checks, they will pose a grave threat to good stewardship.’¹⁶³

4.6 Influence of Industry and Trade Organizations

Industry organisations and trade associations represent the overwhelming majority of institutional investors in the UK. Each type of investor has its own representative association and they play a great role in encouraging good corporate governance among

¹⁶⁰ Cheffins (n126) 1013.

¹⁶¹ Cheffins (n126) 1025.

¹⁶² A Reisberg, ‘The Notion of Stewardship From a Company Law Perspective’ (2011) 18(2) J Financial Crime 141 <<http://dx.doi.org/10.1108/13590791111127714>>[Accessed on 05/03/2014].

¹⁶³ *ibid* 139.

their members in the UK and in facilitating shareholder engagement with investee companies. The trade organisations operating in the UK include the Association of British Insurers (ABI), the National Association of Pension Funds (NAPF), the Investment Management Association (IMA) and the Association of Investment Companies (AIC). Each of these trade organizations serves the classic lobbying function and makes its own contribution to the role of institutional investors in corporate governance in the UK.¹⁶⁴ For example, the NAPF,¹⁶⁵ formed in 1923, is the leading UK body providing representation and other services for those involved in designing, operating, advising and investing in all aspects of pensions and other retirement provisions, while the ABI¹⁶⁶ was formed in 1985 and represents the collective interests of the UK's insurance industry, providing guidance to the industry and representing it to government, regulators and policymakers in the UK and internationally, driving effective public policy and regulation. The IMA¹⁶⁷ is the trade association for the £4.2 trillion UK-based investment management industry. Its members provide investment management services to institutions (life assurance companies, pension funds, individual companies etc) and to private investors, through individual fund management agreements and pooled products such as authorised investment funds. Some associations, such as NAPF, have published statements and guidance of best practice and as representatives of major institutional investors have been involved in promoting good corporate governance and in producing guidance such as the Stewardship Code for investors and voting guidance for investment companies. Chapter 7 will argue that establishing such trade organisations in Saudi Arabia might encourage institutional investors to form coalitions and engage in greater activism.¹⁶⁸

4.6.1 Institutional Investor Committee

The IIC is probably the most influential UK trade body, being a coalition of the four main trade associations: NAPF, ABI, ABI and AIC.¹⁶⁹ It was formed in 1973 at the

¹⁶⁴ John Coffee and Bernard Black, 'Hail Britannia?: Institutional Investor Behavior Under Limited Regulation' (1997) 92(7) Michigan Law Review 2018 <<http://ssrn.com/abstract=276991>>[Accessed on 05/03/2014].

¹⁶⁵ NAPF website <<http://napf.co.uk/>>[Accessed on 05/03/2014].

¹⁶⁶ ABI website <http://abi.org.uk/About_The_ABI/role.aspx>[Accessed on 05/03/2014].

¹⁶⁷ IMA website <<http://investmentfunds.org.uk/>>[Accessed on 05/03/2014].

¹⁶⁸ Section 7.3.3.1.

¹⁶⁹ ICC website <<http://iicomm.org/>>[Accessed on 05/03/2014].

request of the Bank of England¹⁷⁰ and helped to consolidate the power of institutional investors through its Statement of Responsibilities of Institutional Shareholders, which was used in the Cadbury Report of 1992, in the Combined Code in 2003 and the UK Stewardship Code in 2009.

4.6.2 Proxy Voting Agencies

Given the important role played by institutional investors in proxy voting, the efficiency of the proxy tool is noticeably contingent on whether it provides institutions the right inducements to vote knowledgeably and impartially. Proxy voting agencies provide institutional investors with advice and recommendations on a range of issues including voting, corporate governance, conflicts of interest, execution, reporting and record-keeping, making them important contributors to voting activities with the potential to facilitate more effective shareholder activism. Among the leading UK proxy voting agencies are the Pensions and Investment Research Consultants (PIRC), Research, Recommendation, Electronic Voting (RREV) and the Institutional Voting Information Service (IVIS).

PIRC, established in 1986, provides research, advice and consultancy services to institutional shareholders on governance and corporate social responsibility and claims to embrace a corporate social responsibility approach to its own proxy voting policies. Its services cover all shareholders' meetings of companies in the UK FTSE All Share Index and below. It also advises shareholders on engagement strategies and priorities, helping to build coalitions among investors.¹⁷¹

The ABI set up IVIS to advise its members on proxy voting and to provide corporate governance research to the UK insurance industry. Its clients have assets of £1.5 trillion under management and hold approximately 20% of the FTSE All Share. IVIS helps institutions to evaluate companies' compliance with corporate governance best practice, to review their executive remuneration and all other proposed resolutions. It makes voting recommendations and issues guideline reports based on the corporate governance standards set out in the ABI guidance and in the UK Corporate Governance Code. It

¹⁷⁰ Coffee and Black (n164) 2019.

¹⁷¹ PIRC website <<http://pirc.co.uk/services>>[Accessed on 05/03/2014].

claims to provide a non-prescriptive approach, using a flexible colour code to evaluate each resolution on an agenda, reflecting any breaches of best practice and highlighting areas of concern: ‘the strongest concern is Red, followed by Amber. A Blue Top indicates no areas of major concern, while a Green report indicates an issue that has now been resolved’.¹⁷²

The third important UK proxy voting service provider is RREV,¹⁷³ a joint venture between NAPF and ISS, a subsidiary of Morgan Stanley Capital International.¹⁷⁴ Its monitoring services cover all companies in the FTSE All-Share Index and some other UK companies. Its corporate governance research and reports and its electronic voting recommendations are based on NAPF’s corporate governance policies and guidelines, while its best practice recommendations cover governance and financial performance, board structure, remuneration, auditing and accounting disclosure, and shareholder relations.

4.7 Conclusion

As discussed in chapters 1 and 2, corporate ownership in Anglo-Saxon countries can be regarded as compatible with the Berle-Means model, i.e. ownership diffused among a large number of shareholders, each of whom owns only a small share of any single company.¹⁷⁵ The adoption of an approach where the free market drives important corporate governance mechanisms was seen as key to the strong position of the UK capital market; thus, strong emphasis is placed on designing the structure of business relationships in the UK market to respond to the agency problem by applying market-based devices for monitoring and disciplining management, such as the takeover market, to solve the agency problem between shareholders and managers.¹⁷⁶ In other words, it was seen as unjustified and against companies’ interests to concentrate ownership in the hands of dominant controllers who could then obtain the private benefits of control.¹⁷⁷ Therefore, it was necessary to develop and strengthen the UK corporate governance regime so that it would principally control managers’ actions and align them with

¹⁷² IVIS website <<http://ivis.co.uk/>>[Accessed on 05/03/2014].

¹⁷³ RREV website <<http://rrev.co.uk/>>[Accessed on 05/03/2014].

¹⁷⁴ ISS website <<http://issgovernance.com/about/>>[Accessed on 05/03/2014].

¹⁷⁵ Armour et al (n127) 2.

¹⁷⁶ Lütz et al (n135) 317.

¹⁷⁷ Armour et al (n127) 319.

shareholders' interests; the fundamental aim was the empowerment of minority shareholders, unlike corporate governance measures to tighten the system and improve its balance.¹⁷⁸ More precisely, following a number of corporate scandals, the UK's shareholder primacy approach to its corporate governance framework has focused on making the boardroom more transparent and on designing various external and internal governance devices to compensate for the limitations of capital market-based devices,¹⁷⁹ but some of these corporate governance devices have failed to control the power of company affairs alone, as discussed in chapter 2.¹⁸⁰

Meanwhile, although the dominant view in Anglo-American countries is that shareholder primacy is the proper corporate governance objective to address the deeply rooted agency problem between shareholders and managers, it seems to be less deeply rooted in the UK as a result of several factors proposed in this chapter to explain this change in regulatory activity and in the UK's corporate governance regime.¹⁸¹ The Companies Act 2006 aims to make a significant contribution to the corporate governance system and protection of minority shareholders' rights in the UK by embedding in statute the concept of enlightened shareholder value. While this approach seems to have discouraged directors from seeing short-term earnings as the fundamental goal of company strategy and encouraged them to give more weight to long-term value, their enlightened stewardship of companies seems to have been limited in practice by the existing customary bias of shareholder value maximization rather than long-term development. Recognizing that behavioural factors underlay the financial crisis of 2007, it was essential to change the equity market's behavioural qualities.¹⁸² The UK's self-regulation culture has been significant in modifying the behaviour of equity market participants and steering corporate managers and institutional investors towards achieving long-term value. For example, the Stewardship Code 2012 emphasizes the

¹⁷⁸ *ibid*

¹⁷⁹ Lütz et al (n135).

¹⁸⁰ Section 2.6.

¹⁸¹ Armour et al (n127) 3.

¹⁸² Emiliios Avgouleas, 'The Global Financial Crisis, Behavioural Finance and Financial Regulation: In Search of a new Orthodoxy' (2009) 9 *J Corporate Law Studies* 28
<<https://escholar.manchester.ac.uk/uk-ac-man-scw:1b6659>>[Accessed on 05/03/2014].

importance of company strategy.¹⁸³ Nonetheless, short-termism has not been eliminated completely and is sustained by factors such as short-term reporting cycles.¹⁸⁴

Thus, the objective of the recent Kay Review was to shift the behaviour and culture of UK equity markets towards sustainable long-term value creation.¹⁸⁵ The UK government has endorsed some of Kay's recommendations, recognizing that short-termism is indeed a problem in UK equity markets, perpetuated by declining trust and confidence.¹⁸⁶ Specifically, it agrees that 'investment strategies based on trading to benefit from expected share price movements cannot improve the underlying performance of companies, and can instead create incentives on company executives which undermine long-term value creation'.¹⁸⁷ Kay also recommends basing relationships of trust and confidence in the investment chain on minimum standards of fiduciary duty, but the UK government avoids using the word 'fiduciary', preferring to state that all participants in the equity investment chain should adopt principles such as ensuring that 'the direct and indirect costs of services provided are reasonable and disclosed, and that conflicts of interest are avoided wherever possible, or else disclosed or otherwise managed to the satisfaction of the client or beneficiary.'¹⁸⁸ Overall, the Kay review appears to represent an important move towards long-termism that will boost economic growth and job creation, thus encouraging institutions to invest in British companies.

The contextual focus of the next chapter moves to the history and development of the Saudi capital market and the role of institutional investors in corporate governance there.

¹⁸³ UK Department of Business Innovation and Skills (BIS), 'The Government Response to the Kay Review' (2012) 6 <<http://bis.gov.uk/assets/biscore/business-law/docs/e/12-1188-equity-markets-support-growth-response-to-kay-review.pdf>> [Accessed on 05/03/2014].

¹⁸⁴ 'AVIVA Investor's Response to the Call for Evidence on The Kay Review' (2011) 7 <http://avivainvestors.com/internet/groups/internet/documents/salessupportmaterial/pdf_027396.pdf> [Accessed on 05/03/2014].

¹⁸⁵ John Kay, 'Kay Review of UK Equity Markets and Long-Term Decision Making' (2012) 9 <<http://bis.gov.uk/assets/BISCore/business-law/docs/K/12-917-kay-review-of-equity-markets-final-report.pdf>> [Accessed on 05/03/2014].

¹⁸⁶ *ibid* 9.

¹⁸⁷ BIS (n183) 11.

¹⁸⁸ *ibid* 9.

Chapter 5

The Saudi Capital Market: Development, Ownership Structure and value of Institutional Investors

5.1 Introduction

During the 1990s and 2000s the governments of most emerging and developing countries gradually subscribed to the notion of capital markets as an effective engine of growth for their national economies. Capital markets play a vital role in channelling savings to the most productive investments, where the potential for economic growth is greatest. For example, a number of stock exchanges in the MENA region, including that of Saudi Arabia, the largest market in the region, are reported to have undergone a ‘significant transformation over the last decade, motivated by the need to improve the integrity of local markets and align governance practices with the relevant international standards’.¹ Such transformations are indispensable in encouraging a culture of activism among institutional investors. Indeed, it has been argued that a necessary condition for such activism to flourish is a well-developed capital market infrastructure with an appropriate market supervision framework and the micro-structure for trading securities, in order for institutional investors to execute their investment strategies successfully.² Thus, although there is increasing recognition of the important role of institutional investors in corporate governance, this role is diminished in the MENA region as a result of the existence in the capital market of a high proportion of retail investors, who

... were estimated to own approximately \$2.7 trillion USD of assets as of 2010, as opposed to only about \$0.5 trillion USD of institutional investor assets... The annual compound growth rate of assets owned by MENA households is highest globally at almost 23%, while the rate of growth of the pensions and insurance sectors stood at 14 and 15.5%, respectively, during 2000-2010 period. These statistics reflect the slow development of insurance, pensions and mutual fund

¹ OECD, ‘The Role of MENA Stock Exchanges in Corporate Governance’ (OECD 2012) 11 <oecd.org/daf/corporateaffairs/RoleofMENAstockexchanges.pdf>[Accessed on 05/03/2014].

² Hans Blommestein, ‘Institutional Investors, Pension Reform, and Emerging Securities Markets’ (1997) IDB Working Paper 296. 23-24 <<http://ssrn.com/abstract=1815985>>[Accessed on 05/03/2014].

sectors in the region and highlight the reasons for high retail investor participation in MENA markets.³

With regard to Saudi Arabia, little work has been done on the value of institutional investors and their unique position of influence over corporate governance. The primary objective of this chapter is thus to appraise the value of institutional investors in the Saudi capital market. Considering the rapid growth and development of stock exchanges in Saudi Arabia, it first looks at the historical background and recent development of the Saudi capital market, as this has significant implications for any discussion of the supervision structure and government regulatory actions to enhance the stability of the market. Corporate ownership structures will be explained in order to gain a better understanding of the agency problem. This sheds light on the value of institutional investors in the Saudi capital market in mitigating the agency problem and their role in corporate governance. In particular, section 5.2 begins with a historical overview of the Saudi capital market, followed by an account of recent trends in this market and the supervision structure. Section 5.3 is similarly structured, its subject being the history, development and recent trends of ownership structure in the Saudi capital market to identify the agency problem and the value of institutional investors' activism in Saudi Arabia. Section 5.4 provides a broad perspective on the institutional investment environment and the conditions under which institutional investors find themselves operating in Saudi Arabia, then goes on to evaluate their tendency to pursue activism.

5.2 Saudi Capital Market: History and Development Prospects

5.2.1 Informal Operations of the Saudi Capital Market

The Saudi Arabian capital market began with the establishment of the first listed company in the third decade of the 20th century. Then, in the 1930s, the first Saudi publicly-traded company, the Arab Automobile Company, was founded. The period up

³ OECD (n1) 25.

to 1975, in response to the needs of economic development,⁴ saw the establishment of an increasing number of publicly-traded companies, followed by the privatization of three electricity companies and many banks.⁵ At that time, there was no formal capital market in Saudi Arabia, no legally controlled trading of shares and no law governing the capital market. Instead, about 80 unregulated brokers were informally trading in the stocks of those companies and any dispute between the parties would go to the Main Shariah Court under the Ministry of Justice, but there was no written law to guide the judges, who would apply their understanding of custom in this type of trading dispute.

5.2.2 Initial Phase - 1984

Before the establishment of the Saudi Capital Market Authority (CMA) in 2003, 1984 was considered the year when the regulation of the Saudi capital market started, as the government recognized then the need for an efficient capital market structure which could facilitate the recycling of capital surpluses, especially those held by the private sector and households, encouraging individuals and firms to reappraise their holdings of wealth and consider ways in which their capital reserves could be made available and channelled to productive local industry.⁶ Although the market was to be managed by the government, the structure had to be well received by local industry, so that shareholder initiatives were likely to succeed. To facilitate this, the financial system required greater flexibility and adaptability at all levels, to provide appropriate finance in sufficient amounts as required by the growing economy and to accommodate the risk-sharing preferences of investors and financial intermediaries. Therefore, a royal decree was issued in 1984 to regulate stock trading through local banks and to establish the Ministerial Panel for Market Supervision, whose members represented the Ministry of Finance and National Economy (MOF), the Ministry of Commerce (MOC) and the Saudi Arabian Monetary Agency (SAMA). Share trading intermediation was restricted to commercial banks, which established the Saudi Share Registration Company (SSRC),

⁴ Saudi Fourth Economic Plan (1985-1990) 108
<mep.gov.sa/themes/GoldenCarpet/index.jsp;jsessionid=3C486CAE53ED7118A458E607321AD3BE.alfa#1358744048181>[Accessed on 05/03/2014].

⁵ However, the productive function of banks in the Saudi economy was undermined by foreign influence, so in 1975, foreign banks were forcibly transformed into Saudi majority-owned joint ventures, while some were owned completely by the government and/or rich families. Mohamed Ramady, *The Saudi Arabian Economy: Policies, Achievements and Challenges* (Springer 2010).

⁶ This was one of the strategic principles adopted by the Saudi government in its Fourth Development Plan (1985-1990) (n4).

whose duties were to provide central registration facilities for publicly-traded companies and to settle and clear all equity transactions.

Despite these initial improvements, the performance of the Saudi capital market was still poor. To ensure more diversity in the developing private sector, the market was given special attention by regulators, in the belief that establishing a Saudi capital market would help to protect the country's established family-owned entities from vanishing. An organized market is also able to draw savings and provide a means of investment for those who have neither managerial ability nor the financial worth to establish their own businesses.

5.2.3 Established Phase

Further major developments occurred as a consequence of economic growth and development, causing the Saudi government to turn to the financial market to fund the rapid growth in the number of firms and to supply market capitalization. The first of these developments was that when the new regulations transferred share trading from unregulated brokers to the banks in 1984, the latter jointly formed the SSRC as a clearing system for executed trades and a means to coordinate buy and sell orders among bank branches. Because the SSRC, which was established under the supervision of SAMA, served as a clearing system for trades, purchases and sales, it became the source of all brokerage activities⁷. Under the new regulations, commercial banks established new shares departments. Buyers of a given stock first had to go to the branch and fill out an order. After that, the bank checked whether it had this stock in its own list; if not, then the bank contacted other banks. Under this system, different banks traded the stock at different prices and a delay of several days or weeks frequently occurred before orders were completed, indicating a lack of coordination among banks. Thus, ending the informal brokerage system by giving the commercial banks the authority to execute trades in the market did not allow commercial banks to act as market makers, so a group of active investors became unofficial market makers. They traded on their own account and set their own ask and bid prices.

⁷ Abdulaziz M Al-Dukheil, 'Saudi Stock Market' (Paper presented at the Future vision of Saudi Economy Conference, Riyadh, October 2002) 3-4
<https://uqu.edu.sa/files2/tiny_mce/plugins/filemanager/files/4150111/fourm/REVISED-SAUDI%20STOCK%20MARKET-05-10-2002-KM.pdf> [Accessed on 05/03/2014].

The second major development occurred in 1990 as a result of a Saudi government initiative to increase the participation of the private sector and the privatization programme, when SAMA introduced the Electronic Securities Information System (ESIS) to replace the old method. After the introduction of ESIS, the banks established twelve Central Trading Units (CTUs) in Riyadh, all of which were connected to the central system at SAMA, while each branch of each bank in various parts of the country was connected to a CTU in Riyadh. The only way in which market orders can be entered into the ESIS is via the CTU of each bank. In this system, all buy and sell orders placed at individual banks are transferred to a central system at SAMA for matching on an equitable basis. The introduction of the ESIS to the stock market is believed to have had a positive effect on trading and to have encouraged market liquidity and increased trading volume.⁸

There is no doubt that considerable improvements of regulation on the capital market had been made to develop and improve the market, but the new laws were complicated and in need of review. Share trading is an activity distinct from banking and the capital market should be overseen by an organization unconnected with banks. Regulations needed to be developed to deal with such issues as insider trading and the high concentration of holdings by government agencies and family ownership.⁹ It can be said that the Saudi capital market, which remained relatively small and ineffective, continued to face the following particular problems.

First, the small number of companies trading in the market did not match the large economic reputation of Saudi Arabia in goods income. This was caused by the restrictions that made entry into the domestic stock market difficult. Initial public offerings (IPOs) were tightly regulated by the MOC in terms of both initial share price and the size of the share blocks that could be sold. Most companies going public were either newly established corporations with large capital requirements or among the small number of privatized companies. As the process of going public might take more than two years, and because the MOC set initial prices lower than the company value,

⁸ Mohammad Al-Jarf, 'The Impact of Globalization on Saudi Capital Market', (paper presented at the International Conference of Islamic Scholars, Jakarta, 23-26- February 2004) 2<file:///C:/Users/User/Downloads/The-Impact-of-Globalization-on-the-Saudi-Capital-Market.pdf>, [Accessed on 05/03/2014].

⁹ Ramady (n5) 147.

companies which might otherwise participate in the stock market were prevented from doing so. Although these conditions were slightly modified to encourage more companies to go public, there remained many stringent requirements which made it difficult for some companies to participate and discouraged them from going public at that time.

Meanwhile, the financial and legal procedures for the transfer of ownership, the registration of transfers and the issuance of new certificates took a long time, which was considered one of the major factors limiting the liquidity of investments in the capital market and impeding the inflow of domestic investment.¹⁰

A third major problem, which further depressed the liquidity of investments in the capital market and acted as a barrier to domestic investment in the capital market, concerned the information available to potential investors. At that time, some of the companies registered in the capital market did not publish financial statements on time, despite the legal requirement for firms to publish financial statements quarterly, and the information they did provide was generally quite vague, making it difficult to analyze the performance of the companies concerned. These weaknesses deprived individual and other investors of a major source of information needed to make sound decisions regarding investment in the stock market.¹¹

The fourth impediment was the absence of official market traders and brokers promoting liquidity.¹² As noted above, SAMA granted a brokerage monopoly to commercial banks to develop the market and offer mutual funds, but restricted them from buying or selling shares on their own account. These restrictions made it difficult for independent market makers to sell and buy shares. At the same time, it was not to the commercial banks' advantage to develop the market, as they might lose some of the profit from demand deposits. Serious consideration should have been given to the role of independent brokers who could take positions, act as market makers and generally

¹⁰ Fifth Development Plan ch 8, 184-185
<mep.gov.sa/themes/GoldenCarpet/index.jsp;jsessionid=5B04D8E00EE17E952A061EB4DA7A9833.alfa#1359163183441>[Accessed on 05/03/2014].

¹¹ *ibid.*

¹² Badar Alanazi, 'Investor protection and the civil liability for defective disclosures in the Saudi securities market: a legal analysis', unpublished PhD thesis (University of Wollongong 2012) 44
<<http://ro.uow.edu.au/theses/3773/>>.

facilitate trading. Regulations could have been enforced to license these brokers and to ensure that they carried out their activities within permitted norms.

A further problem facing Saudi Arabia's economy was the outflow of capital as many individuals avoided investing in the Saudi capital market, preferring to invest their money in various Western capital markets.¹³ This happened despite the government's attempts to strengthen the national economy through its fourth development plan reforms, amongst which, as noted above, the restructuring of the financial market resulted in much new legislation, beginning in 1984, which promoted the participation of individual shareholders in the capital market. However, it could be said that there was little or no change in the situation whereby the government and certain families held a high concentration of ownership; indeed, the government's regulatory reforms failed to remove the limits to the engagement of many players in the Saudi capital market. For example, individual investors are not likely to be willing to sacrifice their savings when a capital market is small and limited, where investments are considered very risky because there is no past data available for them to use in forecasting the performance of shares, which was the case of the Saudi capital market.

These regulatory problems and the other major impediments discussed above had a negative impact on many Saudi investors, who preferred to hold their financial assets in accounts with commercial banks, having gained a high initial return from IPOs. Others turned their attention either to foreign ventures or to real estate, which led to the overpricing of real estate in Saudi Arabia.¹⁴ As indicated earlier, the regulatory environment of the Saudi capital market was very complicated. It was clear that Saudi policymakers realized the many shortcomings of the former regulatory regime, but it was also clear from the introduction of the new rules that SAMA anticipated such weaknesses and stood ready to review and update the rules when necessary, as stated in the fifth development plan.¹⁵ There was a need for an independent stock exchange, an independent body to regulate the market, special rules for the listing requirements at the

¹³ Sam Hakim, 'Gulf Cooperation Council Stock Markets since September 11', (2008) 15 Middle East Policy 72-75 <<http://dx.doi.org/10.1111/j.1475-4967.2008.00339.x>>[Accessed on 05/03/2014].

¹⁴ Alanazi (n12) 48.

¹⁵ The Fifth Development Plan (n13) emphasizes increased development of the capital market to make it more effective.

stock exchange itself and rules to protect minority shareholders.¹⁶ There was also a need for greater participation of such shareholders via representation on boards of directors. On the other hand, there was a need to privatize many government-owned companies in the public interest and to plan for the challenges of the future. A capital market is not an extravagance, but an essential feature of the economy of any country, especially of one where the private sector is being encouraged to take on additional economic responsibilities. Savings have to be mobilized and efficient markets have to develop to channel the savings of investors to domestic opportunities. The opportunities were there in Saudi Arabia, as large amounts of private capital remained available and could be diverted to domestic investment opportunities; some quite large and profitable ventures in the public and private sectors were yet to go public.

5.2.4 New Trends and Developments in the Saudi Capital Market

The establishment of the Supreme Economic Council in the late 1990s was a major element in the Saudi government's privatization programme and characteristic of the reforms of the Saudi capital market, which were seen to be necessary if the country was at last to join the WTO. Poorly functioning capital markets discourage FDI and foreign portfolio investment (FPI), as it is difficult and expensive to raise capital. The Saudi political forecast was largely positive; therefore, it was indispensable for national policymakers to make regulatory improvements in the capital market that could restore the confidence of local investors and prompt more FDI and FPI providers to seek investment opportunities in the domestic market in the long run, as asserted in the sixth development plan,¹⁷ which gave the following account of the problems affecting the market and of a partial solution:

Although the Saudi [capital] market has expanded, ... it still lags behind developments in the real economy, owing to its recent origins. As a result, the financial market continues to face some difficulties, such as:

...

¹⁶ Al-Dukheil (n7)41.

¹⁷ The CMA issued Circular No. 2-28-2008 (the Circular) on 18 August 2008 (08/17/1429), allowing foreign Saudi investors to enter, under certain terms and conditions, into equity swap agreements in respect of listed Saudi Shares. The circular permits only CMA Authorised Persons to enter into Swap Agreements. See Saudi Gazette, 'Tadawul Swap Deals Prelude to Foreign Direct Investment' (22 April 2014) <<http://saudigazette.com.sa/index.cfm?method=home.PrintContent&action=Print&contentID=000000016370>> [Accessed on 22/04/2014].

- its restricted organizational and administrative capacity to provide services commensurate with the needs of the expanding private sector;
 - the small size of the capital market, with only 89 listed Saudi companies and with share dealing limited to Saudi companies and Saudi citizens, apart from exceptional cases where GCC citizens are allowed to purchase specific amounts of such shares;
 - the weak linkage between the commercial banks (as the main collector of savings in the form of various types of deposit) and the [capital] market, because of the lack of suitable investment channels and diversified savings instruments that can attract various groups of savers.
- ... [T]he possibility of allowing foreigners to deal in the [capital market] under specific rules will also be studied.¹⁸

As a result of these difficulties, of the rise in oil prices and of economic improvements during the late 1990s, the decision was taken to establish a new exchange trading system, the Saudi Stock Exchange or *Tadawul*, in October 2001.¹⁹ This helped to improve the electronic share-trading environment. SAMA's establishment of the Tadawul raised the number of traded shares from 555 million in 2000 to 691 million by the end of 2001, rising sharply to 1,736 million shares in the following year. Meanwhile, the tragic events of 11th September 2001 resulted in capital repatriation by Saudis who had invested heavily in various Western and Eastern capital markets, especially in the USA, providing a boost for the domestic economy.²⁰ In late 2002, the Saudi government decided to privatize a number of its key industries so as to diversify the economy in an attempt to reduce its dependence on oil. Thus, it initiated IPOs for major national enterprises, by offering some shares or selling entire government-owned companies. A number of private businesses followed this trend and decided to go public, which later led to a countrywide wave of investment in the capital market by many businesses, so that a new trend emerged in the Saudi market of offering investment opportunities to local investors.

¹⁸ Sixth Development Plan ch 5, 158-165
<mep.gov.sa/index.jsp;jsessionid=93295568E59CE267D15BC8C29499F2DB.beta>[Accessed on 05/03/2014].

¹⁹ The oil price recovered in 1999, strengthening the Saudi economy. In November 1999, the Saudi stock market opened mutual funds to foreign investors. This boosted the stock market and both oil prices and GDP increased further.

²⁰ Hakim (n13) 72-75.

The period of economic development from 1996 to 2002 was, as noted above, of great significance, marked by major reforms and restructuring efforts, with the Saudi government encouraging the liberalization of its economy and working to ensure that capital flow became the main engine of growth. Although SAMA, as regulator, assumed the added responsibility for monitoring and supervising the trading of shares and capital, it was still necessary for the government, in order to improve the investment environment for capital flows, to assess the ability of many of its existing regulations and systems in the capital market to cope better with world developments. Therefore, it introduced further regulatory reforms in the years following the passage of the foreign investment law, as it recognized the growing importance of the capital market and initiated its own drive to diversify the economy. This assessment resulted in the approval of the Capital Market Law (CML) in late 2002 as part of an attempt to liberalize the Saudi economy. The government had been supportive of the development of the stock market, and the creation of a legislative and organizational structure for the capital market was designed to increase transparency, the thinking being that a regulatory framework for all capital-related activities, including trading in securities, would increase transparency and attract more capital flows to Saudi Arabia.

The CML was intended to restructure the capital market in the Kingdom by introducing a new concept that would protect investors, enhance their confidence in the market and thus attract more of them. The CML also restructured the capital market by separating the control, supervisory and operational roles of the market, thereby providing the regulatory reference needed by the market.²¹ The CMA was therefore established in June 2003, with the purpose of regulating and developing the Saudi capital market and administering the rules and regulations required by the CML. It has been suggested that the CMA is a hybrid of the US and UK regulatory bodies.²²

It was expected that the newly established capital market would facilitate the raising of capital to finance industrial expansion, would be better able to mitigate risk and attract domestic savings and would appeal to international portfolio investors; the next

²¹ To this end, the CML specified the creation of the following new bodies to regulate firms and settle disputes: (1) The Capital Market Authority, (2) The capital market (securities market), (3) The Depository, (4) The Securities Disputes Settlement Committee, (5) The Appeals Committee.

²² Robin Wigglesworth, 'Riyadh Regulator's Gradual Progress' *Financial Times* (London 2008), <<http://ft.com/cms/s/0/6b9441ac-484a-11dd-a851-000077b07658.html#axzz22VdbFDyM>> [Accessed on 05/03/2014].

section therefore turns to the history of ownership structure before looking at the value of institutional investors in Saudi Arabia.

5.3 History & Development of Ownership Structure in Saudi Arabia

5.3.1 Ownership Structure before the Bubble of 2006

As noted earlier, the various sectors of the Saudi capital market were characterized by high levels of ownership concentration, which was relatively common in Saudi Arabia among publicly-traded companies. While the combinations of ownership concentration differed among Saudi-owned companies, most publicly-traded companies in the Saudi capital market were government owned or family controlled. It is notable that although there was a good response from Saudi individuals to the opportunity to buy shares in many privatized or newly established companies, most quickly abandoned the capital market. The likely explanation is that there was a strong draw to buy shares in the IPOs, since they were offered at a low price, then to sell them in order to benefit from their high initial return. Saudi individuals like buying a commodity at a low price with the intention of selling it at a higher price in the near future. There were then just a few families or business people who bought most of these resold shares, which helped to create a highly concentrated market. As a result, the concentration of shareholdings became a major concern for most publicly-traded companies, as the discretionary decisions were concentrated in the hands of a few shareholders who had large shareholdings, mainly the Saudi government and a small number of families.²³

5.3.2 Agency Problems in Saudi Companies

A major agency problem that became manifest at that time in the Saudi capital market was the conflict between large controlling shareholders and minority shareholders. The shareholding structure of Saudi companies was particularly problematic, given the high concentration of ownership in the hands of the government and families, who exerted too much influence on publicly-traded companies. The objectives of such companies were often affected either by political interests or by those of the founding families, which could result in boards and managements being influenced and in the exercise of

²³ Ramady (n5) 121.

insider control in the form of the abuse of company assets to pursue political or private objectives. Yet, although there was less regulatory concern for the protection of shareholders, individuals were still strongly motivated to buy shares in companies where the Saudi government had large holdings, without challenging its representatives on the board. They saw these as distinct from companies where families were the dominant shareholders, as most government-owned companies could be considered at very low risk of bankruptcy and it could be assumed that the government would be loath to allow a significant fall in the value of the shares it owned.²⁴

Thus, although a new dispersed ownership pattern emerged in the Saudi capital market, as will be discussed in the following sections, the literature extensively reviewed in chapter 2 indicates that the agency problem between controlling owners and minority shareholders was and remains a common phenomenon internationally, having appeared in most emerging and developing economies. It may be seen as contributing to the weakness of corporate governance and the absence of protection for minority shareholders, especially when one owner has effective control of a company's management decisions. Such controlling owners often determine not just how the company is run, but also how profits are to be distributed among shareholders. Although minority shareholders are entitled to the cash flow rights corresponding to their shares of equity ownership, they face uncertainty in the absence of sufficient legal protection of their rights, so that an entrenched controlling owner may opportunistically deprive them of these rights.

5.3.3 The Development of Ownership Structure after the Bubble of 2006

Developments in the Saudi economy after its accession to the WTO in 2005 and the consequent need for the government to liberalize its economy led it to reduce gradually its highly concentrated direct government ownership and to increase the involvement of its public funds, agencies and independent funds instead. Consequently, more than 70% of government holdings were bought by large government-controlled institutional investors such as the Public Investment Fund (PIF), the General Organization for Social Insurance (GOSI) and the Public Pension Agency (PPA). In 2008, the government also

²⁴ These motivations would become the norm for most local mutual funds, as discussed in the next section, as they prefer to inject most of their equity capital into government-owned companies.

established the Sanabil Direct Investment Company as an independent investment joint stock company with an authorized capital of \$5.3 billion, owned by the Saudi Arabian Investment Company and subsequently by the PIF and PPA.²⁵ These funds invested heavily in the Saudi capital market, although their holdings in many non-government privatized holding companies were small.²⁶ Eljelly states that although these public institutional investors appear to have only a small percentage of ownership, they are nevertheless considered to be sizable and influential in management and control. ‘This is due in part to the [new] pattern of [share] ownership in Saudi Arabia. ... Thus, sometimes a 1% share ownership in a company places the government as the largest shareholder and therefore entails significant control over the affairs of the company.’²⁷

Meanwhile, there was a significant upsurge on different types of private institutional investors, including Islamic mutual funds and Islamic insurance companies, as will be discussed in section 5.4. It can be argued that this growing involvement of institutional investors strongly affected the development of Saudi capital markets, playing a major role in restoring balance by reducing the agency problem, readjusting the balance of power, strengthening governance and making companies in the Saudi capital market more attractive to investors.

5.3.3.1 Concentrated ownership by family, cross-ownership and pyramid structures

Notwithstanding these changes in institutional shareholding, controlling ownership by families has recently grown to a greater proportion than before the establishment of the CMA in 2003. For example, some publicly-traded companies were recently found to be owned by only one person, such as the Kingdom Holding Company, with 95% holding of the total capital. Similarly, other listed companies are owned by one or two families, such as the Al Rajhi family, which has an average concentration of 45% of the ownership of Al Rajhi Bank, the largest Islamic bank in Saudi Arabia; seven of the 12

²⁵ Sanabil Direct Investment Company was established in 2008 by Cabinet decision No. 199, dated 06/11/2008, and Royal Decree M / 39, dated 06/12/2008.

²⁶ Middle East online, ‘Sanabil, Saudi PPA Acquire 19.4% Equity Stake in ACWA Power’, London, 2013 <<http://middle-east-online.com/english/?id=56415>>[Accessed on 05/03/2014].

²⁷ Abuzar Eljelly, ‘Ownership and Firm Performance: The Experience of Saudi Arabia’s Emerging Economy’ (2009) 8(8) International Business & Economics Research Journal 28 <<http://journals.cluteonline.com/index.php/IBER/article/download/.../3205>>[Accessed on 05/03/2014].

board members are members of the same family.²⁸ A number of rich Saudi families or individuals also own large numbers of shares through cross-ownership and pyramid structures, which has been seen as a new distinctive pattern in the Saudi capital market.²⁹ Such arrangements enable these rich families or individuals to maintain a complete lock on the control of an average concentration of 40% and above of total shareholding in 24 publicly-traded companies in the Saudi capital market.³⁰

This means that although the CMA was founded to ease the agency problem between controlling and minority shareholders, this remains unresolved, because so many new family firms are being founded in the Saudi capital market. Indeed, cross-holdings and pyramid ownership still have the potential to create very large agency costs for the Saudi capital market, particularly given the difficulty for new investors of identifying this type of ownership before investing. Alajlan warns that

these structures are difficult to trace, as under the current Companies Act (1965), [companies] are not required to disclose ownership structure and/or the identity of major owners to the public or investors. Anecdotal evidence, however, illuminates this issue to some extent. According to informal sources, the Olayan Financing Company (which holds and manages all of the Olayan Group's businesses and investments in Saudi Arabia and the Middle East), the ninth biggest company in the country, holds about 20% of the Saudi British Bank ... [and more than] 16% of the Saudi Hollandi Bank[, making it one of] the biggest investors in that bank ... Similarly, the Kingdom Holding Company, the second biggest company in the country, owned by Prince Al-Waleed bin Talal, is one of the major shareholders of the Saudi American Bank. What is also notable is that only 71 companies in Saudi Arabia are listed to trade on the Saudi stock exchange...³¹

The *Aleqtisadiah* newspaper recently investigated the membership of the boards of directors of listed companies and reports that most sectors of the Saudi stock market

²⁸ Alrajhi Bank website <http://alrajhibank.com.sa/en/media-centre/reports/documents/standard_poor_report.pdf>[Accessed on 05/03/2014].

²⁹ Such an ownership structure is commonly found in many countries whose economies are dominated by family-controlled companies. R La Porta, F Lopez-De-Silanes and A Shleifer, 'Corporate Ownership around the World' (1999) 54 *J Finance* 471-517.

³⁰ Waleed Alajlan, 'Ownership Patterns and the Saudi Market', in Mark Hirschey et al (eds) *Corporate Governance* (Advances in Financial Economics, Volume 9) (Emerald 2004) 170 <<http://emeraldinsight.com/journals.htm?articleid=1761362>>[Accessed on 05/03/2014].

³¹ *ibid.*

were dominated by families.³² In the insurance sector, for example, it was found that 31 families held around 79 of the total number of 275 seats, equivalent to 29% of the directorships of companies in the Saudi insurance sector, while in the petrochemical sector 14 families held 30% of seats on the boards of companies.³³ The percentage was even higher in the industrial investment sector, where 17 families had acquired 38% of the total seats on boards, the remaining 62% being held by individuals.³⁴

This shareholding structure, with a high concentration of family ownership among Saudi publicly-traded companies, including banks, has become one of the major governance problems, as too much influence is seen to be in the hands of a few large shareholders.³⁵ Ramady offers an example of a recent governance problem, when the increasing concentration of ownership in the banking sector became

a concern to the regulators in 2009 following the default of two prominent Saudi family groups – the Saad Group, owned by Maan Al Sanei, and the Al Gosaibi Group, which had large exposure to Saudi and international banks. [Some] loans were seemingly extended on a ‘name lending’ basis by banks where both groups held significant share holdings. SAMA moved quickly to reinforce existing regulations that requested more transparent bank corporate governance and disclosure in cases of direct and indirect shareholder loans.³⁶

This is one of the reasons for the Saudi government to encourage greater participation by individual investors, even where it has large concentrated holdings in many publicly-traded companies, such as commercial banks. Ramady issues the following warning:

The issue of large government ownership in banks raises concerns of possible ‘moral hazard’ arising whereby banks with substantial public ownership might be tempted to take on a greater risk, knowing that they will always be bailed out. ... [T]he Saudi government is aware of these issues, and is encouraging wider share ownership by planning a partial privatization of its own bank holdings, especially in the Kingdom’s largest bank, the National Commercial Bank (NCB). According to press reports, the government is planning to sell up

³² *Aleqtisadiah* Issue 7041, dated 20 Jan 2013 (Capital Market)
<http://aleqt.com/2013/01/20/article_726124.html>[Accessed on 05/03/2014].

³³ *ibid.*

³⁴ *ibid.*

³⁵ This began when families and business groups bought the IPO shares sold by individuals and created a high concentration of family holdings, including in banks.

³⁶ Ramady (n5) 121.

to 50% of its current holding in NCB, which, if it happens, would give a large boost to the Saudi capital market.³⁷

5.3.3.2 Development of a new dispersed ownership pattern

The new trend in ownership structure after the creation of the CMA in 2003 as described above, traditionally dominated by a few families and characterized by cross-ownership and pyramid ownership patterns, appears to have been challenged by a remarkable increase in widely dispersed ownership among many publicly-traded companies, marking a slight change in the overall balance in terms of concentration of ownership. Historically, this trend towards a new ownership pattern is believed to be a direct result of the many IPOs made since the deregulation of the Tadawul trading system, where many wealthy individuals with easy access to capital have found themselves able to invest in different portfolios in an attempt to make financial gains and to benefit from a rising market. One consequence was that a large number of shares were traded, but the majority of the wealthy individuals buying them were inexperienced and overly enthusiastic; they became victims of market speculation, paying a high price for shares in the hope of selling them at an even higher price. As a result, a speculative environment was formed, where everyone was optimistic about his or her investment portfolio. Saudi Arabia led the GCC capital market during this period, with a capitalization of SR 590 billion (\$159 billion), accounting for about 50% of the GCC capital market, which totalled SR 937.5 billion (\$250 billion). The Saudi capital market was ranked ninth among emerging markets at the end of 2003.³⁸

One of the many changes during this period was that the IPO market became more dynamic after the creation of the CMA, which helped to augment its value. For example, when Itihad Itisalat, a partially foreign owned telecommunication company, joined the capital market with an IPO of 20 million shares at SR 50 per share, the offer was oversubscribed, due to strong demand among individual investors, of whom 4.25 million subscribed, investing a total of SR 51 billion, which constituted one of the

³⁷ Ramady (n5) 122-123.

³⁸ Alajlan (n30) 162.

largest subscriptions of all time.³⁹ Another offering was that of Al-Sahara Petrochemical Company. Oil prices rose during this period, reaching \$34.53 per barrel, improving the economic development of the Kingdom and fuelling a continued boom in the issuance of IPOs.⁴⁰ When people bought these shares cheaply and saw them increase dramatically in value in only a few weeks, others were eager to invest in future IPOs or in other shares which might appreciate in the near future.⁴¹ It can be said that the trading activity and poor investment culture of such individual investors had a positive effect on the volatility of stock returns, which suggests that individual investors behaved as ‘noise traders’.⁴²

In some cases, a significant factor was the involvement of private consulting firms or individual consultants who helped inexperienced individual investors to select the right portfolios of shares or IPOs, even though they could not be expected to have asymmetric information before particular transaction could occur, and they acquired a good reputation among many individual investors. Companies were also glad to do business with such consultants, because the reputation of a good consultant might help increase the value of an IPO. Therefore, it was difficult to predict the performance of these companies, and investment in their stocks was risky. The market eventually reached a point where these investors could no longer find buyers for their highly inflated assets. Thus, an investment culture built on poor knowledge and understanding resulted in the 2006 bubble and one of the worst downward spirals in the Saudi capital market since its creation. SAMBA reported it thus:

The long-standing dominance of [individual] investors has led to considerable volatility in the Saudi [capital market]. The middle part of this decade saw a vertiginous run-up in the TASI. This reflected a number of factors, but key among them was a huge influx of small first-time traders attracted by a number of under-priced IPOs. (Under-priced IPOs encourage investors to sell part of their existing holdings in order to raise capital to invest in the new issues, thereby fuelling volatility.) Between 2003 and its peak in February 2006 the

³⁹ Abdulaziz Al-Dakhil, *Saudi Capital Market: Historical and Future Prospects* (in Arabic, Dar Al-Farabi 2010) 132.

⁴⁰ The insurance sector was also added to the capital market, as will be seen in the next section.

⁴¹ Kofi Amoateng and Javad Kargar, ‘Oil and Currency Factors in Middle East Equity Returns’ (2004) 30(3) *Managerial Finance* 3-16 <<http://emeraldinsight.com/journals.htm?articleid=865914>> [Accessed on 05/03/2014].

⁴² Thierry Foucault, David Sraer and David Thesmar, ‘Individual Investors and Volatility’ (2011) 66 *J Finance* 1371 <<http://dx.doi.org/10.1111/j.1540-6261.2011.01668.x>> [Accessed on 05/03/2014].

index gained a staggering 700 per cent, with market capitalisation soaring to \$800 billion—around two-and-a-half times nominal GDP.⁴³

5.3.3.3 *The financial bubble of 2006*

In the case of Saudi Arabia, the ‘greater fool phenomenon’ was quite evident as one plausible explanation of the bubble of 2006, as a huge number of individual investors entered the capital market to trade the shares of companies with little previous financial history but with hopes of benefiting from the sudden boom in the market. Surprisingly, the IPOs and trading of shares after the 2006 bubble became more vital and were still subject to strong and sustained interest on the part of many individual investors, both Saudi and foreign residents,⁴⁴ and many shares doubled or tripled in value.⁴⁵ Again, individuals participated strongly in buying and selling shares, even being willing to hold the shares of companies where the extraction of private benefits was expected to be large, while most of them were disinclined to devote resources to researching the companies in question.⁴⁶ Recently, they have become the dominant shareholders in the capital market, with an average of around 87% of the monthly trading by 2009.⁴⁷ Indeed, share ownership appears to be continuing to become gradually more widely dispersed, so that by 2011 a number of small and medium publicly-traded companies held between 30% and 80% (sometimes up to 100%) of the total ownership of other companies, such as Al-Baha Investment & Development Agriculture Marketing and Saudi Chemical.⁴⁸

This new trend towards increasingly dispersed ownership in such companies implies that the separation of management from ownership control is not rare in developing countries. The trend appears likely to continue, even in the presence of the considerable

⁴³ Saudi American Bank (SAMBA), *The Saudi Stock Market: Structural Issues, Recent Performance and Outlook Report* (2009) 5 <http://samba.com/GblDocs/Saudi_Stock_Market_Eng.pdf> [Accessed on 05/03/2014].

⁴⁴ Foreigners resident in Saudi Arabia have been allowed to participate in share trading since 2006.

⁴⁵ ‘Surprisingly ... most listed companies have continued to record reasonably healthy earnings.’ Hakim (n13) 72-76.

⁴⁶ Robert Shiller, ‘Initial Public Offering: Investor Behavior and Underpricing’, 1989, NBER working paper 2806, 1-23 <<http://ssrn.com/abstract=243219>> [Accessed on 05/03/2014].

⁴⁷ Robin Wigglesworth, ‘Local Retail Investors Lead Gulf Slide’ *Financial Times* (London 2011) <<http://ft.com/cms/s/0/9c53a348-44f3-11e0-80e7-00144feab49a.html#axzz1dTyDCvBS>> [Accessed on 05/03/2014].

⁴⁸ Tadawul website <http://tadawul.com.sa/wps/portal/!ut/p/c0/04_SB8K8xLLM9MSSzPy8xBz9CP0os3g_A-ewIE8TIwMLjwALA09vH1c3D2M_IwMDA_3g1Dz9gmXHRQABq365/> [Accessed on 05/03/2014].

private benefits of control.⁴⁹ Indeed, it has the potential to make a greater impact in the future, not only because the number of IPOs has increased as a result of the recent tendency for FDI flows into the country to become more stable and of the ongoing government programme of privatization, but because innovations and technological advances in trading systems make access easy for wealthy individual investors, even those who live in the desert. Having said that, in such widely dispersed companies, where neither the government nor family interests have majority control and where no single shareholder can exercise effective control with a minority shareholding, there are important implications regarding the ability of managers to expropriate from individual dispersed investors and the incentives for them to do so. This raises issues associated with the separation of ownership from control and with the general problem of agency; as widely discussed in the context of the UK, problems can arise whenever managers in such companies have valuable private information which they can use and which is not available to individual investors.

When ownership was concentrated in the hands of families, management could be expected to be under disciplinary pressure to pursue goals and policies that were in the interests of those controlling parties. It could be argued that activist institutional investors may be able to address concerns actively and to put pressure on managers and executive directors to implement best practice in corporate governance; their voices will be heard more loudly and they will be able to bring transparency to the operation. Under the emerging pattern of dispersed ownership in the Saudi capital market, by contrast, no individual security holder in many publicly-traded companies will benefit substantially from monitoring the actions of the management. Hence, no single shareholder will usually have the incentive to expend the necessary time, effort and money to monitor managers, because most of the benefits would go to the other shareholders, who might be family members or relatives owning less than the minority shareholder in question and having a personal connection with the managers concerned.⁵⁰

⁴⁹ John Coffee, 'The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control' (2000) Columbia Law and Economics Working Paper 182, 3
<<http://ssrn.com/abstract=254097>>[Accessed on 05/03/2014].

⁵⁰ Further discussion in Section 6.4.3.

5.3.4 The Value of Institutional Investors' Activism in Saudi Arabia

It might have been expected that the establishment of the CMA in 2003 would lead to the introduction of a more effective regulatory regime to guide the modernization of the emerging Saudi capital market. Indeed, there are apparent benefits of particular rules which exert disciplinary pressure or impose a degree of control over the behaviour of managers and which have played an important part in enlarging the scope of corporate control in the market. But while these regulatory changes were necessary to impose a significant degree of control over management behaviour through continuous monitoring of share prices and thus the implied possibility of merger and takeover,⁵¹ it is also essential to ensure that such rules and regulations can be effectively enforced, which appears not to be the case. Instead, the recent global financial crisis of 2007 has highlighted a number of weaknesses in the existing governance structure and practices in banks, which do not function effectively and have failed to achieve high levels of efficacy. This can be said to show just how crucial is the need for strong activism by institutional investors, which has been heralded as a major contributor to economic competence in the Saudi corporate sector.

The logical conclusion to be drawn from the discussion in the foregoing sections of the development of corporate ownership in Saudi Arabia is that the value of activist institutional investors is that they are potentially the most powerful players in the campaign to rebalance the power of governance in the Saudi capital market, because they have the potential to reduce the divergence of interests between dispersed investors and managers—or between minority investors and dominant owners—and to readjust the balance of power and strengthen governance, making companies more attractive to investors. Indeed, it will be argued in chapter 6 that in the Saudi context, institutional investors serve as a straightforward corporate governance mechanism, helping to reduce agency costs.⁵² Specifically, it is important to keep in mind, as mentioned in earlier sections of this chapter, that since the creation of the Saudi capital market, individual investors still appear to have suffered from a poor investment culture, tending to make immature judgments in favour of assets that should be considered too risky, while

⁵¹ For further details, see the Merger and Acquisition Regulations issued by the Board of the CMA in 2007 and their amendments in 2012 <<http://cma.org.sa/En/Documents/Merger%20and%20Acquisition%20Regulations.pdf>> [Accessed on 05/03/2014].

⁵² Section 6.6.

ignoring the performance and future prospects of the companies concerned. The effects of corporate governance regulations on the behaviour of investors remain relatively unexplored, despite their willingness to invest in companies whose governance is weak. Consequently, companies may be unwilling to respond to allegations of expropriation, knowing that individual investors are unlikely to possess the information needed to substantiate such claims.⁵³

This unwillingness to divulge information is exacerbated by the fact that it can be costly and difficult for individual investors to obtain it in many developing countries, where complete disclosure is not legally obligatory, the only option for individual investors holding less than 5% of ownership being to bargain privately for the right to have information on some of the key transactions. Thus, the fact that individual investors have limited ability and incentive to monitor and influence management or dominant owners raises the need for institutional investors, as a legitimate external corporate governance mechanism in the Saudi capital market, to control agency costs through direct bargaining with the management, with dominant government or family owners or with directors, giving them the power to influence the choice of different corporate governance mechanisms or other means of ensuring that managers act in the interests of individual investors.⁵⁴ Therefore, the aim of the next section is to explore in more depth the environment of institutional investors and their role in Saudi Corporate governance.

5.4 The Environment of Institutional Investment in Saudi Arabia

5.4.1 The Role of Public Institutional Investors in Corporate Governance

The Saudi government has a long history of direct investment, beginning with the formation of the Saudi capital market in the 1930s. Following the waves of privatization and the creation of the CMA in 2003, the government invested heavily through public institutional investors and has recently become the dominant player in terms of percentage of ownership, with substantial shareholdings in many publicly-traded

⁵³ Stephen Bainbridge, 'Shareholder Activism and Institutional Investors' (2005) UCLA School of Law, Law-Econ Research Paper 05-20, 4-6 <<http://ssrn.com/abstract=796227>>[Accessed on 05/03/2014].

⁵⁴ Further evaluation of the role of institutional investors as an external corporate governance mechanism appears in the next chapter.

companies of various kinds, including local commercial banks. It was reported in September 2011 that the Saudi government, through its public institutions, owned the largest concentration of shares in many large privatized companies such as SABIC and STC, which was the natural result of its longstanding privatization programme, while having less concentrated ownership of various other publicly-traded companies, with total capital of some \$116 billion. Around 65% of this ownership was exercised through the PIF.⁵⁵

There is empirical evidence, discussed in chapter 2, that large shareholders may have the potential to become more involved in monitoring activities and decision-making in companies where they have large ownership, as they have a strong incentive to be active and monitor the management's activities. This monitoring is likely not to be wasted, but to offer a return which would cover its costs. It may be assumed that Saudi public institutional investors would have the same potential to become more involved in monitoring the publicly-traded companies in which they have large ownership and that this would tend to ease the agency problem, thus satisfying shareholders of all kinds, since they would all enjoy a greater return on their own shares. In fact, many individual shareholders have the confidence to invest in these publicly-traded companies where the government owns substantial shares, reasoning that the government would not invest in high-risk companies⁵⁶ and that there is little danger of bankruptcy, as noted in the preceding section.⁵⁷ A number of mutual funds also have a longer-term investment horizon,⁵⁸ preferring companies in which the government owns substantial shares, as their performance greatly exceeds those of other publicly-traded companies with concentrated family ownership.⁵⁹

This does not mean that Saudi public institutional investors are totally driven by financial activism. It is evident that if these public institutions were independent of

⁵⁵ *Al Riyadh* 15829 (Newspaper, in Arabic, Oct 2011)

<<http://alriyadh.com/2011/10/26/article678736.html>>[Accessed on 05/03/2014].

⁵⁶ An example is the PPF, which focuses its investments on low-risk and important companies such as banks, petrochemical and non-oil industrial, cement and telecom companies. For more information see PPA web page

<http://pension.gov.sa/Resources/downloads/statistics/PPA_Statistics.pdf>[Accessed on 05/03/2014].

⁵⁷ *Al Riyadh* (n55).

⁵⁸ For example, HSBC long-term investment horizon funds

<hsbcsaudi.com/Prod_Services/Asset_Mgt/Mutual_Funds/Long_term/sef_en.shtml>[Accessed on 05/03/2014].

⁵⁹ Alajlan (n30) 32.

government control and their monitoring was no different, then their influence on the level and quality of corporate governance standards would not extend beyond their influence as financially driven activists, extracting private benefits, rather than politically driven activists.⁶⁰

5.4.1.1 Politically-driven investment approach

Thus it has been claimed that wholly government-owned funds like the PIF are naturally less concerned with monitoring activities than are self-governing institutional investors such as GOSI, SPPF and Sanabil.⁶¹ This may be true, as long as these pension funds are also totally free of any influence or pressure from the government and are driven by purely financial considerations. For example, there is a wide range of evidence that public institutional investors act as financially driven activists and have become important players in corporate governance; examples are the California Public Employees' Retirement System (CalPERS) in the USA and Hermes in the UK.⁶²

This may appear irrelevant to public institutional investors in Saudi Arabia, but close examination of their management structure shows that they are controlled and managed by government-nominated officials from various ministries, who will often simply not have the skills or ability of other money managers and may tend to be guided by political considerations rather than financial or stockholding ones.⁶³

⁶⁰ Actually, there is no simultaneity framework for control of Saudi public institutional investors' private benefits other than financial benefit, but they are mainly political and social benefits. Mary Shirley and Patrick Walsh, 'Public vs. Private Ownership: The Current State of the Debate' (2001) World Bank Policy Research Working Paper 2420, 15 <<http://ssrn.com/abstract=261854>>[Accessed on 05/03/2014].

⁶¹ Ginka Borisova et al, 'Government Ownership and the Cost of Debt: Evidence from Government Investments in Publicly Traded Firms' (2011) University of Oklahoma Working Paper 4 <cefir.ru/download.php?id=3079>[Accessed on 05/03/2014].

⁶² Anne Simpson, 'Public Pension Fund Management and Corporate Governance' (2001) World Bank, Non-Bank Financial Institutions Workshop 3 <1.worldbank.org/.../Anne_Simpson_corporate_governance.pdf>; Stuart L Gillan and Laura Starks, 'A Survey of Shareholder Activism: Motivation and Empirical Evidence' (1998) 1-38 <<http://ssrn.com/abstract=663523>>[Accessed on 05/03/2014].

⁶³ For example, although GOSI and PPA enjoy administrative and financial independence, the government has strong mandatory control and supervision over their investment policies through its various ministries. GOSI website <<http://gosi.gov.sa/portal/web/guest/overview>>[Accessed on 05/03/2014]; PPA website <http://pension.gov.sa/Resources/downloads/statistics/PPA_Statistics.pdf>[Accessed on 05/03/2014].

Although the intention of these public institutional investors is likely to be to hold their investments for a long time, enabling the investee companies to look beyond their annual revenue and cash dividends, there is good reason to presume that Saudi public institutional investors will not always act in the best interests of those in favour of long-term investments, nor of those who prefer a short-term investment horizon. Actually, they do not exercise good corporate governance within their own organisations or act as responsible investors and this disregard for the maintenance of appropriate standards may be said to weaken their potential for encouraging the application of corporate governance in the companies in which they invest and to diminish the power of minority activists.⁶⁴ They can be expected to extract as much benefit as possible for themselves and this divergence of interests away from financial motives will generate agency costs, which may not severely affect those who have a preference for long-term investment, but will affect the broad governance role that would be needed for companies to produce economy-wide social and environment benefits alongside financial ones.

Although there may be no evidence of substantial expropriation or actual costs, it could be said that one of the fundamental assumptions of the agency problem is that there will be a conflict of interest between large public institutional investors and other shareholders when the government's representatives in the controlling companies favour certain strategic opportunities or vote for particular proposals.⁶⁵ For example, they may support political moves to increase the level of employee contributions, which has recently become one of the most important items on the Saudi government's privatization agenda,⁶⁶ rather than limiting themselves to financial goals or trying to increase the company's value. Therefore, it is believed that managers have incentives to make decisions in favour of the controlling parties, rather than maximizing the wealth of shareholders in general or pursuing the interests of other stakeholders. In this situation, the basic rationale for activism, particularly among minority shareholders, is

⁶⁴ Reform of internal governance and encouraging the responsible activism of public institutional investors are discussed in chapter 6, sections 6.6.4.3 and 6.7.

⁶⁵ Roberta Romano, 'Public Pension Fund Activism in Corporate Governance Reconsidered' (1993) 93 *Columbia Law Review* 851-853 <http://digitalcommons.law.yale.edu/fss_papers/1958/>[Accessed on 05/03/2014].

⁶⁶ For discussion of the Saudi government's privatization objectives, see Saudi Economic Conditions <sec.gov.sa/Privatization_Strategy/Privatization_Objectives_and_Policies.aspx?lang=en-US>[Accessed on 05/03/2014].

the desire to monitor managers, to ensure that the company is being managed in such a way as to safeguard the interests of all shareholders rather than the controlling party's own interests, or to influence the directors to do their duty to uphold the interests of all stakeholders, including the shareholders. Such activists may pursue direct action, or have the incentive to be more active in monitoring, to achieve significant changes to standards of corporate governance.⁶⁷

Not surprisingly, an examination of typical Saudi listed companies indicates that most private institutional investors—whether their preference is for long or short investment horizons—have been unwilling to engage in activism and thus choose not to seek minority control of publicly-traded companies in which the government or families own substantial shares, because it would be costly for them to monitor management or even to achieve significant changes in corporate governance in order to increase their wealth. Instead, they choose either to remain passive, holding their shares and doing nothing,⁶⁸ or to ‘vote with their feet’.⁶⁹ This is one of the issues which requires reform, so that such investors have stronger incentives to act, although it is uncertain whether their current reluctance to do so is explained more by the legal framework or by cultural factors.

Actually, as the following sections will show, it can be said that private institutional investors in Saudi Arabia face a number of regulatory hurdles which may hinder their empowerment via the investment of private funds and their tendency towards activism, amounting to a significant weakening of governance by diminishing the tendency of private institutional investors to become activists.⁷⁰

5.4.2 The Role of Private Institutional Investors in Corporate Governance

5.4.2.1 *Investment funds*

In order to understand the role of private institutional investors in the Saudi capital market, it is important first to look at the history of investment funds and the

⁶⁷ *ibid.*

⁶⁸ Another important reason for different classes of Saudi investors to prefer companies where the government has controlling ownership over those dominated by families is the private benefit from reduced agency costs.

⁶⁹ Gillan and Starks (n62) 2.

⁷⁰ *ibid* 17-18.

development of their characteristics and performance as they began to dominate investment. Although the first one was formed by the NCB in 1979,⁷¹ it can be said that investment funds—as the traditionally dominant form and lately the largest industry in the Arab world—have emerged and rapidly developed since 1993, when SAMA officially put into effect the first regulatory regime for investment funds and collective investment schemes in the Kingdom. Although the Saudi capital market was relatively small and there were only 38 listed companies by 1993, SAMA aimed to overcome the deficiency in official market makers or specialists promoting liquidity and felt that it was important to regulate this industry, having witnessed increasing demand from small and medium investors in Saudi Arabia for more diversity of investment opportunities in the local and international financial markets.⁷² Following the enactment of this regulation, the number of mutual funds increased to around 71 in 1995,⁷³ yet there were many legal and regulatory restrictions that may have interacted to yield the characteristic culture of passivity. For example, SAMA outlined a set of investment restrictions that limited the percentage of total investment of these funds in the shares traded in the Saudi capital market; thus, policy 5 of the SAMA memorandum states: ‘a. A fund shall not invest more than 1% in the outstanding capital of a Saudi company that is traded in the shares market. . . . Investment by a fund in a single equity or debt issue shall not exceed 10% of its net assets’.⁷⁴

Perhaps because these investment funds themselves were not separate entities and did not have the sole legal capacity to deal on their own, the full responsibility for managing their assets was granted only to the local commercial banks, which also had to assume the responsibilities of custodians, administrators and marketers.⁷⁵ However, SAMA’s restrictions on commercial banks under their investment control, which made

⁷¹ NCB website <alahli.com/en-US/About%20Us/.../Pages/History_Page.aspx>[Accessed on 05/03/2014].

⁷² See the Regulations for Investment Funds and Collective Investment Schemes, Saudi Arabian Monetary Agency web page <<http://sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD07.aspx>> [Accessed on 05/03/2014].

⁷³ Hicham Benjelloun and Abdulkader Abdullah, ‘Index Funds and Diversification in Saudi Arabia’ (2009) 2 International J Islamic and Middle Eastern Finance and Management 203 <<http://emeraldinsight.com/journals.htm?issn=1753-8394>>.

⁷⁴ SAMA, policy 5, The Regulations for Investment Funds and Collective Investment Schemes Circular, paras a & d <<http://sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD07.aspx>> [Accessed on 05/03/2014].

⁷⁵ SAMA, policy 1, The Regulations for Investment Funds and Collective Investment Schemes Circular <<http://sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD07.aspx>>.

these investment funds ineffective, was not the only major or decisive reason for the weakness of investment funds in building an engagement culture.⁷⁶ Actually, SAMA fell short of granting the commercial banks full responsibility for managing the assets, as it feared creating a more acute set of agency problems as a result of conflicts of interest where banks had dual intentions or objectives and scope of operations. Therefore, SAMA took away their independent role of involvement through investment funds in the capital market, which went beyond the true limits of the activity that had been granted to them by the regulations as lenders and depositors.

This sounds reasonable if one assumes that commercial banks would be more sympathetic in conducting their traditional business and building a commercial lending relationship with many publicly-traded companies, particularly with companies that were controlled by families and the government, especially when we know that there were many banks where government and families were the major owners.⁷⁷ Therefore, a bank could exercise direct control of such funds through its staff, who could misrepresent the assets of the funds or be less motivated to use their voting power to demand good corporate governance and accept funds as investors, since they would be strongly motivated towards passivity. Consequently, there was great potential for banks' staff, as asset managers, to neglect their fiduciary responsibilities to the mutual funds as investors, because there was a risk of a divergence of interest between the funds and the banks, which as asset managers would act in their own interests or those of the government, rather than seeking to maximise the wealth of the funds' investors. These dual objectives of the banks are presumed to have played a part in sustaining the development of a strong and independent private institutional investment industry with incentives to build a sound culture of activism, which in turn could play a fundamental role in the capital market by reducing the high concentration of government and family ownership that has characterized the Saudi capital market ever since its establishment in the 1930s.

⁷⁶ Bernard Black, 'Shareholder Passivity Reexamined' (1990) 89 Michigan Law Review 548 <<http://ssrn.com/abstract=366820>>[Accessed on 05/03/2014].

⁷⁷ Ramady (n5) 114.

5.4.2.2 *The CMA and new Investment Fund Regulations*⁷⁸

In 2006 the CMA drew up new Investment Fund Regulations (IFRs) that aimed to broaden the range of investment funds, as commercial banks would no longer be the only asset managers.⁷⁹ The passing of the IFRs had an important impact on the developing investment funds industry in a short time, increasing its business scope and the number of mutual funds dramatically in 2006. Benjelloun and Abdullah note that investment funds now differed

...in nature, objectives and scope of operations. Some of them concentrate on investing in local financial securities, while others extend their financial activities regionally and internationally. The main types of investment funds are grouped under six areas: balanced funds, stocks, bonds, money market, trade finance, and real estate funds. The total asset of these funds increased from \$3.5 billion in 1995 to 37 billion in 2006, an increase of 960 percent. The value of local stocks funds managed by Saudi commercial banks increased from \$418 million in 1999 to \$24,715 in 2006, an increase of 581 percent.⁸⁰

In addition, the CMA increased the share of the total investment of these funds in traded shares to more than 10% of each company listed on the Saudi capital market and reduced the possibility of collective problems arising: ‘A fund manager may hold more than ten (10) per cent of the investment fund’s net assets value in shares issued by any single issuer provided that such investment does not exceed the market capitalization of the issue expressed as a percentage of the total market capitalization.’⁸¹

The new IFRs marked the end of the regulatory barriers to investment funds owning large shares in individual publicly-traded companies and pursuing their real interests in building a sound activist culture. By 2010, most funds focused their investments on the local equity market, with a value of SR 19.1 billion, particularly in the petrochemical

⁷⁸ CMA board resolution for the formation of the IFRs, 1-219-2006, dated 3/12/1427H, corresponding to 24/12/2006.

⁷⁹ Paragraph (b) of article 39 of CML states that the CMA ‘shall assume the power to regulate the activities of investment funds managed by banks within two years from the enactment of this Law’. Also see Beach J, ‘The Saudi Arabian Capital Market Law: A Practical Study of the Creation of Law in Developing Markets’ (2005) 41(2) *Stanford J International Law* 336 <<http://heinonline.org/HOL/Page?page=307&handle=hein.journals%2Fstanit41&collection=journals>> [Accessed on 05/03/2014].

⁸⁰ Benjelloun and Abdullah (n73) 203.

⁸¹ Investment Fund Regulations, para e.2 of article 39.

sector and that of banks and financial services, where they invested SR 5.6 billion (29.3%) and SR 4.7 billion (24.7%) respectively.⁸²

However, while it is true that the CMA mitigated the agency problem to some extent by granting investment funds an independent legal personality and that the wording of the regulations clearly acknowledges any conflict of interest that may arise between these investors and controlling or other parties, in order to protect the interests of the former, thus ensuring a sounder corporate governance system,⁸³ there is nonetheless no absolute divorce between investment funds and such controlling parties. Indeed, it is even possible for them to have affiliate relationships,⁸⁴ given that most investment funds are mainly managed indirectly by the eleven commercial banks through subsidiary investment vehicles.⁸⁵ The conflicting incentives that investment fund managers could face appear more serious when it is noted that there is a heavy domination by government and particularly by families, which have controlling ownership of many financial intermediaries, including many banks; this may discourage investment funds from taking an active position.⁸⁶ Thus it is difficult to say that the asset managers of these investment funds have changed their attitude of cautious passivity and now respond to a more positive motivation to use their voting rights to pursue good corporate governance. Nor is there any evidence of such investment funds trying to stand up to the government or families that have a controlling ownership of the companies in which they invest by rejecting proposals that might harm the investment funds; this is considered another of the complex web of issues which require reform.

In view of this lack of evidence, there is another plausible regulatory deterrent which may explain the caution of investment funds and their reluctance to adopt a more vigorous activism, which is that investment funds face the risk of being held legally

⁸² CMA Annual Report (2010) 54

<<http://cma.org.sa/En/Publicationsreports/Reports/Report2010.pdf>>[Accessed on 05/03/2014].

⁸³ For example, articles 13 and 41 of the Authorized Persons Regulations issued by the Board of the CMA, resolution 1-83-2005, dated 21/05/1426H, corresponding to 28/06/2005
<<http://cma.org.sa/En/Documents/AUTHORISED%20PERSON.pdf>>[Accessed on 05/03/2014].

⁸⁴ John Thompson and Sang-mok Choi, 'Governance Systems for Collective Investment Schemes in OECD Countries' (2001) OECD Financial Affairs Division Occasional Paper 1, 9
<oecd.org/dataoecd/3/3/1918211.pdf>[Accessed on 05/03/2014].

⁸⁵ Benjelloun and Abdullah (n73) 203.

⁸⁶ The government, through GOSI, PIF and PPA, has around 50% of shares in the Saudi American financial group that manages various investment funds. Tadawul web page:
<<http://tadawul.com.sa>>[Accessed on 05/03/2014].

liable for insider trading regarding the information that may be obtained, especially when it is realized that they have close relations with many affiliates, parties and government agencies, as discussed above, which hinders their indirect or direct trading.⁸⁷ The risk of insider trading becomes correspondingly great and must be confronted if the investment funds vote for their nominated directors in the company, especially in a concentrated ownership environment. Avgouleas argues that there is a strong and incontrovertible connection between corporate fraud, which leads to manipulation of securities prices and the occurrence of insider dealing on one hand, and the quality of corporate governance structures on the other, and that such corporate fraud is more likely to occur in a concentrated ownership environment, not a diffused one, mainly because of the relationships that corporate patriarchs frequently uphold and the reduction of activism.⁸⁸ This risk could be diminished by the construction of an appropriate Chinese wall and other safeguards, including rational insider dealing regulations, to avoid conflicts of interest, to divorce these funds completely from banks and to ensure that confidential or inside information is not communicated to those connected with the directors' funds.⁸⁹

This may become possible, specifically when it is found that most of these investment funds have recently acquired a large share or a minority share of 5% in one of the publicly-traded companies or in dispersed companies, which are not controlled by families or the government.⁹⁰ Meanwhile, these investment funds do not want to lose their reputation in the market and will try to preserve it among the public, who must believe that asset managers operate within the law and uphold the reputation and ethical good standing of the business. Even the emergence in the Kingdom of a large body of Islamic mutual funds which, as noted in the next section, are also more inclined towards a long-term investment horizon, does not change the situation materially, since they appear to feel the same trepidation and are reluctant to acquire minority shares, which may accordingly hinder the development of the institutional investment industry in Saudi Arabia and slow the growth of activism among investment funds.

⁸⁷ CML article 50.

⁸⁸ E Avgouleas, *The Mechanics and Regulation of Market Abuse* (Oxford University Press 2005) 95.

⁸⁹ Authorized Persons Regulations article 30.

⁹⁰ Under the CMA regulations, any person who is interested in owning 5% of shares in any listed company must submit to the CMA a disclosure form identifying any information sensitive to the investment objectives of investment funds. CMA disclosure forms web page: <<http://cma.org.sa/en/FormsSite/Pages/Disclosure.aspx>>[Accessed on 05/03/2014].

5.4.3 The Role of Islamic Institutional Investors in Corporate Governance

The Islamic financial industry, including Islamic banking, Islamic mutual funds and insurance companies (*takaful*), is increasingly perceived by many Western academics and professionals in the global financial market to offer an efficient alternative to the conventional model of financial intermediation. Indeed, the UK government has pursued the promotion of London as a centre for Islamic finance, to deliver such financial services and products to the Muslim community.⁹¹ The justification for this global awareness and the increasing demand for Islamic financial products is simple to apprehend, as there is a global emphasis on a wider choice of modern products with common values and a growing awareness of incentive-creating forces such as markets, politics and social factors,⁹² with a more ethical investment-based structure. The principles behind Islamic finance may be viewed as having been similar to those behind the development of the open structure of modern Western finance and investment, whereby reasonable investors seek investments with ethical foundations.⁹³ Islamic institutional investors are much more in line with this modern Western approach and their investments are based on products that should be approved by a Shariah supervisory board, comprising a number of Islamic scholars who ensure the compliance of the investment operation and portfolios with Islamic principles. This involves the use of many Islamic instruments such as *mudarabah* (profit-sharing) and *musharaka* (joint venture), which are both based on equity of participation,⁹⁴ as well as ensuring that the offering, product or investment is free of any prohibited business activities before it can be presented to individual investors.⁹⁵

Hence, it is imperative for this thesis to examine the role of Islamic institutional investors in Saudi Arabia. Actually, the adherence of Saudi Arabia to Islamic finance

⁹¹ Rodney Wilson, 'The Development of Islamic Finance in the GCC' (2009) Working Paper, Kuwait Programme on Development, Governance and Globalisation in the Gulf States 2 <<http://w.lse.ac.uk/collections/LSEKP/documents/Wilson.pdf>>[Accessed on 05/03/2014].

⁹² KAD Camara, 'Classifying Institutional Investors' (2005) 30 J Corporation Law 226 <<http://ssrn.com/abstract=573441>>[Accessed on 05/03/2014].

⁹³ The International Organisation for Security Commissions (IOSC), 'Islamic Capital Market Fact Finding Report', (2004) Report of the Islamic Capital Market Task Force of the International Origination of Securities Commissions 1 <<http://iasplus.com/resource/ioscoislamiccapitalmarkets.pdf>>[Accessed on 05/03/2014].

⁹⁴ The *mudarabah* principle is seen as the cornerstone and ideological basis of Islamic banking for mobilizing funds from the public and providing finances for entrepreneurs. There are many models of Islamic finance and investment products underlying different Islamic institutional models. Details are given by the IOSC (n93).

⁹⁵ *ibid.* The major prohibited activities are *riba* (interest), *gharar* (uncertainty) and *maisir* (gambling).

and investment is easily explained, as it is known as the most religious country in the world and its governance system and constitution are based on Shariah.⁹⁶ The legal prohibition of interest, for example, is unambiguously affirmed in the charters of all Saudi government institutions, notably SAMA and the CMA, while the Shariah scholars' positive views of the long-term investment horizon are among the most important factors in structuring the Saudi capital market.⁹⁷ In addition, Saudi Arabia has restructured the central platform of its Islamic financial and private institutional investment market so that it depends heavily on equity financing, to an extent that has recently become impressive. Many types of investor can be classified as Islamic institutional investors, but when it comes to the Saudi context, the market typically comprises several institutions including Islamic banks,⁹⁸ takaful funds, which are similar to conventional insurance companies, and Islamic mutual funds.

5.4.3.1 Takaful insurance⁹⁹

Although there is no conventional or commercial insurance market in Saudi Arabia, there is a relatively new Islamic insurance market. Indeed, the Saudi insurance market has witnessed major developments since the issuance of the Law on the Supervision of Cooperative Insurance Companies in 2003, followed by the formation of the first cooperative insurance company in 2005 and the eventual opening of the market to foreign participants during the last five years, making it the largest in the Arab world and the international takaful market, with around 31 listed companies in June 2011 and an expected capital of around of \$7 billion in 2012.¹⁰⁰

Islamic insurance companies have features such as the relationships between their directors and a twofold fiduciary responsibility towards policyholders and shareholders, as well as the requirement that investments must be compatible with Islamic principles.

⁹⁶ Further details of the Saudi legal system are given in the next chapter.

⁹⁷ Articles 2 and 6 of the charter of SAMA, issued by Royal Decree no 23, 1957, state that it 'shall not pay nor receive interest [nor act] in any manner which conflicts with the teachings of Islamic Law.'

⁹⁸ Islamic banking has been excluded from this analysis, since SAMA expressly prohibits Islamic or conventional banks from playing a direct part in the capital market.
<<http://sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD03.aspx>>
[Accessed on 05/03/2014].

⁹⁹ The word "*takaful*" comes from the verb "*kafala*" and is translated from Arabic as "guaranteeing each other". The Holy Quran says: "...Help ye one another in righteousness and piety, but help ye not one another in sin and rancour: fear Allah: for Allah is strict in punishment" (5:2).

¹⁰⁰ Zawya report, 20 Nov 2011

<http://zawya.com/story.cfm/sidZAWYA20111120053925/Growth_of_Takaful_insurance>.

Takaful is similar to conventional insurance, in that the latter includes general and life insurance, while Islamic insurance can be general (standard insurance) or family (life insurance).¹⁰¹ Islamic general insurance meets the needs of individuals and corporations for protection against any future damage to their property,¹⁰² while Islamic family insurance helps the person or family in the case of death or disability.¹⁰³ The important features of the Islamic model are that there are two separate funds, the takaful (or policyholders') fund and an operator's (shareholders') fund,¹⁰⁴ and that the relationship between the takaful operator and the policyholders is based on *wakala* (agency) or *mudarabah*. Consequently, the role of the operator of the takaful company is limited to managing the funds, investing money and managing compensation.

Given the nature of the operation, there is, as in conventional insurance, a large amount of money from the accumulation of contributions to cover future payouts. It would be a loss for the company not to invest in these funds and Islamic insurance companies are thus required to do so. Investment in takaful is different from investment in conventional insurance, however, in that it must be well matched with the Islamic principles of Shariah, making it impossible for takaful to invest in interest-bearing or any other forbidden form of investment; the investment must be in Shariah-compliant assets, such as in the profits of publicly-traded companies not dealing with any product prohibited under Shariah, in Islamic mutual funds or in *sukuk* (Islamic bonds). Moreover, investment income is shared among policyholders, shareholders and the takaful operator, while the contract is normally based on *mudarabah*, the ratio being agreed upon in the contract. Therefore, the takaful operator may be liable to the policyholders if there is misconduct or negligence in the investment. In addition, due to fluctuations in rates of foreign exchange and indicators, the takaful operator must account for these risks by choosing investment diversification outside the Saudi capital market, since a limited range of investments in certain companies—particularly the portfolio sector in the Saudi capital market—may lead to a concentration of risk.

¹⁰¹ Carlos Wong-Fupuy et al, 'Draft: Rating Takaful (Shari'a Compliant) Insurance Companies' (2011) AM Best Methodology 2 <<http://ambest.com/press/120503TakafulMethodology.pdf>>[Accessed on 05/03/2014].

¹⁰² Islamic Financial Services Board, 'Guiding Principles on Governance for Takaful (Islamic Insurance) Undertaking 6 <<http://ifsb.org/standard/IFSB%208-Takaful%20Governance%20Standard.pdf>>[Accessed on 05/03/2014].

¹⁰³ *ibid.*

¹⁰⁴ Wong-Fupuy et al (n101) 3.

Takaful operators must also take account of the quality of risk in each investment. Moreover, the operator's relationships with both agents and brokers are of great importance, since the operator seeks to build the portfolio with a variety of risks through the acceptance of a large number of investments. Due to this diversity, the risks of each are less likely to be correlated, which reduces the chance of an overall loss to the portfolio.

Another issue facing the Islamic finance industry in Saudi Arabia is that there is still a limited set of asset classes compatible with the provisions of Shariah. Islamic institutions are trying to offer a variety of liquid instruments, yet Islamic mutual funds are mostly limited to low yields by their passivity and long-term investment, like sukuk. Furthermore, long-term investments such as real estate have no secondary market liquidity. As a result, a takaful undertaking faces the risks associated with the appropriate investment allocation and liquidity management of the takaful fund. Although there is thus limited depth in Islamic investments, the key role that Islamic institutional investors have given to the cooperative risk-sharing model of takaful and its routine activism is predicted to become very important in the Saudi capital market in the future. This is especially likely because SAMA introduced a new statute of Investment Regulations in 2012, to regulate the investment activities of insurance and reinsurance companies, including specific items regarding investment policy, the implementation of any monitoring activities and relations with outsourced portfolio investment managers.¹⁰⁵ While the UK has adopted the 'Prudent Person Rules', whereby there is no regulatory restriction on life insurance companies' equity shareholding and they enjoy free portfolio diversification,¹⁰⁶ Islamic insurance companies are subject to quantitative portfolio restrictions under the Investment Regulations, limiting their holdings to a maximum of 15% of equity share in the Saudi capital market and prohibiting them from investing in derivatives, option contracts, hedge funds, deposits with foreign banks and private equity investments.¹⁰⁷ It is

¹⁰⁵ SAMA, Insurance Supervision Department, Investment Regulation dated 21/02/2012 <http://sama.gov.sa/Insurance/InsuranceLib/II_4600_Investment_Regulations.pdf> [Accessed on 05/03/2014].

¹⁰⁶ E Davis, 'Prudent Person Rules or Quantitative Restrictions? The Regulation of Long Term Institutional Investors' Portfolios' (2002) 1 J Pension Economics and Finance 157, 181 <http://info.worldbank.org/etools/docs/library/67915/oxford2004/pdf/Davis_2002_Prudent.pdf> [Accessed on 05/03/2014].

¹⁰⁷ Article 54 of the SAMA Investment Regulation.

important for SAMA to ensure that such new investment regulations should be amended so that they have the scope to enhance portfolio diversification and encourage the activism of insurance companies in their investment policies.

5.4.3.2 Islamic mutual funds

The Islamic mutual funds industry entered the Saudi market in the 1970s. Some of these funds were designed to conform to Islamic principles through investments in different companies in the UK and the US that were leaning towards Islamic compatibility, such as companies founded by Quakers or similar religious groups.¹⁰⁸ In 1987, the NCB launched the first model of an Islamic-designed mutual fund with a Shariah supervisory board, which was the first signal for more Islamic mutual funds offered to the public by different local commercial banks.¹⁰⁹ However, very few individuals bought units in these Islamic mutual funds, because most banking operations in Saudi Arabia were interest-based and therefore held no attraction for the public at large, even though they were designated as Islamic funds. As the rest believed that the Saudi financial environment was a mix of local conventional commercial banks offering such Islamic funds, so that their Islamic capital could be mixed with non-Islamic capital, this was an important issue for individuals who wanted to ensure that their income source would not be affected by prohibited practices. This could be seen clearly within conventional financial institutions and corporations that offered Islamic finance within an Islamic window, rather than a totally independent Islamic-compliant legal entity. In addition, after the deregulation of the Tadawul and the CMA, most Saudis preferred to invest directly in publicly-traded companies and rejected the option, offered by local conventional commercial banks, of investing through Islamic mutual funds. This was one of the reasons for most conventional financial institutions to perceive a need to reform their existing models; indeed, they have recently modified their whole systems so that they operate in complete accordance with Islamic principles,¹¹⁰ making them more compatible with the wider goals and institutions of Saudi society.¹¹¹

¹⁰⁸ ‘This was a group of investors that applied social criteria to investing, based on their beliefs in human equality and non-violence. They were considered to be the first group of ethical investors.’ Rob Bauer, Kees Koedijk and Rog er Otten, ‘International Evidence on Ethical Mutual Fund Performance and Investment Style’ (2005) 29 J Banking & Finance 1752
<<http://arno.unimaas.nl/show.cgi?fid=15670>>[Accessed on 05/03/2014].

¹⁰⁹ Wilson (n91) 14.

¹¹⁰ Examples of Islamic banks are SAMBA, HSBC AMANA, NCB, Aljazira Bank and INMA Bank; for more information see Tadawul listed companies web links:

Accordingly, the number of Islamic mutual funds has increased dramatically and they have recently overtaken conventional mutual funds, with more focus on Shariah-based structures for equity investments, making Saudi Arabia the world's largest market for Islamic asset management, comparable to Malaysia.¹¹² However, after the 2006 bubble, the number of individual investors has decreased and many chose to exit the investment funds permanently; they were no longer interested in investing in these Islamic mutual funds and most have preferred to invest directly in publicly-traded companies.¹¹³ It has been argued that although there is an increasing number of Islamic mutual funds in Saudi Arabia, offering investors the widest choice of Islamic mutual funds in the world, individual investors have reacted negatively to the 2006 bubble and the further collapse of the market during the past years, which have resulted in negative returns from these funds, leading such individuals to believe that the asset managers of these mutual funds are not adequately qualified or skilled and that they have gained personal benefit at the expense of individual investors.¹¹⁴

Benjelloun and Abdullah investigated how best to diversify in the Saudi capital market and found that the basic reasons for individual investors to prefer direct investment in the Saudi capital market over Islamic mutual funds were that the latter were more expensive and that:

When the cost of investing in index funds is 2 percent and the borrowing rate is 7 percent it would take investors eight stocks to beat the fund and therefore to be fully diversified. On the other hand, an investor with seven stocks in his portfolio will be indifferent between investing directly by paying the brokerage fees and investing indirectly by paying the 2 percent fee. When the cost of investing in an index fund is 3 percent and the borrowing rate is 7 percent, the investor needs only five stocks to be fully diversified. Comparing these results to

<http://tadawul.com.sa/wps/portal!/ut/p/c0/04_SB8K8xLLM9MSSzPy8xBz9CP0os3gX35DgIB9TQwOLQH9nA08jX_dAp7AAIwMDA_3g1Dz9gmxHRQA2g6A0/>[Accessed on 05/03/2014].

¹¹¹ 'Between 70% and 90% of investors prefer Islamic products and the Saudi investors are much more likely to demand Islamic investment than investors from other GCC states.' Ernst & Young (2008) Islamic Funds and Investment Report 35

<[http://ey.com/Publication/vwLUAssets/The_Islamic_Funds_and_Investments_Report_2008/\\$FILE/Ernst_&_Young_-_IFIR08.pdf](http://ey.com/Publication/vwLUAssets/The_Islamic_Funds_and_Investments_Report_2008/$FILE/Ernst_&_Young_-_IFIR08.pdf)>[Accessed on 05/03/2014].

¹¹² *ibid* 41-48.

¹¹³ In 2009, individual investors became the main drivers of the Saudi capital market and the most heavily traded, accounting for around 88%, while mutual funds accounted for just 1.5 percent. SAMBA report (n43) 5.

¹¹⁴ *Al Riyadh* 15693 (Economic section, 12 June 2011)
<<http://alriyadh.com/2011/06/12/article640841.html>>[Accessed on 05/03/2014].

developed stock markets we can see how low this number is. This is mainly due to the high cost of investing in funds.¹¹⁵

Consequently, resolving complexity depends on what conflicts of interest may arise between individual investors and investment managers. Such conflicts may be identifiable in many ways in the relationship between individual investors and asset managers. For instance, they may occur, as explained in chapter three,¹¹⁶ because asset managers sometimes represent more than one client, or because certain interests might conflict with the objectives of other affiliates or institutional shareholders, such as mentioned in this chapter regarding the relation with affiliates or controlling parties.¹¹⁷ These conflicts may be considered to have some influence on asset managers' behaviour, tending to make them remain passive all the time, allowing negative returns on many of these funds, which will obviously affect the confidence of individual investors. Moreover, such investors' anxieties are reinforced by the fact that the Islamic model of mutual funds means that asset managers concerned with affiliates' interests would not focus on real investments to maximize value for the shareholders while maintaining reputable standards of ethical and moral conduct, which is considered of secondary importance.¹¹⁸

Such concerns put the internal corporate governance framework for these funds under the spotlight as to the extent to which it is possible to control these conflicts of interest and to deliver an environment supportive of institutional investors' activism. These concerns and the proposed reforms will be evaluated in the next chapter, which discusses the legal framework of corporate governance and investor protection in Saudi Arabia.

5.5 Summary and Findings

This chapter has discussed the foundation of corporate governance, namely, corporate ownership. In particular, it has explored the developing patterns of the ownership

¹¹⁵ Benjelloun and Abdullah (n73) 203.

¹¹⁶ Section 3.5.4.3.

¹¹⁷ Section 5.4.2.2.

¹¹⁸ Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh University Press 2000) 142 <<http://iefpedia.com/english/wp-content/uploads/2011/03/2000-Ibrahim-Warde-Islamic-finance-in-the-global-economy-Edinburgh-University-Press1.pdf>>[Accessed on 05/03/2014].

structure of Saudi publicly-traded companies and the value of institutional investors' activism in the Saudi capital market. It first reviewed the historical development of the Saudi capital market, seeking to highlight the market management structure of the several authorities that govern its function and operation, and to detail the different legal, political and financial explanations which have been offered for the marked trend towards a concentrated ownership structure. Despite the significant developments that the Saudi stock market has witnessed since the establishment of the CMA in 2003 as a single regulator, it was expected that the establishment of the CMA would be able to mitigate risk and attract domestic savings, as well as increasing demand among international portfolio investors. Having said that, after the bubble of 2006 among dominant government and family shareholders, there has emerged a pattern of pyramid structures and cross-ownership by members of rich families as well as one of diffused ownership in a number of publicly-traded companies. This implies that although the agency problem in the Saudi capital market concerns the conflict between controlling and minority shareholders, there also exists a possibility of agency issues arising in the relationship between managers and diffused owners. Could these controlling owners and blockholders become activist shareholders and solve these agency problems? The evidence is scant as to the impact of a highly concentrated ownership structure that puts great influence in the hands of a few shareholders, some of whom chair several companies in different sectors, which could accelerate the acquisition of personal benefit while having an insignificant impact on corporate governance practice.¹¹⁹ The uncertainty of the consequences of corporate ownership in Saudi Arabia suggests that institutional investors play a valuable role in mitigating agency problems, thus readjusting the balance of power and strengthening governance practice in Saudi corporations.

Thus, by discussing the environment of institutional investors and their role in corporate governance in the Saudi context, the findings of this chapter constitute important indicators regarding the attitude of institutional investors toward activism in Saudi Arabia; in particular, they have rather limited incentives and lack an important element of activism: to monitor actively. This chapter has identified many impediments to the application of this role. Given the independence of public institutional investors

¹¹⁹ Maria Maher and Thomas Andersson, 'Corporate Governance: Effects on Firm Performance and Economic Growth' (2000) Working paper 33-34 <ssrn:<http://ssrn.com/abstract=218490>>[Accessed on 05/03/2014].

from direct government control and their dominant position in terms of percentage of ownership, their monitoring is not satisfactory, they lack the clear application of a corporate governance framework in their own organisations and there is good reason to expect them to support a political agenda, which means that the maximisation of these benefits may be in conflict with the goal of achieving optimal encouragement for corporate governance standards in the companies they invest in.¹²⁰

Meanwhile, private institutional investors run the risk of potential conflicts of interest and there appears to be no sharp separation between investment funds and banks, which may discourage the funds from taking an active position while there are close relations with many affiliates. Asset managers sometimes also represent more than one client and have certain relations and interests with business affiliates which might conflict with the objectives of their clients and owners. These conflicts may be considered to have some influence on asset managers' behaviour, tending to make them remain passive and not focus on real investments to maximize value for their clients and owners, which is recognized as of secondary importance, while trying to maintain good relation with their affiliates. On the other hand, although it is suggested that the invention of the Islamic model of insurance and its routine toward activism will become very important in the Saudi capital market in the future, in monitoring the performance of Saudi firms, or in other words in influencing the adoption of good corporate governance standards in the companies in which they invest, there are still regulatory restrictions on these insurance companies, as they are subject to quantitative portfolio restrictions that limit their holdings in the Saudi stock market, which need to be implemented to enhance their portfolio diversification and encourage activism in their investment policies.

Finally, the awareness of the importance of activism for the investment decision process among public and private institutional investors, as well as the level of legal protection for minority shareholders, may be considered the main factors underlying the comparatively weakened importance placed on the role of institutional investors in

¹²⁰ Markus Loewe, 'Pension Schemes and Pension Reforms in the Middle East and North Africa' (2009) UNRISD Draft Working Document 27
<<http://unrisd.org/80256B3C005BCCF9/search/B266E600844E793DC125760400497ACE?OpenDocument>>[Accessed on 05/03/2014].

corporate governance in Saudi Arabia. This suggests the need to discuss the deficiencies in the existing legal framework of corporate governance, which the next chapter does.

Chapter 6

The Legal Framework of Corporate Governance and Investor Protection in Saudi Arabia

6.1 Introduction

Following the discussion of the structure of corporate ownership in Saudi Arabia, this chapter explores the corporate governance framework prevailing there and its effectiveness in achieving sound governance. To this end, it considers the ability of the country's legal system to protect the rights of minority shareholders and examines the extent of activism among institutional investors. It begins with an overview of the Saudi legal system and its origins, this being an important factor in the shaping of the corporate governance system, because there are always problems in strengthening corporate governance in emerging and developing countries. Some of these problems are associated with the weakness of the legal system and regulatory framework in the country. The influence of a country's legal origins or traditions on the quality and effectiveness of its laws and regulatory framework is argued by various academic sources to contribute to the strength or weakness of corporate governance practice, affecting financial development and the protection of minority shareholders from expropriation by managers or controlling shareholders.¹ In addition, the ease of access of a company to capital on the world markets depends on the country's legal system and its attempts to generate such prerequisite conditions.² Section 6.2 explores these effects in the case of the Saudi legal system by considering its foundation, history and essential reforms in a concise way, rather than attempting to offer a more comprehensive description of all of its distinctive features. The most important reason for taking this approach is that Saudi Arabia has a distinctive legal system that is to some extent unique in its fundamentals and thus unrelated to the models existing in the rest of the world, such as the UK's system of common law and statute, which is more integrated

¹ 'Legal origin matters for financial development because legal traditions differ in their ability to adapt efficiently to evolving economic conditions.' Thorsten Beck, Asli Demirgüç-Kunt and Ross Levine, 'Law and Finance: Why Does Legal Origin Matter?' (2003) 31(4) J Comparative Economics 672-673 <<http://sciencedirect.com/science/article/pii/S0147596703000982>>[Accessed on 05/03/2014].

² Rafael La Porta et al, 'Legal Determinants of External Finance' (1997) 52 J Finance 1148-1149 <http://economics.harvard.edu/files/faculty/56_LegalDeterminants.pdf>[Accessed on 05/03/2014].

and secular. Indeed, many scholars emphasise this distinctiveness, which arises from the fact that Saudi Arabia has never fallen under the extraterritorial jurisdiction or within the sphere of influence of Britain or any other European power.³ Another consideration is that the embracing of a particular legal system can be attributed to a country's cultural history. The section ends by considering the Saudi judicial system in terms of the independence of the judiciary and the ability of the judges to absorb the corporate governance concept. Section 6.3 then reviews the corporate governance regulatory framework, including Companies Law and its important provisions on matters such as the structure of boards of directors. It then examines recent developments in corporate governance regulations in order to assess the extent to which the various corporate governance devices are included and effective in reducing agency costs. Next, section 6.4 discusses the effectiveness in the Saudi Arabian context of the diverse external and internal corporate governance mechanisms described in chapter 2 of this thesis, before section 6.5 explores the protection of minority shareholders and the remedies available to ensure it, and in particular the derivative action. Section 6.6 establishes the rationale behind institutional investors' activism as a legitimate external corporate governance mechanism and evaluates the strength of the current trend towards such activism in Saudi Arabia. A discussion of the rationale for a trend towards socially responsible investment among Saudi institutional investors follows in section 6.7 and the chapter ends with a summary.

6.2 The Saudi Legal System

The Saudi legal system cannot be considered similar in any way to those of the common law countries, nor of the civil law countries, being principally based on Shariah (Islamic law), which is religious in origin and nature. Layish notes that the characteristics of Shariah

...are manifested in the textual sources, legal methodology, and the authority for sanctioning legal rules. The legal methodology (*usul al-fiqh*) of the *shari'a* consists of four sources of law: the Qur'an and the Prophetic *hadith* or *sunna*

³ A Al-Suwaidi, 'Developments of the Legal Systems of the Gulf Arab States' (1993) 8(4) Arab Law Quarterly 300 <<http://jstor.org/stable/3381723>>[Accessed on 05/03/2014]. Also see A Layish, 'The Transformation of the Sharī'a from Jurists' Law to Statutory Law in the Contemporary Muslim World' (2004) 44 Die Welt des Islams New Series 86 <<http://jstor.org/stable/1571336>>[Accessed on 05/03/2014].

(custom, normative way of life) that make up the material sources; the analogical deduction (*qiyis*) which is the method of deriving legal rulings from the above mentioned sources; and the consensus (*ijma'*) of the *fuqaha'* of each of the schools of law (*madhahib*) which substantiates the new rulings. This legal methodology did not leave the political ruler any leeway, except by means of administrative decrees ... to control the formulation of the legal norm in spite of all his efforts to the contrary.⁴

Modern Saudi Arabia was founded in 1924 as an Islamic state by King Abdul Aziz Al-Saud, who rejected the idea of adopting a secular written constitution and decided to accept Shariah not only as a religious spiritual code but as the foundation of the country's constitution and law and as a comprehensive guide to all aspects of life and legal duties. This significant pronouncement of the most traditionalist Islamic state in the world was also made in recognition of the country's importance in the Islamic world as the site of the Two Holy Mosques, which made it particularly appropriate to adopt Shariah as the supreme law, so that all statutes, regulations and acts of the state must be in conformity with and defer to Shariah.⁵

6.2.1 Shariah v Positive (Man-made) Law

Indeed, the fact that Shariah had been adopted as the main constitutional law was the reason for the Saudi government not having a written constitution for a long time. This was a matter of concern among members of the world community, especially those oil-consuming countries which depended on Saudi exports and needed to ensure the stability of supply by identifying a fundamental movement in the country towards a modern system of government and new laws based on modern legal concepts.⁶ It was in fact relatively recently, in 1992, that the successor of King Abdul-Aziz, his son King Fahad, enacted considerable and very important modern reforms and promulgated fundamental laws which were essential and the first in the Kingdom's history to respond to the exigencies of the global legal environment and of the internal political system, its

⁴ Beck et al (n1).

⁵ Saudi Arabia never experienced the Western colonization which considerably changed the legal systems of other Muslim countries around the world. See more on this in Ron Shaham, 'Review of F Vogel, "Islamic Law and Legal System: Studies of Saudi Arabia"' (2002) 122(3) J American Oriental Society 646 <<http://jstor.org/stable/3087557>>[Accessed on 05/03/2014].

⁶ R Aba-Namay, 'The Recent Constitutional Reforms in Saudi Arabia' (1993) 42(2) The International and Comparative Law Quarterly 299 <<http://jstor.org/stable/761101>>[Accessed on 05/03/2014].

principal elements being the Basic Law, the Shura Council Law, the Council of Ministers Law and the Regional Law. However, possibly among the most important reforms from the legal point of view was the introduction of the Basic Law, otherwise known as the Basic System of Governance, which comprises eighty-three articles. It basically reaffirms the Islamic foundation of the state and maintains that Shariah is to be considered to underlie the Kingdom's constitution,⁷ its form of government, the rules of accession, its social and economic principles, the rights of individuals and the duties of the state and its authorities.⁸

Alongside the body of traditional Shariah as the foundation of the system of government, there is a body of modern statutory laws with its own institutions, giving rise to the notion that there is a duality in the legal system.⁹ This duality resulted from the need to modernize the country's legal system, as is clear from article 67:

The Regulatory Authority shall be concerned with the making of laws and regulations which will safeguard all interests, and remove fault from the State's affairs, according to Shariah. Its powers shall be exercised according to provisions of this Law, the Law of the Council of Ministers and the Law of the Shura Council.

This means that there are two legislative authorities within the political system, the Council of Ministers and the Shura (consultative) Council, which are responsible for codifying statutory laws and regulations concerning various aspects of social, financial and economic development, in order to benefit the integration of a modern Western business culture in Saudi Arabia. However, these statutory laws, regulations and international treaties can be ratified and approved by royal decree¹⁰ only after having been thoroughly studied and reviewed by both the Shura Council and the Council of

⁷ Article one of the Saudi Arabia Basic Law states that 'The kingdom of Saudi Arabia is a sovereign Arab Islamic state. Its religion is Islam, and its constitution is the Holy Qur'an and the prophet's (peace be upon him) Sunnah (traditions) ...' See the Basic System of Governance, Royal Order No. A/90, (27/8/1412H, Mar. 1, 1992 G) <<http://shura.gov.sa/wps/wcm/connect/ShuraEn/internet/Laws+and+Regulations/The+Basic+Law+Of+Government/Chapter+One/>> [Accessed on 05/03/2014].

⁸ *ibid.*

⁹ George Sfeir, 'The Saudi Approach to Law Reform' (1988) 36(4) *American J Comparative Law* 746 <<http://jstor.org/stable/840279>> [Accessed on 05/03/2014]

¹⁰ In Saudi Arabia, legislation issued by royal **order**, such as the Fundamental Laws, is sanctioned by the king only, while legislation issued by royal **decree** is first viewed and approved by the Council of Ministers before sent to the king for final sanction. Examples of the latter are the Implementation Mechanism of the Judiciary Law and the Board of Grievances Law or the Saudi Companies Regulations, which are examined in the following sections. See Royal Decree No. 19746 (22/9/1379 H, 20 March 1960).

Ministers.¹¹ This means that although the Basic Law declares the separation of powers between the judicial, legislative and executive authorities, the King is still granted extensive executive power in his capacity as prime minister,¹² head of state and commander-in-chief of the armed forces.¹³

Actually, the King has a primary and autonomous lawmaking function, which he enjoys because as head of state, according to the Shariah *fuqaha* (jurists),¹⁴ he has control over all state functions. The provision of the Basic Law establishes the King as having supreme authority over all organs of the state, including the legislative and judicial authorities.¹⁵ For instance, the King has the right to amend any of the Fundamental Laws, including his primary role within the process of promulgation of ordinary laws, through his authority to approve such Laws by royal decree, with or without the approval of the Council of Ministers and the Shura Council, which illustrates the contrast between the constitutional system of Saudi Arabia and the UK parliamentary system of government. Al-Jarbou offers the following examples of similarities and differences between the Saudi and British systems:

‘Unlike the situation with a system of parliamentary government, the Council of Ministers is responsible to the King. He is the only one who has the right to dissolve it and reform it. ... [One of the similarities between the two systems of governance concerns the] Council of Ministers[: as is] the case with the Parliamentary Law, the *Shura* Council Law, and the New Council of Ministers Law, no regulations, treaties, international agreements or concessions shall be enacted or amended unless they are approved by royal decrees after having been studied by the Council of Ministers’.¹⁶

This was an essential step, according to those who believed that the Saudi government had to pay attention to the practical demands for growth and argued that the impact of globalization and international trade would not allow Saudi Arabia to remain remote and different from the rest of the world, especially given that all other Islamic

¹¹ See Basic Law Arts 67-70; Shura Council Law Art 18; Council of Ministers Law Art 20.

¹² Basic Law Art 56.

¹³ *ibid* Art 60.

¹⁴ The influence of Islamic concepts and traditions can be seen clearly when viewing Basic Law Art 55.

¹⁵ *ibid* Art 44.

¹⁶ A Al-Jarbou, *Judicial Review of Administrative Actions under the Saudi Law* (King Fahad National Library 2011) 93-94.

countries had promulgated codes to cover all aspects of life, including financial and business activities. Indeed, the establishment of international business and the emergence of conventional financial banking since 1927,¹⁷ as well as increased demand for international commercial transactions, enhanced the Saudi government's realisation that it needed to develop a legal system, including the enactment of a range of codified laws and regulations concerning the financial and commercial sectors in particular, which would be influenced by Western traditions and principles.¹⁸ As a result, the country now has a dualistic legal system encompassing both Islamic law and its principles on the one hand and positive law on the other.

This certainly does not mean that Shariah is never in favour of financial and commercial activities. Scholars have determined assorted causes of the recent financial crisis of 2007 and some have blamed the lack of adequate market discipline in the Western financial model.¹⁹ Meanwhile, it has been argued that Islamic finance is expanding and may be considered one of the possible solutions, providing a viable alternative financial model; indeed, some argue that the Islamic world has developed a financial system that is much more sophisticated than those existing under Western laws.²⁰ This sophistication arises from the Islamic principles inherent in Shariah, which apply moral value not only to the activities of human life but also to financial and business practices.²¹ Therefore, the Kingdom's legal system encompasses a degree of

¹⁷ Mohamed Ramady, *The Saudi Arabian Economy: Policies, Achievements and Challenges* (Springer Science Business Media 2010) 113.

¹⁸ The following sections review the legal origins of Saudi company regulations.

¹⁹ Avgouleas gives different alternative measures of the adequate market disciplines in the Western financial model in various recent articles, e.g. E Avgouleas, 'Financial Regulation, Behavioural Finance, and the Global Credit Crisis: In Search of a New Regulatory Model' (2008) Working paper <<http://ssrn.com/abstract=1132665>>[Accessed on 05/03/2014].

²⁰ H Ahmed, 'Shari'ah-based Islamic Financial System that can Produce the Desired Stable, Resilient and Just Alternative' (2009) 1(1) ISRA International J Islamic Finance 30 <<http://kantakji.com/fiqh/Files/Markets/c47.pdf>>[Accessed on 05/03/2014]. See also E Ambah, 'Islamic Banking: Steady in Shaky Times' (2008) Washington Post Foreign Service <<http://washingtonpost.com/wpdyn/content/article/2008/10/30/AR2008103004434.html>>[Accessed on 05/03/2014]; N Foster, 'Islamic Perspectives on the Law of Business Organisations I: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-Style Law' (2010) 11 European Business Organization Law Review 8 <<http://journals.cambridge.org/action/displayFulltext?type=1&fid=7572200&jid=EBR&volumeId=11&issueId=01&aid=7572196>>[Accessed on 05/03/2014].

²¹ M Chapra, 'The Global Financial Crisis: Can Islamic Finance Help Minimize the Severity and Frequency of Such a Crisis in the Future?' Presentation at the Forum on the Global Financial Crisis to be held at the Islamic Development Bank 12 <http://isdbforum.org/presentationPapers/5-M_Umer_Chapra.pdf>[Accessed on 05/03/2014].

morality in its business standards, which stems from the Shariah component that was in place before the adoption of any modern Western law in the country.

However, since reform of the Fundamental Laws, the Kingdom's legal system has been reshaped and it has become clear that although it has unique characteristics, it can also be seen to have a general affinity for codification; nevertheless, it would be wrong to claim that the Saudi commercial and financial legalisation is entirely based on French civil law, any more than on English common law.²² Instead, it has maintained its uniqueness from its flexibility to respond to and accept or amend elements of a variety of modern regulatory frameworks needed to support economic development more efficaciously, such as that in force in the UK, where the demand for codification has arisen from the need to respond to growth in the field of the company law and where it has been found essential to build a modern legal framework including codification, as witnessed, for example, by reference in the previous chapter to the UK Company Act of 2006, particularity in the area of shareholder remedies and directors' fiduciary duties. This means that the Saudi legal system may adopt and learn from these various aspects of Western legal traditions and experience, updating its statutory laws as necessary to enhance the investment environment, with one condition: that any laws and legal principles adopted must be in conformity with Shariah, because all regulations in the country are secondary to Islamic law and must not contradict it.²³

That said, it is also considered critically important that the Basic Law should stipulate how the Shariah courts should deal with statutory laws and regulations, assuming them not to be in conflict with Islamic law. This has led to a duality in the application of laws and an ambiguity in the judicial system that may be difficult to understand without some appreciation of its development, discussed in the following section.

6.2.2 The Effectiveness of the Saudi Judicial System

As the efficiency of the judicial system and the quality of law enforcement are indispensable constituents of corporate governance and finance and essential for institutional investors to have confidence in practising their activism efficiently, it has

²² Discussed further in section 6.3.1.

²³ Although legislative authority is inherent in the King, any laws and regulations issued by royal decree are valid only if they do not conflict with Shariah.

been argued that certain institutions have vital roles in ensuring the effective application of the corporate governance system in any country. One of these institutions is a legal infrastructure that ensures the independence of judges and the appropriate enforcement of laws.²⁴ The language of the Basic Law has had a great impact on the development of the Saudi judicial system, on ensuring the independence of judges,²⁵ on the appropriate enforcement of laws, on how judicial review is carried out and on verifying the application of the various statutory laws and regulations that are necessary in different areas of law, in addition to Shariah.²⁶

It was this concern that led to the establishment of various quasi-judicial committees,²⁷ in response to the need for the comprehensive development of many statutory regulations, which were promulgated in particular to cover certain aspects of financial and commercial activity in the Kingdom, given the lack of relevant experience of the Shariah judges, and to regulate activities which are considered unlawful under Shariah.²⁸ For instance, the Banking Disputes Settlement Committee was established in 1987 under the supervision of SAMA to adjudicate all disputes that might arise between conventional or non-Islamic banks and their customers. Another example is the Commercial Disputes Committees, established under the supervision of the Ministry of Commerce, pursuant to decision number 227 of the Minister of Commerce dated 23/21/1382 (1962), with the authority to adjudicate disputes and offences under the company regulations and any other commercial disputes.²⁹ Similarly, the Capital Market Disputes Committee was established with the authority to adjudicate disputes and offences under the CML. Finally, the Insurance Committees were established pursuant to the Law on Supervision of Cooperative Insurance Companies, which was

²⁴ Rafael La Porta et al, 'Investors Protection and Corporate Governance' (2000) 58 J Financial Economics
5<<http://leedsfaculty.colorado.edu/bhagat/InvestorProtectionCorporateGovernance.pdf>>[Accessed on 05/03/2014].

²⁵ Article 46 of the Basic Law stipulates that 'The Judiciary is an independent authority. The decisions of judges shall not be subject to any authority other than the authority of the Islamic Sharia.'

²⁶ Article 48 of the Basic Law stipulates: 'The regulatory authority lays down regulations and motions to meet the interests of the state or remove what is bad in its affairs, in accordance with the Shariah. This authority exercises its functions in accordance with this law and the laws pertaining to the Council of Ministers and the Consultative Council.'

²⁷ Because the main focus of this section is not to examine the structure, formation and competence of each committee, it is important to mention that these committees were created to adjudicate and deal with issues in most aspects of life, including commerce, banking, insurance and the capital market.

²⁸ A Al-Ghadyan, 'The Judiciary in Saudi Arabia' (1998) 13(3) Arab Law Quarterly 247
<<http://jstor.org/stable/3382009>>[Accessed on 05/03/2014].

²⁹ Al-Jarbou (n16) 118.

enacted by Royal Decree No M/32 dated 2 Jumada II 1424 (2003). They are authorized to undertake to resolve disputes arising between insurance companies and their customers or other companies.

In fact, these committees were established due to the passive attitude of the Shariah authorities and their failure to accept those laws or regulations that had been adopted from Western legal practice. The Shariah courts rejected the adjudication of such disputes, so no appeal could be made to a higher court. The most common features of these quasi-judicial committees are that they are controlled by various governmental executive authorities and perform judicial functions: each was created under the supervision of a particular ministry pursuant to a decree defining its jurisdiction. This provides strong support for the argument that the system of allocation of state authority in Saudi Arabia is not based on the doctrine of the separation of the powers of the judicial, legislative and executive branches.³⁰ Another feature of these committees is that their members have the status of civil servants, different from that of judges, even though as members of quasi-judicial committees they perform judicial functions. Importantly, the committees are not recognized as independent judiciary authorities and their appointed members are not granted and do not enjoy the independence which is considered a cornerstone of justice, unlike judges in the courts, who enjoy the freedom to make decisions and who are subject to no higher authority in the exercise of adjudication, other than the rules of Shariah.³¹

6.2.3 Recent Reform of the Judicial System

The quasi-judicial status of the committees remains an issue of concern following the recent reforms of the judicial system by King Abdul-Allah bin Abdul-Aziz in 2007,³² intended to bring the Kingdom's legal system into line with WTO requirements, to respond to various developments in the economic and investment sectors and to the

³⁰ *ibid* 119.

³¹ Although the Basic Law establishes the King as the supreme authority, it incorporates the principle of judicial independence. Article 46 stipulates that 'The Judiciary is an independent authority. The decisions of judges shall not be subject to any authority other than the authority of the Shari'ah.' Article 52 states that 'Judges shall be appointed and relieved by Royal Decree, based on a proposal of the Supreme Judiciary Council, in accordance with provisions of the Law.' However, neither the Basic Law nor the new judiciary statute of 2007 assert that these committees enjoy the same judicial independence as general courts.

³² 'King Abdullah Approved the Judiciary and the Board of Grievances Laws', *Al Riyadh* 14344 (2 Oct 2007) <<http://alriyadh.com/2007/10/02/article284080.html>>[Accessed on 05/03/2014].

need to enhance the business environment.³³ Their aims were to improve the judiciary and to develop it in an inclusive and integrated manner, including the establishment of courts specialized in labour, commercial, domestic and criminal cases, which would have complete jurisdiction over their areas of specialization, so that the quasi-judicial committees could be abolished and their jurisdiction transferred to the new Shariah courts.³⁴ This new Saudi judicial system was supposed to pass through a transition period lasting two to three years following the promulgation of the reforms, after which the system would be fully implemented.³⁵

The situation today is undeniably different from that in the past and the crucial question to be addressed is how the Shariah judges in the new commercial court will deal with cases that are not governed by any clear provision or which fall outside the application of statutory laws. It has been stated that in such cases the judge must apply the general rules of the default law, which is Shariah. The jurisprudence should work on the disputed matter and if the statutory law applies somewhat to the case at bar, but if its application is not completely adequate, the Shariah judges should fit the statute to the facts of the case through their judicial interpretation and understanding of the statute.³⁶

This question may arise, for example, when a claim involves shareholders of a Saudi company who have initiated a personal action complaining of the company's conduct of its affairs or that the people who control the company have caused them to suffer a loss by their misconduct or by acting in a manner that is discriminatory against them or damaging to their personal interests. Indeed, the main problem facing the Shariah judges in the new specialized commercial court is to accept prohibited investment activities which are known to be among the main investment goals of certain

³³ A Alarefi, 'Overview of Islamic Law' (2009) 9 International Criminal Law Review 727 <<http://booksandjournals.brillonline.com/content/10.1163/156753609x12487030862782>> [Accessed on 05/03/2014].

³⁴ According to article 9 of the Organisational Plan for the Judicial Authority, published by Royal Decree No. A/14 dated 23/2/1426 H (2005), these quasi-judicial committees and others which adjudicate commercial disputes shall be abolished and their jurisdiction transferred to the commercial courts after they are established. Exception was made of the Capital Market Dispute Committee, to be retained under the supervision of the CMA, and the Banking Disputes Committee, to be supervised by SAMA.

³⁵ The Implementation Mechanism of the Judiciary Law and the Board of Grievances Law, Royal Decree M/78 (19/9/1428H, 1Oct 2007); OG Umm al-Qura 4170 (30/9/1428H, 12Oct 2007). The specialized quasi-judicial committees still exist at the time of writing this thesis and it cannot yet be indicated when the new judicial reforms will be fully implemented.

³⁶ Al-Jarbou (n16) 210.

institutional investors that have been recognized as strongly activist in Western countries. The problem arises precisely because of the unpredictability of the court's decisions and the discretion granted to the Shariah judges in certain circumstances, where a legal action has been brought before the commercial court by hedge funds and other investment vehicles with the same investment approach against an investee company's conduct of its affairs or alleging that the people who control the company have acted in a manner which is discriminatory or abuses claimants shareholders' personal interests and intentionally diminishes the short-term value of their investments, causing them losses. Clearly, the people who control the company are supposed to act in the interests of all shareholders, as will be explained in the next section, but such a case may be rejected because the Shariah judge will apply the general rules of the default law, which is Shariah, under which the short-term approach of hedge funds and other investment vehicles with the same investment approach is considered unlawful, as the uncertainty of hedge fund contracts is considered to constitute *gharar* (risk) and thus to invalidate them.³⁷ Indeed, the legality in Saudi Arabia of the practice of hedge funds and other investment vehicles with the same investment approach could be questioned if the Shariah judges first look at any cases involving foreign hedge funds, for example, as it is unpredictable whether the new commercial court might dismiss the case on the grounds that a claim on the part of a hedge fund as a shareholder involves personal interests in contradiction of the principles of Shariah.

What is needed, therefore, is a way to give foreign investors and shareholders more confidence in the Saudi judicial system. This could be done not only by building a developed body of law based to some extent on the local adaptation of Western laws, but also through the new Saudi commercial court contributing to the development of company regulations in different circumstances, aiming to create a responsive legal doctrine similar to that of the UK and other common law countries. Indeed, there is a great need to codify the legal rules under which the new commercial court makes decisions, especially since Shariah judges are able to infer solutions for the inherent deficiencies of the adopted Western laws, because they are in daily contact with the problems that emerge from the application of the current laws when they are dealing with disputes; but such codification is still strongly opposed by the Ulama, who support

³⁷ Article 48 of the Basic Law states that 'the courts shall apply rules of the Islamic Sharia in cases that are brought before them....'

the application of Islamic law but whose (valid) opinions on certain issues differ.³⁸ Codification of the future decisions of the new commercial court would allow the Saudi judicial authorities to choose one such conflicting opinion to be binding in each case, which would increase transparency, strengthen trust in the Saudi judicial system and give confidence to institutional investors with differing investment goals, who would feel comfortable that their litigation rights would enjoy meaningful protection in the new commercial court if they were involved in a dispute whose resolution would be uncertain under Shariah.

It must be recognized that codification itself is not necessarily a solution to all problems of variability in decisions of the new commercial court, because such problems might arise even if the Shariah rules were codified, but at least codifying them would deter judges from resorting to the traditional Shariah sources and thus reduce the likelihood of contradictions arising from the duality of the legal system. Many common law countries appear to have found codification to be essential and have adopted a number of codes which may be seen not to conflict with the common law tradition. For example, the UK has no codified constitution, but there is codification in some areas of UK law, such as the Companies Act 2006, which is considered a good example of the recent history of the common law, where the courts play a major role in making law through precedent. This codification, as discussed in chapter 4, follows a clear trend and gives foreign institutional investors trust in the UK legal system. Actually, what is important is that although the Saudi government has recently considered a new educational programme to send Shariah jurists to countries such as the UK, where they can learn new concepts and gain experience of the new principles and traditions of the common law, the rapid development of global investment activity and the migration of foreign investment capital to emerging and developing countries, alongside the CMA's recently declared intention to open the Saudi capital market to foreign institutional investors, suggests that the Shariah judges in the new commercial court need to be more familiar with the recent reforms of Saudi corporate governance in the context of foreign investment. Indeed, they must become better acquainted with the new global context of corporate governance and developments in investment, particularly when it is recognized that litigation, as discussed in chapter 2, is one of the rational external

³⁸ Al-Jarbou (n16) 42.

corporate governance mechanisms appreciated as a substitute and considered an effective monitoring tool in the hands of the shareholders and that transparency is desired to reduce the agency problem.

On the other hand, the functioning of the Saudi legal and regulatory framework is closely interrelated with that of the corporate governance scheme, which is believed to provide a more valid indicator of the extent to which shareholders will choose to engage in activism. Therefore, the following sections are mainly concerned with a legal analysis of aspects of the corporate governance regime in Saudi Arabia, to establish whether major laws and regulations can or cannot on the one hand enhance and strengthen the ability of institutional investors to move towards activism and on the other provide better protection for shareholders against opportunistic expropriation by the management or controlling shareholders, as this is a critical concept in almost all corporate governance literature and is particularly challenging for the strategic plans of activist institutional investors.

6.3 The Saudi Corporate Governance Framework: Government Regulations

There is a multifaceted corporate governance regulatory framework in Saudi Arabia that considerably affects the level of activism among institutional shareholders and the protection of minority shareholders. Most important among its constituents are the Saudi Companies Regulations 1965 (SCR) and the Corporate Governance Regulations (CGR) of 2006. Other regulations, such as the Capital Market Law and the Listing Rules (LRs), may have some relation or minor effect, but the following sections are mostly concerned with the major aspects of the SCR and CGR, which are most relevant on the one hand to empowering institutional shareholders as minority shareholders by enabling them to engage in corporate governance in the companies in which they invest. But before introducing the SCR and CGR, it should be mentioned that two governmental bodies, the Capital Market Authority and the Ministry of Commerce, share direct primary responsibility within the legal framework for regulating, supervising and monitoring corporate governance and its development in publicly-

traded companies in the Saudi capital market.³⁹ The MOC is considered an important regulator, as the SCR covers many aspects of corporate governance and includes rules to regulate publicly-traded companies.⁴⁰ For its part, the CMA has since its creation in 2004 originated and implemented regulations intended to develop the Saudi capital market, such as the CGR of 2006. Thus, there appears to be some overlap between these two monitoring bodies, since they share responsibility for most corporate governance provisions concerning publicly-traded companies, such as those on shareholders' rights, directors' duties, disclosure and auditing requirements, creating ambiguity as to which of them should enforce the compliance of publicly-traded companies with the corporate governance provisions, particularly in light of the fact that each body has its own penalties for non-compliance.⁴¹ Therefore, it is important to give a brief description of the SCR and its legal origin, without intending to cover in detail all aspects of all regulations concerning the protection of minority shareholders and the related remedies, as they will be discussed in greater detail in later sections.

6.3.1 Legal Origin of Company Regulation in Saudi Arabia

It is important to look at the legal origin of the SCR⁴² with specific reference to the concept of corporate governance and to identify the main approach to it as developed in Saudi Arabia. Since much of this fundamental legislation has arguably been modelled on equivalent Western laws, it is germane to consider how Saudi policymakers recognized the importance of their development. For example, the SCR of 1965 formed one of the first bodies of such legislation, creating a legal framework within which publicly-traded companies could be established and governed, defining shareholders' rights and directors' responsibilities.⁴³ This can be seen as a good example of balance between Western laws and Shariah compliance.

³⁹ SAMA is also considered one of the main regulating, supervising and monitoring bodies for corporate governance, but for Saudi banks and cooperative insurance only.

⁴⁰ It has been claimed that the SCR encompass 80% of the corporate governance principles. See IK Falgi, 'Corporate Governance in Saudi Arabia: A Stakeholder Perspective', unpublished PhD thesis (University of Dundee 2009) 115.

⁴¹ This point was also made by the IMF in its report of 2009, which primarily focused on the Saudi CGR. See eStandardsForum, 'Saudi Arabia: Principles of Corporate Governance' (2010) <<http://estandardsforum.org/saudi-arabia/standards/principles-of-corporate-governance>> [Accessed on 05/03/2014].

⁴² The SCR has been amended many times since being issued by Royal Decree M/6, dated 22/3/1385H (21 July 1965). The last amendment was made by the Royal Decree M/29 dated 16/09/1418 H (15 Jan 1998).

⁴³ More details of shareholders' rights and directors' responsibilities are given in the following sections.

There are, in fact, divergent views as to the legal origin of the SCR: some state that it can be traced back to French company law in its version prior to 1966,⁴⁴ while others argue that it was inspired by the UK Companies Acts of 1948, 1967 and 1976.⁴⁵ Actually, both opinions may be assumed to be valid, as the Saudi legislators declare in the explanatory memorandum to the SCR, noting that the formulation of the SCR 1965 was based on pragmatic principles. Rules and regulations concerning the modern concept of corporate regulation were taken from other countries where appropriate and embodied in the SCR. In addition, the term ‘company’ was defined as including several forms of corporate structure. The arrangements recognized under Article 2 of the SCR, for example, are: general partnerships, limited partnerships, partners limited by shares, joint stock companies and cooperative companies. The language of the explanatory memorandum clearly asserts that whatever their forms and regulations might be, these are all valid and are not different from companies recognized under Shariah, except in a few details; thus, no sanction, prohibition or legal transactions under the SCR may contradict a text, tradition or consensus of Shariah. Although it has been asserted that the emphasis on the SCR’s compliance with and adherence to Shariah make it unlike Western commercial laws and significantly more complex,⁴⁶ this compliance also encompasses basic concepts and forms the cornerstone of reputable corporate governance, which influences the principles and style of corporate governance in Saudi Arabia, as Shariah preserves essential ethical and moral business standards.⁴⁷ In addition, the SCR is influenced by aspects of the Anglo-American model of corporate governance in many of its provisions concerning the duty to maximize owners’ wealth,⁴⁸ such as the unitary board structure and the separation of the roles of the

⁴⁴ T Koraytem, ‘The Islamic Nature of the Saudi Regulations for Companies’ (2000) 15 Arab Law Quarterly 65 <<http://jstor.org/stable/3382136>>[Accessed on 05/03/2014].

⁴⁵ K Hussainey and A Al-Nodel, ‘Corporate Governance Online Reporting by Saudi Listed Companies’ (2009) 8 Research in Accounting in Emerging Economies 39, 45

<<http://emeraldinsight.com/journals.htm?articleid=1827009&show=html>>[Accessed on 05/03/2014]; R La Porta, F Lopez de Silanes and A Schleifer, ‘The Economic Consequences of Legal Origins’ (2008) 46(2) J Economic Literature 289

<http://economics.harvard.edu/faculty/shleifer/files/consequences_JEL_final.pdf>[Accessed on 05/03/2014]; A Alghamdi, ‘Investigation into Earnings Management Practices and the Role of Corporate Governance and External Audit in Emerging Markets: Empirical Evidence from Saudi Listed Companies’ Doctoral thesis (Durham University 2012) 17.

⁴⁶ Foster (n20).

⁴⁷ MK Lewis, ‘Islamic Corporate Governance’ (2005) 9 Review of Islamic Economics 16 <http://perpustakaan.depkeu.go.id/FOLDERJURNAL/9-1-Lewis_1.pdf>[Accessed on 05/03/2014].

⁴⁸ Yaser Fallatah and Denise Dickins, ‘Corporate Governance and Firm Performance and Value in Saudi Arabia’ (2012) 6 African J Business Management 10026

chairman of the board and the CEO, as will be discussed in the next section; these provisions are consistent with the English view of corporate governance and meaningfully enhance the tendency of institutional investors towards activism.⁴⁹ Indeed, as discussed in detail later in this chapter,⁵⁰ the Saudi corporate governance model may be said to take a stance midway between the shareholder and stakeholder approaches.

Yet many believe that the SCR has not evolved satisfactorily since its enactment in 1965, because it provides limited protection to minority shareholders, given the rapid growth of corporate governance regimes in global business since then.⁵¹ Saudi policymakers are said to have moved slowly to revise the SCR and to have learned to a limited extent from the example of other countries, reflected in models such as the UK Companies Act 2006. One recent response to such criticisms of the SCR was the issuance by the CMA of the CGR 2006, providing several optional governance and minority protection rules which go beyond the legal minimum standards required by the SCR.⁵² Thus it can be said that the prime function of the CGR was regulatory, as it was intended to address the weak development of the SCR. This implies that any discussion of corporate governance in Saudi Arabia must take full account not only of the SCR, but also of the recent developments brought about by the application of the CGR.

6.3.2 Corporate Governance Regulations 2006

Unlike the recent rapid development of corporate governance in the UK, which began in the early 1990s with the publication of the Cadbury Report 1992, concern for corporate governance in the GCC region began only during the present century. According to Hawkama,⁵³ the awareness and development of corporate governance first emerged in 2002, when the Sultanate of Oman adopted the first corporate governance standards in

<<http://academicjournals.org/ajbm/PDF/pdf2012/12Sept/Fallatah%20and%20Dickins.pdf>>[Accessed on 05/03/2014]

⁴⁹ *ibid*; Foster (n20).

⁵⁰ Section 6.5.2.

⁵¹ Alghamdi (n 45) 17.

⁵² The CMA is an independent government body and one of its roles is to apply modern, comprehensive corporate governance rules reflecting best global practice, as discussed in the next section, to maintain the growth and stability of the Saudi capital market.

⁵³ Hawkama – the Institute for Corporate Governance was established in 2006 by the Dubai International Financial Centre (DIFC) in association with a number of international agencies such as the Institute of International Finance (IIF), as part of a coordinated strategy towards the harmonization of good corporate governance standards in the GCC countries.

the region comparable to global standards and best practice.⁵⁴ In Saudi Arabia, although the SCR, as mentioned, comprised 80% of corporate governance provisions, it was still essential for the CMA to issue new regulations called *Howkamat al-Sharikat*⁵⁵ (Corporate Governance) in 2006.⁵⁶ One reason for this was that although the SCR is the primary corporate governance legislation, some related corporate governance provisions contained in the SCR, as mentioned, were not consistent with modern aspects of global corporate governance. Another was that the Saudi capital market crisis in 2006 was a subject of heated debate and showed significant weaknesses in the financial reporting provisions, particularly regarding transparency, disclosure and accountability.⁵⁷ These facts drew the CMA's attention to problems regarding companies' performance and the necessity to fill a legislative vacuum by issuing modern corporate governance regulations that were not covered in the SCR, to reflect current global standards, to improve the working practices of Saudi publicly-traded companies and to ensure that they comply with best international governance practices in order to sustain investors' confidence.⁵⁸

Perhaps one of the most important characteristics of the CGR is that it adopts the same enforcement approach (comply-or-explain) as the UK Corporate Governance Code of 2010. Thus, the CGR is not mandatory, but is a guideline for good practice. Publicly-traded companies are required to disclose in the board's report which provisions are implemented and which are not, and to give reasons for non-compliance.⁵⁹ It was considered reasonable for the CMA to adopt this approach, as corporate governance had been introduced only recently in a separate and independent set of provisions for Saudi publicly-traded companies and the time needed for them to comply completely with the CGR would vary, given that such companies differ in size and each has its own ownership and board structure. This may be seen as an important

⁵⁴ 'Hawkama Brief on Corporate Governance Codes of the GCC' (2010) <http://hawkamahconference.org/uploads/2010_files/conf_material/frameworks_to_implementation/Hawkamah%20brief%20on%20GCC%20Code.pdf>[Accessed on 05/03/2014].

⁵⁵ There are several accepted terms for corporate governance in Arabic but the dominant one, accepted by the CMA and other GCC countries, is *Howkamat al-Sharikat* (corporate governance). For other translations of 'corporate governance' into Arabic see C Adwan, 'Translating "Governance" into Arabic' (2011) World Bank <<http://go.worldbank.org/WVPE3YNQJ0>>[Accessed on 05/03/2014].

⁵⁶ CGR, under the CMA Board Resolution 1/212/2006 dated 21/10/1427AH (corresponding to 12 Nov 2006) and the Regulation further implemented in 2010 under the CMA Board Resolution 1-10-2010 dated 30/3/1431H (corresponding to 16 Mar 2010).

⁵⁷ Alghamdi (n 45) 19.

⁵⁸ Article 1(a) of the CGR.

⁵⁹ Article 1(b) (c) of the CGR.

factor affecting shareholders' tendency to become active, as it allows activist shareholders to have the incentive as owners to exercise their right to call on the directors of the invested company to comply with the CGR or to provide an explanation to shareholders of their non-compliance.

While the CMA made it clear that the CGR principally comprised guidelines, it made allowance for exceptions, in that some provisions might be made mandatory, either by a resolution of the CMA board, by rules such as LRs or by other legislation such as the SCR. Despite the fact that the comply-or-explain enforcement approach was being questioned in academic debates after the global crisis of 2007, especially in the UK,⁶⁰ the CMA made some important provisions mandatory after 2008 in order to protect the interest of shareholders; thus, the company was obliged to disclose in its annual report which provisions had and had not been implemented and to explain any non-compliance. However, the code mostly consists of principles of good practice relating to major internal and external mechanisms of corporate governance and to topics including acknowledgement of shareholders' rights, disclosure, transparency and the formation and functions of the board of directors.⁶¹ Therefore, attention turns in the remainder of this section to features of these internal and external mechanisms of corporate governance in the CGR.

6.3.2.1 Shareholders' general statutory rights⁶²

Generally speaking, shares in publicly-traded Saudi companies confer equal rights and obligations.⁶³ This means that the default rules of voting systems in the Saudi corporate regulatory framework are similar to those in the UK, recognizing a single class of shares (one share, one vote), which is considered among the major forms of activism available to institutional shareholders to monitor corporate governance.⁶⁴ Thus, there is an expectation that this is the default rule, although companies may be permitted by the

⁶⁰ M Mizuno and I Tabner, 'Corporate Governance in Japan and the UK: Codes, Theory and Practice' (2009) 14 *Pacific Economic Review* 622 <<http://dx.doi.org/10.1111/j.1468-0106.2009.00472.x>>[Accessed on 05/03/2014].

⁶¹ The evaluation of minority shareholders' rights and directors' duties is deferred to the following sections, which review the protection of minority shareholders and their rights and duties within the legal framework of Saudi corporate governance, as contained in the SCR and CGR.

⁶² Some of the shareholders' general statutory rights are defined by the SCR.

⁶³ Article 103 SCR.

⁶⁴ CA 2006 s. 284(1)

annual general shareholder meeting (AGSM) or a by-law to issue other categories of shares, such as preference, priority and golden shares.⁶⁵ Other than this, all kinds of voting class which may be granted in some jurisdictions, such as voting right ceilings, multiple or limited voting rights and depositary receipts, are considered null and void.⁶⁶ In addition, shareholders enjoy the general rights regime that is attached to ordinary shares, granting (1) the right to a share of the distributable profits, (2) the right to have a share in the assets of the company upon liquidation, (3) the right to attend the AGSM to participate in deliberations and to vote on relevant decisions, (4) the right to dispose of shares (exit), (5) the right to supervise the activities of the board of directors and file responsibility claims against board members and (6) the right to inquire and have access to information.⁶⁷ Moreover, ordinary shareholders are allowed to exercise the right of access to information related to the functioning and performance of the company; the CGR provides that the procedure for gaining such access to information be stated in the articles of association and stresses that there should be no discrepancy in providing such information.⁶⁸ Ordinary shareholders have the right to attend and vote at the AGSM; article 5 of the CGR stipulates that they shall have the opportunity to discuss the agenda, that the board of directors and external auditor shall respond to the shareholders without prejudice to the company's interests and that shareholders shall be provided with appropriate information on all matters on the agenda of the AGSM to enable them to make decisions.⁶⁹ The CGR also acknowledges that the shareholders' right to vote at such meetings is fundamental and that the company must facilitate the exercise of this right and avoid any action that might impede it.⁷⁰ More fundamentally, ordinary shareholders enjoy the right to use cumulative voting for the nomination of directors in the AGSMs and to vote by proxy in writing, and the right to have the first opportunity to buy new issues of stock in the investee company (pre-emptive right).⁷¹ Finally, shareholders have the right to elect and dismiss some or all members of the board, even if the company's articles of association suggest otherwise.⁷²

⁶⁵ *ibid.* Golden shares confer exclusive rights and have recently been used by the Saudi government to preserve a degree of influence over privatized companies in spite of the existence of private partners.

⁶⁶ Article 103 of the SCR states that 'it is prohibited to issue stock which may entitle to multiple votes'.

⁶⁷ Article 3 of the CGR. Also see Article 108 of the SCR for similar rights.

⁶⁸ Article 4 CGR.

⁶⁹ Article 5 CGR.

⁷⁰ Article 6(a) CGR.

⁷¹ Article 6(b) and (c) CGR and Article 136 SCR.

⁷² Article 33 SCR.

6.3.2.2 Disclosure and transparency

Disclosure is considered fundamental to sound corporate governance. It is a reflection of accountability and transparency that increases the scope of management responsibility; it is difficult for shareholders to engage in effective activism by using their voting rights or to hold the board accountable when there is a deficiency of information transparency. Although the SCR and the LRs list financial standards that are mandatory for all Saudi companies regarding public disclosure in the company's annual financial statement,⁷³ after the capital market crash of 2006, the CMA urged Saudi companies to disclose additional information important to prospective investors and to reduce the information cost to shareholders. These requirements, under article 9 of the CGR, reflect the awareness of the CMA of the need to control the performance of Saudi companies in terms of the quality and integrity of information needed to protect the interests of investors and shareholders' activism. The provision of such information became mandatory in 2008 and concerns a variety of actions taken by the board of directors of a Saudi publicly-traded company, which must be declared in writing in the annual financial statements. Other than showing the extent of the company's compliance with the CGR provisions, the requirements include a brief description of the jurisdictions and duties of the bodies subsidiary to the board of directors, such as the audit committee and the nomination and remuneration committee.⁷⁴ The company must also publish details of compensation and remuneration, such as the salaries or benefits of the chairman and board members, which have also recently become a critical issue, giving rise to shareholder activism as investors demand heightened corporate accountability and broader levels of transparency,⁷⁵ and of any punishment, penalty or deterrent restriction imposed on the company by the CMA, any other governmental body including the MOC, or the court.⁷⁶

6.3.2.3 The board of directors: structure and main functions

While the specific powers and duties of boards of directors will vary with the legal traditions of each country, the overarching role of the Saudi board is to strategically

⁷³ For example, see Article 89 of the SCR and Articles 42 and 43 of the LRs, which explain the financial disclosure requirements and obligations and the financial information that shall be contained in the directors' reports of the issuers in the annual financial statement.

⁷⁴ Article 9(d) CGR.

⁷⁵ Article 9(e) CGR.

⁷⁶ Article 9(f) CGR.

guide and oversee the management and protection of shareholders, as well to ensure that a robust corporate governance framework is in place. Unlike the model of a two-tier board as practiced in Germany, Saudi Arabia is more in favour of a unitary board structure, similar to that of the UK. The CMA, in implementing good board practices, requires that all Saudi publicly-traded companies should have a board containing a certain proportion of both non-executive and independent directors. This supports shareholder engagement in activism, as it limits the influence of the government and family representatives on the board and gives other shareholders the chance to choose their representatives among non-executive and independent directors, who will maximize their profits, especially by using cumulative voting. Article 12(c) and (e) of the CGR asserts that ‘the majority of the members of the Board of Directors shall be non-executive members... (and) the independent members of the Board of Directors shall not be less than two members, or one-third of the members, whichever is greater’. Moreover, in common with the UK corporate governance regime, article 12(d) of the CGR ensures the separation of the roles of the chairman of the board of directors and the CEO. Actually, the CGR goes beyond this and emphasises that the company should separate the role of the chairman from any executive position in the company other than that of the CEO.

On the other hand, although the CMA does not make it a point to address clearly, at least in the preamble of the CGR, the agency problem arising from the conflict of interest between majority and minority shareholders, due particularly to the concentration of ownership by government and family shareholders, it does nonetheless partly recognize this conflict of interest and emphasises the role of the board of directors as trustee for all shareholders, stating that each director must undertake to do whatever may be in the general interests of the company, not of the group he represents or those who voted in favour of his appointment to the board.⁷⁷ In addition, Article 10 contains an expanded list of the functions of the board of directors, which became mandatory for all Saudi publicly-traded companies at the end of 2011 and which requires a sound system of internal control. One of the most important mandatory functions of the board, other than drafting a corporate governance code,⁷⁸ is to develop a written policy which can effectively regulate any conflict of interest that may arise

⁷⁷ Article 11(d) CGR.

⁷⁸ Article 10(c) CGR.

among the company's members, the executive management and the shareholders.⁷⁹ Another is to establish an effective internal control system to prevent the commission of accounting fraud by developing a written policy which effectively protects against the mismanagement of the assets and facilities of the company and the arbitrary disposition of its resources resulting from dealings with related parties.⁸⁰ An additional mandatory function of the board of directors of a Saudi publicly-traded company is to establish a sound framework to identify and determine the nature and extent of any significant risk associated with the business which it is willing to take in pursuing its strategic objectives, to disclose any such risk transparently and to prevent any loss of profits or missed opportunities in the future.⁸¹

A further extremely important mandatory function of the board is to have clear recognition of the role of stakeholders, constituting a form of enlightened shareholder value such as in the UK, which marks a significant new development in the treatment of corporate governance among academics and professionals, especially since the financial crisis of 2007. This requires the board of directors to set out a written policy that regulates the company's relationship with non-shareholder constituencies as well as protecting their respective rights. Such a written policy should include a method of compensation in case of the infringement of stakeholders' rights under the law and should provide arrangements to identify a suitable means of settlement of any dispute that may arise between the company and the stakeholders.⁸² Furthermore, the CGR requires this written policy to contain a code of conduct for the company's executives and employees which is compatible with the proper professional and ethical standards, which regulates their relationship with the stakeholders, including customers and suppliers, and which reflects the company's contribution to society.⁸³

6.3.2.4 Audit, nomination and remuneration committees

In order to ensure that the board works effectively, the establishment of board committees can be an effective method of dealing with new challenges and complex issues that can be more efficiently dealt with by experts, who then make

⁷⁹ Article 10(b(1)) CGR.

⁸⁰ *ibid.*

⁸¹ Article 10(b(3)) CGR.

⁸² Article 10(b(1,2)) CGR.

⁸³ Article 10(b(3.4.5)) CGR.

recommendations to the board. The three principal committees for the purposes of corporate governance are the remuneration, nomination and audit committees. The CMA, reflecting UK practice, recognized the need for such committees to assist the board of directors to perform its duties in an effective manner.⁸⁴ Furthermore, such committees should contain an appropriate number of non-executive directors in order to protect the interests of the investors and encourage shareholders to engage in activism. The committees should also steer clear of any 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, nominations for membership of the board, the appointment of executive directors and the determination of remuneration. The CMA made it mandatory for all Saudi publicly-traded companies to have at least two sub-committees, viz. an audit committee and a nomination and remuneration committee, whose functions, duties and responsibilities are specified in the CGR.⁸⁵

Although the CGR itself, since its issuance in 2006 and its subsequent implementation, has become very important as the basis of legislation that reflects the best modern practices of global corporate governance, it can be argued that it still has limitations and shortcomings of which the CMA needs to be aware, especially in view of the large number of publicly-traded companies with a heavy concentration of government and family ownership. This need was recently raised by the World Bank's Report on the Observance of Standards and Codes (ROSC), which has revealed that although Saudi corporate governance seeks to reflect best global practice, there remains a disparity in awareness; thus the ROSC recommends certain adjustments to the CGR in order to bring the legislation into line with international good practice.⁸⁶

Another recent study of the concerns of individual shareholders and the business community in Saudi Arabia found that while most were generally satisfied with the situation since the issuance of the CGR, there were others who believed that the legislation was neither efficient nor adequate, consisting of basic provisions which cover only major topics, some of which were already covered by the SCR. Some felt

⁸⁴ Article 13(a) CGR.

⁸⁵ All functions, duties and responsibilities of the audit, nomination and remuneration committees are itemized under Articles 14(c) and 15(c) of the CGR respectively.

⁸⁶ World Bank, 'Report on the Observance of Standards and Codes (ROSC), Corporate Governance Country Assessment: Kingdom of Saudi Arabia' (2009) 34
<worldbank.org/ifa/rosc_cg_saudia_arabia.pdf>[Accessed on 05/03/2014]; eStandardsForum (n41).

that although the CGR was issued by the CMA as a set of guidelines for Saudi publicly-traded companies, it failed to be sufficiently specific or to define in adequate detail some substantial issues, such as the standard policy or requirements regarding the nomination of directors, methods of protecting against corruption and the accountability of the board and the company; furthermore, it lacked a clear list of penalties for companies which were non-compliant with the mandatory provisions.⁸⁷ Other individual shareholders and members of the Saudi business community who participated in the study were uncertain as to whether the voluntary approach was working well in the absence of published evidence of the level to which Saudi publicly-traded companies adhere to corporate governance standards; thus, considerably more effort is needed to ensure that any limitations of the CGR provisions can be identified clearly and addressed satisfactorily. However, while it is not possible to undertake a comprehensive review of the published literature on the failure of the different internal and external corporate governance monitoring mechanisms in an international context, as shown in chapter 2, it is necessary at least to explore their strengths and weaknesses from a Saudi perspective in the next section and so to determine whether they might take on different functions and play a significant and effective role in monitoring and reducing agency costs.

6.4 The Effectiveness of Internal and External Corporate Governance Mechanisms in Saudi Arabia

The absence of market control of corporations through takeovers and mergers in the concentrated ownership environment of Saudi Arabia directs the focus onto alternative internal and external mechanisms, onto their practicality and onto their effectiveness as disciplining mechanisms to solve the agency problem. Therefore, the intention of this section is to re-examine some major corporate governance mechanisms among the alternatives that were considered in chapter 2, viz. voting rights, board sub-committees, external audit, non-executive and independent directors. It should be noted that a comprehensive examination to establish the effectiveness or ineffectiveness of these mechanisms in Saudi Arabia is subject to limitations. The following discussion relies on the results of questionnaire surveys recently undertaken by PhD students, which cannot

⁸⁷ Falgi (n40) 278-279.

be claimed to provide a precise measure of the effectiveness or otherwise of each mechanism, but it can be said that it may offer a reasonably sound general evaluation of their effects.

6.4.1 Voting Rights

The corporate governance regime in Saudi Arabia clearly provides individual shareholders with various rights, including the right to vote, which is considered an important internal corporate governance mechanism that can be used by shareholders to claim their ownership rights. Although the CGR offers shareholders the clear opportunity to participate and ask questions of managers, directors or dominant owners, however, it gives them little or no incentive to exert monitoring pressure; they may prefer to believe that they are better off in trading or acting as free riders, given the knowledge that the ownership of most companies is concentrated in either government or family hands. Notwithstanding the recent trend towards a slightly more diverse or diffused ownership, as discussed in chapter 5,⁸⁸ both dominant owners and managers of publicly-traded companies may be able to control the type of questions and to constrain the content of the information given, which may in turn limit the value to individual shareholders of such participation. Although individual shareholders, as indicated in chapter 5, have become dominant in the Saudi capital market, with an average of around 87% of monthly trading by 2009, there are some who prefer trading, while others do not have the required familiarity, capability and skill to deal with voting information and materials, such as using proxy voting or cumulative voting to choose their representatives on the board of directors. These procedures appear to be difficult for individual shareholders to manage, so that many have not yet fully realized and adopted them. This implies that in Saudi Arabia, the use of voting rights by individual shareholders as a corporate governance mechanism may not actually serve to reduce agency costs or constitute an effective functional substitute for the professional skills of managers and large shareholders. Clear evidence in support of this contention comes from a recent claim that almost no individual legal actions have been reported against directors or managers in the Saudi courts.⁸⁹

⁸⁸ Section 5.3.3.2 .

⁸⁹ eStandardsForum (n41).

6.4.2 Board Sub-committees and External Audit

Another requirement of the internal corporate governance monitoring mechanism, according to the CGR, is for Saudi listed companies to establish two sub-committees in order to help the board of directors to fulfil its duties and responsibilities effectively. First, the audit committee is intended to take responsibility, for example, for supervising the company's internal audit department to ensure its effectiveness in executing the activities and duties specified by the board of directors, for reviewing the internal audit reports and pursuing the implementation of the corrective measures in respect of the comments included in them, and for reviewing the external auditor's comments on financial statements and monitoring the actions taken in response. The second mandatory committee is responsible for nominations and remuneration, in particular for recommending to the board of directors appointments to membership of the board in accordance with the approved policies and standards, for the annual review of the qualifications required for membership of the board, for reviewing its structure and recommending changes, and for drawing up clear policies regarding the indemnities and remunerations of board members and top executives.

Audit committees have been common in Saudi publicly-traded companies for a long time and tend to be well organized.⁹⁰ However, in a recent report assessing their role, the Saudi Organization for Certified Public Accountants (SOCPA), which acts as auditing regulator and is responsible for reviewing all accounting standards, determined that there were certain weaknesses and a lack of clarity regarding the functions, duties and responsibilities of audit committees in Saudi publicly-traded companies. For example, some of their members were not aware of the purpose of such committees, there was a deficient understanding of the concept of independent auditing, and professional qualifications were sometimes insufficient.⁹¹

While in theory audit committees apparently function efficiently, in practice their work in Saudi publicly-traded companies is not satisfactory, as most of their members do not exercise their roles appropriately in favour of shareholders, being influenced by culture to serve the wishes of the management instead.⁹² As for the alternative

⁹⁰ Falgi (n40) 258.

⁹¹ *ibid* 60.

⁹² Alghamdi (n45) 172.

mechanism of independent external auditors, although this is considered a key element of corporate governance, some have challenged the value of their intended role. It has been asserted that the accounting and auditing profession in Saudi Arabia experiences severe difficulties, such as

... the reduction of audit fees, [legal incompetence] and monopoly of services. These issues threaten the accounting and auditing profession and impair the audit quality... Moreover, the role of audit committees that are linked directly to external auditing is still absent in the shadow of difficult circumstances and challenges facing the accounting and auditing profession.⁹³

Let us now consider whether the remuneration committee constitutes an effective internal corporate governance mechanism. In theory at least, it provides incentives and discipline to the management of the company and an appropriate way to avoid possible conflicts of interest or interference in the optimal design of compensation policies. Although the topic of earnings management has recently been hotly debated among academics and business practitioners since the global financial crisis of 2007,⁹⁴ as noted in chapter 2, there is mixed evidence concerning the effects of remuneration and nomination committees on earnings management and there appears to be no relation between effective compensation and shareholder earnings. Such committees have only recently been introduced into the Saudi corporate governance framework; consequently, there is no clear evidence yet of their effectiveness as an internal corporate governance mechanism.

It is not well appreciated that the CGR does not assign clear responsibilities to board committee members and to the independent directors, leaving it to the companies' articles of association to determine how such committees will help the board of directors to fulfil its duties and responsibilities effectively.⁹⁵ It has been argued that the presence of a CEO or executive director on such a committee would diminish its value, as it might prejudice the renunciation of personal interest and the proper exercise of responsibility by forcing personal decisions in recommending board members; it has

⁹³ *ibid* 24.

⁹⁴ OECD Steering Group on Corporate Governance, 'Corporate Governance and the Financial Crisis: Conclusions and Emerging Good Practices to Enhance Implementation of the Principles' (2010) 3 <<http://oecd.org/dataoecd/53/62/44679170.pdf>>[Accessed on 05/03/2014].

⁹⁵ World Bank (ROSC) (n86) 34.

been seen as an encouragement to act opportunistically by obtaining high levels of compensation.⁹⁶ Actually, whether the structure and responsibilities of the board and its sub-committees become successful and more effective in Saudi Arabia undoubtedly depends on the role and independence of the non-executive directors.

6.4.3 Non-executive and Independent Directors

There is an obvious argument in favour of the expansion of the roles of non-executive and independent directors in publicly-traded companies, who are likely to control agency costs and ensure that managers are brought into line with shareholders' interests, as noted in chapter 2.⁹⁷ While their appointment can be seen as constituting an external corporate governance mechanism, however, there is little clear evidence as to whether this represents a concerted, reliable and achievable instrument of control.⁹⁸ In the Saudi context, although the improvements and reforms made by the CMA in relation to board structure and corporate governance in publicly-traded companies have brought about a reduction in the number of executive directors and an increase in the presence of non-executive or independent directors on corporate boards and sub-committees, their effectiveness in monitoring managers and controlling shareholders is not yet clear, as there is no formal definition of their responsibilities, no specific screening process for their appointment and indeed no constraint on their duration.⁹⁹

Actually, personal relationships are considered to constitute one of the most influential factors in the process of selecting board members in Saudi companies.¹⁰⁰ Indeed, as a result of tribalism, Saudi society is strongly dependent on family connections and personal relationships, which may influence the effectiveness of corporate governance mechanisms and the role of non-executive directors, as monitoring becomes less efficient as a major corporate governance mechanism that will actually reduce the agency problem. A recent study used interviews and questionnaires to explore

⁹⁶ Alghamdi (n45) 122.

⁹⁷ 2.6.3.

⁹⁸ John Birds et al, *Boyle & Birds' Company Law* (6th edn, Jordans 2007) 395-97.

⁹⁹ The CGR does not constrain the duration of service of non-executive or independent directors. Article 12(b) of the CGR provides that this shall not exceed three years, unless otherwise provided for in the Articles of Association.

¹⁰⁰ Falgi (n40) 197.

...the crucially influential role that social and cultural factors have over the practices of corporate governance in the Saudi business environment. The cultural and social aspects such as favouritism, family ties and tribalism have a major impact over companies' corporate governance practices as these are considered to have a deep power over the whole of society. These factors influence companies' activities and consequently affect corporate governance and accountability practices. The main issues that appear to be influential as social and cultural factors are: the process of appointing companies' directors and managers and defining their authorities and responsibilities; and the perceived low level of accountability relationships. The interviewees indicate that some social and cultural factors, such as the low level of compliance with laws and systems as well as a negative attitude towards monitoring and evaluation of people in the Saudi society, leads to a negative impact on the practices of corporate governance among Saudi companies.¹⁰¹

This implies that non-executive and independent directors are habitually selected by the majority owner of the company for their loyalty rather than their skills and objectivity, both of which are vital for companies to grow. Therefore, it would be unsafe to assume that appointing more non-executive and independent directors to the board and its sub-committees would of itself constitute an effective corporate governance mechanism, without ensuring clarity as to their functions and a strong screening process before the appointment of their members, because such appointments are likely to be affected by the prevalent culture of Saudi society and the position in it of controlling shareholders, who can use their power and interrelationships to appoint their relatives of the second degree as supposedly independent directors, in order to expropriate the rights of minority shareholders.¹⁰² Moreover, a recent study of the effect on firm performance of the characteristics of boards of directors and audit committees in Saudi publicly-traded companies found that these internal governance mechanisms might not work well and in line with agency theory to mitigate agency problems—and so to reduce agency costs—and that the prediction that good board and audit committees would enhance company performance was inaccurate in Saudi Arabia. This can be understood in relation to institutional theory, which views these mechanisms as practices or regulations resulting from coercion by the CMA, which imposes certain practices so as to improve Saudi companies' structural effectiveness, or as a result of imitation, which

¹⁰¹ *ibid* 280.

¹⁰² Alghamdi (n45) 169.

may require the CMA to develop and improve the awareness and skills of board and audit committee members.¹⁰³

While various studies suggest that concentrated ownership by founders and families is likely to provide meaningful monitoring of corporate governance in publicly-traded companies and may reduce agency costs despite a lack of monitoring by individual shareholders,¹⁰⁴ it can be argued that this model may not have much traction in the Saudi context of negative aspects of family management. In other words, the concentrated family ownership of Saudi publicly-traded companies may be less effective in providing vital monitoring than the dominant owners in other national contexts. They may also exploit the firm's growth potential, especially in an environment of weak institutional investors' activism, which may influence its performance to an economically meaningful extent.¹⁰⁵

The evaluation in this section suggests that the various internal and external corporate governance monitoring mechanisms that have been established in Saudi Arabia, including those whereby individual investors are encouraged to compensate for deficits in family monitoring, are of limited effectiveness and may indeed have negative effects. Each of these mechanisms has its own weaknesses and they collectively fail to constitute a reliable and robust corporate governance framework, which implies that their application, however efficient, cannot provide a substitute for a great deal of institutional shareholder activism as a disciplining mechanism in Saudi Arabia, at least in the case of companies whose standards of corporate governance fall short of best practice.

It is believed that activist institutional shareholders may serve to strengthen the effects of the various internal mechanisms and work collectively to build an effective corporate governance monitoring framework. For example, institutional shareholders'

¹⁰³ Yahya Ali Al-Matari et al, 'Board of Directors, Audit Committee Characteristics and Performance of Saudi Arabia Listed Companies' (2012) 2 *International Review of Management and Marketing* 247-248 <<http://econpapers.repec.org/article/eojourn3/2012-03-5.htm>>[Accessed on 05/03/2014].

¹⁰⁴ RC Anderson and DM Reeb, 'Founding-Family Ownership and Firm Performance: Evidence from the S&P 500' (2003) 58 *J Finance* <<http://jstor.org/stable/3094581>>[Accessed on 05/03/2014].

¹⁰⁵ Benjamin Balsmeier and Dirk Czarnitzki, 'Ownership Concentration, Institutional Development and Firm Performance in Central and Eastern Europe' (2010) Centre for European Economic Research Discussion Paper 10-096, 3 <<http://ssrn.com/abstract=1739752>>[Accessed on 05/03/2014].

monitoring costs will be lower than those of many incompetent individual shareholders, as institutional shareholders can exercise their influence effortlessly, dynamically and in ways more fitting to the concentrated ownership environment. They are more likely to be able to address concerns actively and to put pressure on managers and executive directors to implement best practice in corporate governance; their voices will be heard more loudly and they will be able to bring transparency to the operation of the audit, remuneration and risk management committees by using cumulative voting and proxy voting. Thus, foreign institutional shareholders' activism has an important role to play in motivating and influencing change in corporate governance practices in Saudi publicly-traded companies. Before embarking on a detailed analysis of this external corporate governance mechanism, it is important first to examine the protection of minority shareholders.

6.5 The Protection of Minority Shareholders in the Saudi Context

6.5.1 Introduction

This section explores the protection of minority shareholders in Saudi Arabia and seeks to establish whether or not improvement is needed in order to encourage the activism of institutional investors. Actually, this is considered a powerful tool of corporate governance, primarily by institutional investors, no less than voting for institutional investors with minority shares to hold the board of directors accountable when they feel that their money is not being protected or managed properly. At the same time, they cannot exercise much influence over companies, especially in the case of a concentrated ownership structure dominated by the government or families. But before looking at minority shareholders' rights and the legal remedies available under Saudi law to those seeking redress in respect of a breach of duty by the directors of a company, it would be useful to consider the responsibilities and duties of the board of directors to act in a way that promotes the interests of shareholders. First, it is essential to examine the directors' duties as established in Saudi statute law, since they have been found to be important in the field of corporate governance to protect the interests of shareholders. This is necessary to determine how directors should interpret their primary role and management strategy in order to comply with their duties and responsibilities in managing the company: should they do so to serve the best interests of the company

itself and pursue the accumulation of wealth for shareholders (the shareholder primacy model), should their emphasis be on stakeholders' interests (the stakeholder approach), or should they take the alternative 'third way' of the 'enlightened shareholder value approach', recently cultivated in the UK, as discussed in chapter 4?¹⁰⁶ In other words, the next section seeks to establish what kind of corporate governance approach to directors' duties and responsibilities is embodied in the statutes of the SCR, since as mentioned above,¹⁰⁷ the regulations themselves are influenced by diverse legal traditions, including Shariah. The aim is to develop a clear understanding of whether a directors' legal obligation is to pursue the success of the company for the financial benefit of the shareholders or whether the law requires directors to consider the full range of stakeholders' interests and to promote the company's longer-term financial performance, which would reflect an understanding among both academics and professionals of the new trend in company law and developments in corporate governance, specifically following the global financial crisis of 2007, in addition to being considered a rational objective for institutional investors tending towards activism.¹⁰⁸

6.5.2 The Corporate Governance Approach to Directors' Duties in Saudi Arabia

The general structure of directors duties is predominantly laid down in the various provisions of the SCR and the CGR. While these two sets of regulations include references to different directors' duties, both require directors to adhere to a set of similar duties. An essential difference is that the CGR emphasises that directors of publicly-traded companies should be aware of and understand their duties to promote transparency and accountability and to address any deficiency in or misunderstanding of the SCR. Generally speaking, the statutory provisions of the SCR and CGR relating to the corporate objectives for which the Saudi director should aim in corporate governance may be presumed to be inspired or influenced by the Anglo-Saxon model of shareholder primacy, whereby the shareholders' interests are fundamental to the company and should be given priority by its directors. For example, the following general duties of directors reflect this view:

¹⁰⁶ Section 4.3.

¹⁰⁷ Section 6.3 .

¹⁰⁸ B Rogers, 'The Complexities of Shareholder Primacy: A Response to Sanford Jacoby' (2008) 30 *Comparative Labor Law & Policy Journal* 98
<http://law.illinois.edu/publications/cllpj/archive/vol_30/issue_1/rogersjacobycorment30-1.pdf>[Accessed on 05/03/2014].

The duty to promote the success of the company, whereby members of the board of directors are expected to obey the legal principle that requires them to act in the interests of the company and which makes it clear that personal obligations may be owed by directors to the company and to the shareholders, but not in the interests of any specific group that voted for the appointment of a particular member to the board.¹⁰⁹ However, the directors' duty is not only to the company, but extends to the shareholders and others; the directors can be held jointly accountable for any injury or damages arising from their maladministration of the company's affairs or for violation of the provisions of the SCR or of the company's memorandum and articles of association.¹¹⁰

The duty to act on a fully informed basis, with due diligence and in good faith,¹¹¹ which requires directors to act in the interests of the company, diligently, in a responsible way and in good faith.¹¹² The board should base its judgments and decisions on adequate information, either from the executive management or from other sources that are absolutely reliable.¹¹³

Notwithstanding these correspondences, adherence to the Anglo-American model is not absolute. It can be said that both sets of legislation have some contradictory implications for shareholder primacy, being more inclined to obligate directors to have regard to the interests of a broader group of stakeholders, including employees, suppliers, customers and society. This confirms that there is no universally applicable model of corporate governance and that factors including the national culture, language and legal traditions in developing countries and emerging markets may play a part in

¹⁰⁹ Article 11(d) CGR. See also article 44 of the LRs, which clearly requires the directors to exercise their powers and carry out their duties to serve the interest of the company.

¹¹⁰ Article 76 of the SCR. The term 'third parties' is not defined in the SCR and no plausible meaning or scope of limitation of the term 'others' is given. Therefore it is anticipated that 'others' should be taken to include the stakeholders defined in the CGR and to refer to any persons other than shareholders.

¹¹¹ In common law the duty to exercise reasonable care, skill and diligence is not a fiduciary duty but is enforceable in the same way as any other fiduciary duty owed to a company by its directors. For more detail see David Cabrelli, 'The Reform of the Law of Directors' Duties in UK Company Law' (Paper presented at Bocconi University, Milan, 2008) 26-17
<http://research.ed.ac.uk/portal/files/13215836/CABRELLI_D_PRESENTATION_FOR_UNIVERSITA_BOCCONI_ON_THE_REFORM_OF_THE_LAW_OF_THE_DIRECTORS_DUTIES_IN_UK_COMPANY_LAW.pdf>.

¹¹² CGR article 11(b,c).

¹¹³ *ibid.*

shaping their corporate governance practice.¹¹⁴ Indeed, there is clear evidence of a tendency towards the stakeholder approach, as a result of the influence of the Shariah legal tradition and economic philosophy on the corporate governance approach to directors' duties and responsibilities in Saudi Arabia, requiring them not to have as their sole objective to ensure a financial return to all shareholders, but also to protect the economic interests and rights of a wider range of stakeholders having diverse relationships with the company, including through its social participation.¹¹⁵

This emphasis is reflected in the wording of article 1 of the CGR: '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.' Furthermore, as noted earlier,¹¹⁶ article 10 of the CGR clearly requires the board of directors to draw up a written policy to regulate the company's relationships with stakeholders and to protect their respective rights and interests, including determining appropriate mechanisms for indemnifying them in case of the infringement of their rights and dispute-settlement mechanisms for any problem that might arise between the company and the stakeholders. This does not mean that when making business judgments the directors should merely weigh the interests of corporate social responsibility against the primary objective of maximising financial returns to shareholders. Indeed, there is no specific and positive duty of directors towards stakeholders that they can enforce under article 11 of the CGR, which makes clear the directors' duty is owed towards shareholders. It is quite obvious that the requirement for directors to take stakeholders' interests into account in policy decisions is secondary to their paramount duty towards the shareholders, which may be said to place the Saudi approach midway between the shareholder and stakeholder approaches. While there is a stakeholder approach, it is set within the framework of directors' duties to advance shareholders' interests (the shareholder value approach), which fundamentally encourages the board of directors both to take a short-term perspective on its functions and to use broader thinking, embracing and sustaining long-term value creation by

¹¹⁴ B Black, A Gledson de Carvalho and E Gorga, 'What Matters and for Which Firms for Corporate Governance in Emerging Markets? Evidence from Brazil (and Other BRIK Countries)' (2012) University of Texas Law and Economics Research Paper 152, 5 <<http://ssrn.com/abstract=1832404>>.

¹¹⁵ Lewis (n47) 16. See also Z Iqbal and A Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (John Wiley & Sons 2007) 283.

¹¹⁶ Section 6.3.2.3.

adopting policies to protect stakeholders' rights and interests and to promote the company's social ethics.

Thus it may be argued that the Saudi system has developed a different approach, merging elements of the shareholder value and stakeholder approaches, which means in narrow terms that it shares the ideology of the UK approach to 'enlightened shareholder value'. Both jurisdictions have adopted a new form of corporate governance model, recognizing that while the primary obligation of directors is to promote the success of the company for the benefit of its shareholders, they should still to a certain degree recognize and consider the wider interests of the community, so that their primary responsibility to shareholders does not lead them to make business judgments and decisions which are unacceptable to that community. Indeed, in a context of concentrated family ownership and of high retail investment activity, the activism of institutional investors is already a significant element influencing directors to favour companies' long-term performance and the interests of the wider society.¹¹⁷

6.5.3 Minority Shareholder Protection by Substantive Statutory Rules

The important point to raise first is that the Saudi culture of corporate governance pertaining to the protection of minority shareholders is very limited. For example, the SCR neither offers a specific definition of the term 'minority shareholder', nor do its provisions give an explanation or description of such shareholders and their position in the company. This omission from the language of the regulatory regime pertained for many years, until the term became a matter of concern for Saudi regulators with the introduction in 2006 of the CGR, whose article 2 defines minority shareholders as 'those who represent a class of shareholders that does not control the company and hence they are unable to influence the company'. While the Saudi corporate governance regulatory regime grants those holding not less than 5% of the paid up voting share capital the general statutory rights mentioned above, such as pre-emptive rights and cumulative voting, they are further entitled to a variety of rights similar to those applicable in the UK to protect them from abuse by controlling shareholders. In particular, shareholders holding not less than 5% of the paid up voting share capital can require the directors to call an AGSM and have the right to submit proposals and to add

¹¹⁷ Discussed further in section 6.7.

one or more items to the agenda of such a meeting.¹¹⁸ Such shareholders can also require the directors to call an extraordinary general meeting (EGM).¹¹⁹ Thirdly, they can ask the court to appoint inspectors to investigate the company if suspicion becomes evident, inter alia from the dispositions of the members of the board of directors or auditors of the company's affairs, of conduct unfairly prejudicial to the complainant shareholders.¹²⁰ Finally, minority shareholders are not restricted in their right to deposit or block any of their shares with the Securities Depository Centre in respect of their expectation to vote in the AGSM, without the imposition of cost, to show that they are unable to sell their shares, which gives them the freedom to exercise their voting rights and the opportunity to consult and build coalitions with other shareholders.¹²¹

6.5.4 Legal Remedies for Minority Shareholders

Litigation is considered very important in corporate governance as a remedial tool to address mismanagement of the company's affairs and to hold directors accountable for abusing their powers towards shareholders. Article 108 of the SCR grants shareholders the right, among others, to monitor the functions of the board of directors. It encourages aggrieved shareholders to file liability lawsuits against board members and to remedy the oppression of a minority by a majority by appealing for the nullification by the AGSM of any decision, which is not made according to the conditions and restrictions of the SCR. While it is not easy to say precisely what legal remedies should be applied to protect the interests of minority shareholders under the SCR for any abusive management of the company's affairs, it can nonetheless be said that there are several grounds on which decisions might be challenged in the Saudi courts in order to protect the legitimate interests of individual shareholders, through various types of legal action under the SCR. First, article 76 states:

¹¹⁸ Article 5(b) and (f) CGR. Under s 303 and s338 of the UK CA 2006, shareholders holding not less than 5% of the paid up voting share capital can require directors to call for a general meeting and have the right to submit proposal or items in the AGSM.

¹¹⁹ Article 87 SCR.

¹²⁰ Article 109 of the SCR. Such performance of inspection on the company '... shall be under the expense of the complainants. If the complaint is confirmed as valid, the commercial court shall order whatever it deems of precautionary measures and shall call for the [AGSM] to take necessary decisions.'

¹²¹ S Djankov et al, 'The Law and Economics of Self-dealing' (2008) 88 J Financial Economics 454 <sciedirect.com/science/article/pii/S0304405X08000160>[Accessed on 05/03/2014].

Members of the board of directors shall be jointly liable to compensate the company, shareholders or third parties, for damages emanating from their mismanaging the company affairs, or violating the provisions of the [SCR], or the company's by-laws; and each condition ruling otherwise shall be considered null and void. ... The approval of the [AGSM] to discharge the members of the board of directors does not prevent a claim of responsibility. Such claim must be commenced within three years from the date of discovery of the harmful act.

It is clear from the wording of this article that individual shareholders are able to bring such a legal action before the court against the members of the board jointly in regard of mistakes or actions harmful to those shareholders originating in a decision made unanimously by the directors that results in their mismanagement of the company's affairs or breaches the provisions the SCR or the company's by-laws. The action must be commenced within three years of the harmful act and it is for the Shariah judges in the commercial court to decide whether the minority shareholders will be entitled to compensation for the fault. It can be argued that a serious weakness of article 76 is that the terms 'mismanagement' and 'damages' are not defined and may therefore be open to wide legal interpretation. For example, the SCR does not specify whether 'damages' means personal or legal damages, including disgorgement damages, or literal damage or any breach of duty or of trust by the directors of the company. This breadth of potential meaning can be said to give broad discretion to the courts to grant a range of remedial compensations to aggrieved parties, which could be seen as an advantage, giving institutional investors as minority shareholders the power to prevent controlling shareholders of the investee companies from damaging their interests by enabling them to bring a wide range of legal actions before the commercial court under different circumstances, as long as their grounds are reasonable and the damage or harm has arisen as a result of the directors' mismanagement. Unlike breach of fiduciary duty claims, which concern duties owed to the company itself, the fundamental nature of the derivative action lies in empowering institutional as minority investors to use litigation to prevent managers or controlling owners from stealing the firm's assets or benefiting themselves in many ways.¹²²

¹²² Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (OUP 2007) 23.

6.5.4.1 *Derivative action*

Under article 77 of the SCR, the company has the right to bring a legal action against the directors in respect of their faults causing damage to all shareholders, but the company's right to bring such actions depends on a shareholders' decision made at the AGSM to appoint a member of the company to launch the legal action on behalf of the company against the directors. However, the board may often not be willing to bring an action against the managers where the board members themselves are the wrongdoers, where they are substantially under their controlling influence or where they share personal interests with them. The presence of controlling shareholders in many Saudi publicly-traded companies may be a motive to discharge the liability of the directors in the AGSM and it may further be assumed that they will block in the AGSM the initiation of any lawsuit against directors' liability. It is therefore significant that article 78 of the SCR allows an aggrieved minority shareholder or shareholders to pursue such a legal action on behalf of the company against the directors for their wrongdoings that have caused damage to the company and to them individually or collectively:

Any shareholder shall be entitled to file a liability lawsuit against the directors on behalf of the Company, if their fault causes damage to him. The shareholder may not file the said claim unless the company entitlement to file such lawsuit is still standing; and the shareholder shall be obligated to inform the company of his intention to file the lawsuit; the judgment in his favour shall be proportionate to the damage inflicted on him.

Accordingly, although the controlling shareholders may discharge the liability of the directors in the AGSM and may block the bringing of legal action in respect of directors' liability, any minority shareholder has the right to bring a legal action before the court on behalf of the company against wrongdoing directors for their breach of duty under certain conditions: first, if a wrong is done to the company which results in damage to aggrieved minority shareholders; secondly, the claimant cannot bring the legal action unless the company's right to launch the legal action is still standing or unless it has already decided not to pursue the claim in the AGSM; thirdly, the claimant must inform the company of his or her intention to bring such a legal action. As long as these conditions are fulfilled, the aggrieved minority shareholder will qualify as an eligible litigant with the right to bring a legal action on behalf of the company against

the directors and will be eligible to personal compensation only as a result of losses to him. Thus, while action under article 78 of the SCR can be seen as similar to a derivative action in the UK, it would be better considered to be a useful corporate governance mechanism, attractive to institutional investors and differing from the derivative action in some important respects. First, the ultimate motive of the derivative action is to obtain personal remedial compensation, not to serve the interests of the company as a whole; secondly, action under article 78 lacks the complexity of process and conditions prescribed by part 11 of the UK Company Act 2006 for obtaining permission to pursue a derivative action. In addition, minority shareholders face economic costs in bringing a derivative action in countries including the UK when the financial benefit of doing so exceeds the cost, but the situation is different in Saudi Arabia, where there are no court fees and where attorneys' fees are lower than in the UK.¹²³

Given these comparisons, it may seem surprising that no legal action is reported to have ever been taken against company directors for breach of duty in Saudi Arabia. The most plausible explanation is that many directors are representatives of controlling shareholders and as such are much less likely to be sued. Having said that, the Saudi policymakers should bear in mind that under part 11 of the UK Companies Act 2006, aggrieved shareholders are faced with a long process in two stages and a complex set of conditions for obtaining permission to pursue a derivative action, which at least gives the court the power to control a potential flood of derivative actions. It would be sensible to give the Saudi commercial court equivalent power to grant or withhold permission to bring a derivative action and to start the legal process against company directors, given the possibility that a great number of retail shareholders who generally have no interest in voting rights will have easy access to the commercial court and will wish to sue directors on behalf of the company, potentially resulting in a heavy load of derivative actions being brought before the commercial court and perhaps having an impact on the share price and reputation of any company involved. Moreover, there is no legal justification for minority shareholders to bring a case on behalf of the company against dishonest or negligent controlling shareholders, although the horizontal agency problem between minority and controlling shareholders is a principal concern in Saudi

¹²³ Dan Puchniak, 'The Derivative Action in Asia: A Complex Reality', (2013) 9 Berkeley Business Law Journal <<http://ssrn.com/abstract=2256275>>[Accessed on 05/03/2014].

Arabia. Therefore, it is suggested that Saudi policymakers should make the necessary amendments to articles 77 and 78 of the SCR to specify that the company itself should also gain from the claimant's recovery, to prevent multiple legal actions. They should introduce a wider range of new grounds under which such derivative actions could be brought against the controlling owners and give the commercial court more power to decline to grant leave to a claimant where it appears to the court that he or she is not acting in good faith and that the lawsuit does not reveal a prima facie case for the court to give permission for proceedings to continue if it would adversely affect the market value of the company.

Nonetheless, it would perhaps be appropriate to challenge the preference of institutional investors regarding national investor protection in the light of the status of minority shareholders' rights in Saudi Arabia. While the predilections of institutional investors are not easy to determine, recent empirical studies have shown that their preferences vis-à-vis investor protection are broadly in line with the measures set out in the 'anti-directors index' of La Porta et al and in the 'anti-self-dealing index' of Djankov et al.¹²⁴ Both of these empirical studies use a combination of measures to examine the extent to which investors are protected under common and civil law. Hitherto it has been claimed that measures based on the anti-self-dealing index are better grounded in theory and offer a more robust reflection of a variety of measures of capital market development across many common and civil law countries.¹²⁵ It can be broadly assumed that regarding most of what has been discussed above, Saudi Arabia is to be found near the middle of the range. More precisely, it can be said the Saudi market scores 4 out of six 6 on measures based on the revised anti-directors index, which means that the degree of investor protection in Saudi Arabia is greater than many developed and developing countries (e.g. France scored 3) but lower than in common law countries; for example, the UK scored 5. These scores are considered to offer the best indication of the extent of investor protection provided under the anti-self-dealing index,¹²⁶ yet it can be argued that the protection of minority shareholders in Saudi

¹²⁴ J McCahery et al, 'Behind the Scenes: The Corporate Governance Preferences of Institutional Investors' (December 13, 2010) AFA 2011 Denver Meetings Paper; Tilburg Law School Research Paper 010/2010, 36 <<http://ssrn.com/abstract=1571046>>[Accessed on 05/03/2014].

¹²⁵ Djankov et al (n121) 46.

¹²⁶ Although, as discussed earlier, the cumulative right is contained in the CGR as given to shareholders, it is not to be taken into account, as it is not explicitly contained in the SCR as the primary source of

Arabia is still weak and that Saudi policymakers should do more to encourage activism on the part of institutional investors as part of the necessary reforms to protect the interests of minority shareholders, since more active institutional shareholders should enhance minority shareholder protection. For example, although various legal measures have been designed to encourage institutional investor activism and to protect minority shareholders, such protection measures need to be developed more fully to enable institutional investors, as minority shareholders, to make use of proxy voting more easily, such as by allowing such votes to be submitted in writing, especially as it has been asserted that proxy voting is one of the measures which institutional investors regard as positively influencing companies' governance.¹²⁷ Thus, such measures and other suggested improvements that are important in strengthening the integrity of the environment of activism among institutional investors in Saudi Arabia are discussed in the next section, where it will be argued that institutional investors constitute an acceptable corporate governance mechanism to reduce agency costs, especially in relation to their activism designed to change the practice of corporate governance in many Saudi publicly-traded companies.

6.6 Institutional Shareholders as an External Corporate Governance Mechanism in Saudi Arabia

Despite the calls for institutional investors' activism that have been increasing around the world for many years and in the UK at least since the Cadbury Committee reported in 1992, the emergence of institutional investors' activism has unfortunately not been encouraged by the Saudi regulatory framework; nor has such activism been evident in the investment practice of various institutional shareholders, even after the collapse in 2006 of the Saudi capital market, when there was a need to restore investor confidence in the share market and to make it more competitive. Indeed, institutional investors have had little or no effect in Saudi Arabia, while neither the CGR nor the SCR has addressed the significance of shareholder activism or recognized the important role of institutional shareholders as responsible investors with the incentive to improve corporate

company law in Saudi Arabia; therefore it will be treated as an enabling provision, not a mandatory rule.

¹²⁷ R Aggarwal, PAC Saffi and J Sturgess, 'The Role of Institutional Investors in Voting: Evidence from the Securities Lending Market' (2012) Georgetown University Working Paper 35 <<http://ssrn.com/abstract=2023480>>[Accessed on 05/03/2014].

governance practice in the Saudi capital market. Consequently, it is not clear to what extent institutional shareholders are aware of activism or could effectively determine outcomes—in other words, what their activism could achieve—but it can be said that a tendency to engage constructively is not part of their investment culture and strategy. Nonetheless, it is assumed, in the light of the evidence adduced in chapter 5,¹²⁸ that in order to achieve a more competitive investment culture in the Saudi capital market, there is a need for them to play a stronger role in enhancing the integrity of corporate governance.

With respect to any potential monitoring costs that may be incurred in relation to institutional shareholder activism as a result of the highly concentrated government and family ownership of shares in most Saudi publicly-traded companies, the question arises as to whether Saudi policymakers should appropriately strengthen at least the monitoring incentives of institutional shareholders as a legitimate external corporate governance mechanism.

In fact, within the Saudi corporate governance regulatory framework, support for shareholder activism is relatively weak, while various governance hurdles may hinder the empowerment of institutional shareholders and their tendency towards activism as a reliable external corporate governance mechanism. Accordingly, it is the intention here to shed light on potential hurdles which may elevate other direct and indirect costs on the part of institutional investors, especially in markets which are considered less liquid, where the possibility of selling is limited, and in the presence of highly concentrated corporate ownership, as discussed below. It is also the intention to examine factors that may help to reduce these costs, because they weaken the influence of institutional investors, if it is assumed that they are acceptable corporate governance mechanisms to reduce agency costs, especially in relation to their activism designed to change the practice of corporate governance in many Saudi publicly-traded companies.

6.6.1 Institutional Investors and Proxy Voting in Saudi Arabia

Voting is the most important governance tool in the hands of institutional investors who desire to change corporate governance practice. The importance for institutional

¹²⁸ Sections 5.3 and 5.4.

shareholders of using their voting rights effectively has long been acknowledged in the UK. For example, the Cadbury Report asserts that

...the way in which institutional shareholders use their power to influence the standards of corporate governance is of fundamental importance. Their readiness to do this turns on the degree to which they see it as their responsibility as owners, and in the interest of those whose money they are investing, to bring about changes in companies when necessary, rather than selling their shares.¹²⁹

Similarly, Mallin argues that voting

...should be regarded as the first principle of proper conduct by [institutional shareholders] ... Investors wish to see voting viewed as a fiduciary responsibility by UK institutional investors, and also various overseas countries who take their lead from UK corporate governance development as a key influence on the evaluation of their own corporate governance systems.¹³⁰

In an environment with a concentration of ownership comparable to that of Saudi Arabia, the OECD, in a recent paper aiming to strengthen the role of institutional investors in Latin American corporate governance, advocates the use of electronic voting to increase the participation of institutional investors in AGSMs and to encourage the emergence of activism among foreign institutional investors.¹³¹ In Saudi Arabia, institutional shareholders have been granted the same rights as ordinary shareholders, including the rights to participate and vote in AGSMs; all shareholders are given at least 20 days in advance of the meeting to make arrangements before attending and voting on the agenda items.¹³² Although the CGR requires boards to use electronic means in communicating with shareholders and to display the agenda of AGSMs on the company's website,¹³³ it still specifies writing as the only method allowed to appoint other shareholders and to exercise a proxy vote.¹³⁴ Moreover, despite the attention given to the use of proxy voting in recent years as part of the growing emphasis on shareholder activism in corporate governance, the CGR fails to provide any general

¹²⁹ A Cadbury et al, 'Report on the Financial Aspects of Corporate Governance' (1992) <ecgi.org/codes/documents/cadbury.pdf>[Accessed on 05/03/2014].

¹³⁰ C Mallin, 'Institutional Investors and Voting Practices: An International Comparison' (2001) 9(2) *Corporate Governance* 119 <<http://dx.doi.org/10.1111/1467-8683.00236>>[Accessed on 05/03/2014].

¹³¹ OECD, 'White Paper on Strengthening the Role of Institutional Investors in Latin American Corporate Governance' 31 <<http://oecd.org/dataoecd/56/31/46200302.pdf>>[Accessed on 05/03/2014].

¹³² Article 5(c) CGR.

¹³³ *ibid.*

¹³⁴ Article 6(c) CGR.

guidelines or specific instruction on how the proxy should vote on the items on the AGSM agenda; nor does it specify the number of proxies that can be appointed or how proxy votes are to be submitted in the AGSM. This failing may give company directors the chance to weaken the effectiveness of proxy voting by fixing the submission of proxy votes at an inconvenient time, or by imposing conditions on the exercise of proxy voting which make it too complicated for some shareholders to understand, so that they are in effect unable to elect directors of their choice or to vote down directors' resolutions. Thus, it is reasonable to argue that ordinary shareholders in Saudi publicly-traded companies would benefit from a fuller understanding of the proxy voting process while attending and participating in AGSMs. As for institutional shareholders, their exercise of direct and proxy voting can be assumed to be more complex than is the case for individual shareholders, not only because they are likely to own large shares in many different companies, but because the non-availability of options such as electronic means of voting and the use of proxy voting agencies will add significantly to their direct costs when they engage in corporate governance. In response, they may be more likely to apply the 'Wall Street rule' by selling their shares or to vote with their feet by reducing their participation in AGSMs. If in the near future foreign institutional investors are allowed to invest directly in the Saudi capital market, they may face high costs as shareholders, in part because evidence has shown that they do care about the proxy voting process as a channel.¹³⁵ They are therefore likely to prefer to invest in countries which apply standard rules of corporate governance that protect their interests; and electronic proxy voting will be of particular interest to them in this context. Indeed, increasing the number of voting options to include the secure use of telecommunications and other electronic means of the appointment of proxies is considered an important element of modernisation that would help to build the confidence of foreign institutional investors in the integrity of the Saudi capital market. Electronic proxy voting is an important means of improving efficiency, as it ensures the effective exercise of shareholder activism and thus promotes higher standards of corporate governance and accountability. In the UK, for example, electronic proxy voting is considered more effectual than paper voting and its use has increased

¹³⁵ Aggarwal et al (n127) 35.

markedly among companies and institutional investors since the Myners report recommended it in 2004.¹³⁶ Another recent study has found that

...electronic voting has a positive impact upon the overall engagement approach of the fund managers... they may vote against the resolution or consciously abstain. In both cases, fund managers convey their displeasure in relation to operations at portfolio company management.¹³⁷

Therefore, enforcing the exclusive use of writing in proxy voting can be assumed to constitute a governance hurdle which may restrict the use of proxy voting by institutional shareholders and if so will obviously affect shareholder activism significantly, as it is of particular interest to institutional shareholders and an indicator of their activism behaviour. Thus, encouraging the exercise of voting rights by allowing electronic proxy voting is not sufficient to ensure that institutional investors follow a tendency toward activism, as asset managers may be influenced by financial affiliates or by their relations with corporate capital. This makes it important for institutional investors to disclose whether they vote or not and furthermore to explain why and in whose interests they make their voting decisions and cast their proxy votes.

6.6.2 Institutional Investors' Voting Policies and Disclosure of Voting Activities

An issue which has attracted much attention and become a topic of lively debate in many Western countries is whether to adopt the US mandatory approach to the disclosure of mutual funds' proxy voting or to maintain a voluntary approach.¹³⁸ For example, in the UK, the Walker Review 2009 recommended that institutional investors be obliged to disclose their voting practices and policies 'on their websites or in another publicly accessible form'.¹³⁹ More recently, the adoption of the voluntary comply-or-

¹³⁶ P Myners, 'Review of the Impediments to Voting UK Shares' (2005) 2 <<http://bba.org.uk/download/4436>>[Accessed on 05/03/2014].

¹³⁷ R Martin and T Nisar, 'Activist Investment: Institutional Investor Monitoring of Portfolio Companies' (2007) 45 Management Decision 836-837 <<http://eprints.soton.ac.uk/45623/>>[Accessed on 05/03/2014].

¹³⁸ K Schmolke, 'Institutional Investors' Mandatory Voting Disclosure – European Plans and US Experience' (2006) New York University Law and Economics Working Papers 29-33 <http://lsr.nellco.org/nyu_lewp/7/>[Accessed on 05/03/2014].

¹³⁹ David Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations' (2009) Recommendation 22 <http://webarchive.nationalarchives.gov.uk/+http://hm-treasury.gov.uk/d/walker_review_261109.pdf>[Accessed on 05/03/2014].

explain principle as a requirement of the Stewardship Code has encouraged institutional shareholders to reveal their voting policies and actions; for example, principle 1 requires institutional investors to disclose how they have used proxy voting and principle 6 requires them to disclose their voting policy. However, a recent study shows that few UK asset managers have disclosed a full voting record and that many smaller investors consider such information sensitive and confidential, preferring to explain rather than to comply.¹⁴⁰ Under section 1277 of the UK Companies Act 2006, the Treasury or the Secretary of State has the power to make provision by regulations requiring certain types of institutional investors, such as pension schemes and collective investment schemes, to provide information about the exercise of voting rights attached to shares if a voluntary regime fails to improve disclosure, which suggests that there will sooner or later be a move to follow the US approach and make such disclosures mandatory.¹⁴¹

For its part, Saudi Arabia generally adopts the voluntary approach and encourages institutional investors to disclose their voting behaviour and policies. Article 6(d) of the CGR states:

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.¹⁴²

Hence, it can be said that Article 6(d) of the CGR is short, lacks detail and imposes no requirement on institutional investors to disclose their voting practices and policies publicly on their websites, which could change the image of institutional investors in a positive way, boost their integrity and help to convince both the dominant proportion of retail investors in the Saudi market and potential foreign investors that they were now able to make more knowledgeable investment decisions and safely entrust their savings to fund managers, thus reversing the decline in the number of subscribers to most funds since the losses which followed the market collapse of 2006. It may be argued that for institutional investors in Saudi Arabia, however, the disclosure of their voting practices

¹⁴⁰ Ruth Sullivan, 'Institutions Wary of Full Disclosure of How they Vote' *Financial Times* (London, 29 April 2012) <<http://ft.com/cms/s/0/a8b53d6c-8f94-11e1-98b1-00144feab49a.html#axzz2JaRTB0HK>>[Accessed on 05/03/2014].

¹⁴¹ *ibid.*

¹⁴² Article 6(d) CGR.

and policies on publicly accessible websites is a risky, sensitive and confidential issue. For example, it would reflect a true picture of the weak influence of various collective investment schemes with non-convertible shareholdings in the presence of a high concentration of ownership by the government and families. Eventually, the institutional investors would suffer a loss of reputation among the few investors left to them after the market collapse of 2006.

The main issue of concern is how to control institutional shareholders' conflicts of interest, which is considered more difficult to resolve than in the UK or the USA. Undeniably, potential conflicts of interest may be identifiable in many ways in the Saudi environment of concentrated ownership. It is assumed that the complexity of this problem stems from the sort of interests that institutional shareholders could come into conflict with or about in Saudi Arabia. For example, as was discussed in chapter 5,¹⁴³ a great number of mutual funds may not want to become active in exercising their governance rights because of business-relational conflict. At the same time, other collective investment schemes that have recently emerged in the Saudi capital market may not want to influence the behaviour of company directors, because their interests may conflict with the objectives of those who control the company. In other words, there is little evidence of such collective investment schemes trying to stand up to the government or families that have controlling ownership of the companies in which they invest by rejecting proposals that may harm the investment funds. Therefore, it may be seen as unmerited for collective investment schemes to become activists and against their own interests to promote good corporate governance practice in the investee companies, as they may eventually have difficulty in accessing valuable inside information and may find that their relations with managers and board members are weakened, negatively affecting their investments, so that activism will indirectly become highly costly for them. The question is thus whether institutional investors in Saudi Arabia should be under a mandatory requirement to disclose their voting policies and practices or whether disclosure should be subject to a voluntary approach similar to that in the UK, in a way that would encourage institutional shareholders' role in corporate governance and their tendency towards activism.

¹⁴³ Section 5.4.

It may also be argued that while there is merit in the claim that a mandatory approach works effectively to enforce institutional investors' engagement, one consequence would be to harm the growth of institutional investment activism in Saudi Arabia, since the Saudi capital market is in the early stages of development; therefore, it might be more appropriate to implement article 6 to prompt an extension of associated guidance and so to strengthen the engagement of institutional investors in activism. Indeed, it seems unquestionable that the regulatory regime of institutional investors' disclosure of voting policies and practices under article 6(d) needs to be implemented to enhance explanation and offer more comprehensive guidance. On the one hand, it would appear necessary as a good indicator of the levels of transparency among institutional shareholders, through disclosure of their proxy voting policies and practices, so as to bring good corporate governance practice into investee companies. Such transparency of disclosure would enable investment fund clients to monitor fund managers' performance and to ensure that they exercised their voting rights in consideration of the interests of the beneficiary, rather than their own interests. To solve the complexity of conflicts of interest, on the other hand, there should be regulatory control of the level of conflict of interest. In order to increase the effectiveness of activism, steps should be taken by Saudi policymakers to protect clients and owners against the potential for conflicts of interest by ensuring that institutional investors implement and effectively operate a risk management system that reflects high standards of risk management, especially to demand a disclosure system to publicize potential business-relational conflicts when they arise. Such policies would promote more independent relations between institutional investors and business affiliates.

6.6.3 Developing Institutions to Govern the Investment Regime

Actually, it can be said that since the recent global financial crisis of 2007, there has been a growing worldwide awareness of the need to introduce self-regulation schemes designed particularly to control the behaviour of institutional investors in favour of activism. For example, the UK Stewardship Code, which the UK legislature issued in 2010, replaced the provisions of section C of the Corporate Governance Code related to the principles of institutional shareholders' engagement. The new provisions of the Stewardship Code were designed specifically to strengthen the engagement of

institutional investors in activism.¹⁴⁴ There is a strong need for the Saudi government to create a more comprehensive professional set of principles, similar to those of the UK Stewardship Code, to enhance the quality of engagement by institutional investors. However, it has been argued that while the voluntary approach of the Code is wholly appropriate in the UK, given the substantial institutional presence in its capital market, the voluntary comply-or-explain approach would perhaps not work as well in the Saudi context, because of the prevalence of close relations between institutional investors and their business affiliates on the one hand and of such relations between controlling shareholders and company management on the other, which would tend to render them less effectual as a mechanism of checks and balances.¹⁴⁵ This implies that it is of critical importance for the Saudi authorities to take a mandatory approach, given the widespread existence of strong conflicts of interest.

6.6.4 Promoting Internal Governance among Institutional Investors

There is a strong need for Saudi policymakers to encourage institutional shareholders as a whole to codify their internal governance, which may diminish the complexity of conflicts of interest, promote the independence of institutional investors and their affiliates and ensure that such investors implement a risk management system and operate it to a high standard of effectiveness, especially in responding to demands for a disclosure system to publicize potential business-relational conflicts when they arise. Such policies should promote more independent relations between institutional investors and business affiliates, while ensuring that institutions have good internal governance in place, encouraging them to exercise their ownership rights in a more active way and in line with their fiduciary obligations, in the best interests of clients and owners alike. It can be said that the separation of ownership and control in investment funds is just like that in publicly-traded companies, which may give rise to a divergence of interests between fund managers and their beneficiaries. The concept of fiduciary duty has a significant role in solving these problems in common law countries;¹⁴⁶

¹⁴⁴ Financial Reporting Council, 'Review of the Combined Code: Final Report' (2009) 3
<<http://frc.org.uk/images/uploaded/documents/2009%20Review%20of%20the%20Combined%20Code%20Final%20Report1.pdf>> [Accessed on 05/03/2014].

¹⁴⁵ P Montagnon, 'The Role of the Shareholder' in K Rushton, *The Business Case for Corporate Governance* (Law practitioner series, Cambridge University Press 2008) 85.

¹⁴⁶ Although no such special system exists in most other jurisdictions, there are similar rules that solve the problem of conflict of interest. Marc Kruihof, 'Conflicts of Interest in Institutional Asset

however, as discussed in chapter 3,¹⁴⁷ the specific nature of the fiduciary relationship between investment fund managers, clients or owners has, since its inception, had a function beyond the relations of private shareholders with managers or the normal principal-agent relationship. This has long caused confusion over how investment managers should manage assets in their customers' best interests, enforcing such fiduciary duty clauses.

Enforcing the fiduciary duties of investment fund managers has the important functions of ensuring that they exercise their voting rights properly and particularly of resolving the potential conflicts of interest that may arise from their relations with affiliated institutions or from self-dealing transactions with investee companies, which require fund managers to maintain good performance when investing the beneficiaries' savings and to exercise their fiduciary duties of responding to their investors' interests and of making the right investment decisions. The following subsections examine the policy implications with regard to private, Islamic and public institutional investors in turn.

6.6.4.1 *Private institutional investors*

The CMA has recognized the specific nature of the fiduciary relationship between investment fund managers and beneficiaries and has prescribed the values of fiduciary responsibility. According to article 18(b) and (c) of the IFRs,

The fund manager's fiduciary responsibility to unitholders includes a duty of loyalty and a duty to exercise reasonable care... Investment actions should be carried out for the sole benefit of the unitholders and in a manner that the fund manager reasonably believes to be in the best interest of the unitholders, given the facts and circumstances known to the fund manager or that ought reasonably to have been known to the fund manager.

If, in an attempt to achieve better and more effective monitoring of the performance of institutional shareholders regarding activism, the application of these fiduciary duties were imposed alone and without ensuring that fund managers put in place more

Management: Is the EU Regulatory Approach Adequate?' (2005) Ghent University Financial Law Institute Working Paper 2005-07, 24 <<http://ssrn.com/abstract=871178>>[Accessed on 05/03/2014].
¹⁴⁷ Section 3.5.4.3.

systematic governance standards or a professional code of investment conduct, the effect might be to obstruct fund managers, which would not represent a good indicator of the levels of awareness of activism. In Saudi Arabia, the CGR has been designed as a corporate governance model for Saudi publicly-traded companies as well as for institutional investors. This may be seen in relation to the similarities between the functions of the boards in both public holding companies and institutional investors, such as the presence of independent directors and subcommittees. However, it has been alleged that the governance model that has been designed for publicly-traded companies may be considered too vague for use in the world of institutional investors in respect of activism and that the mere assertion that ‘...[institutional investors’] directors should be more diligent or aggressive in their oversight role understates the dilemma they ... face. Without a set of policies, rules of engagement and protection against management retribution, it is unclear how directors can satisfy the needs of investors and regulators.’¹⁴⁸

However, the question arises of whether specially designed corporate governance rules would significantly encourage institutional investors to promote good corporate governance in the companies in which they invest. Chou and her colleagues have examined whether the internal governance practised by mutual funds affects their investment decisions and monitoring activities in the investee companies and whether mutual funds with strong internal governance will place more stress on shareholder rights and monitoring efforts aimed at improving the management of the companies in which they invest. Their evidence has many important implications, as follows:

[C]orporate governance plays a significant role in the voting decisions of well-governed mutual funds, but not of badly-governed ones. For both management- and shareholder-sponsored proposals, poorly-governed funds strongly vote in favor of management on issues of antitakeover, board quality, director elections, and executive incentives. ... [On the other hand], fund governance practices ought to play an important role in the investment decision-making process of mutual fund investors. Mutual fund investors should look beyond funds’ past performance when selecting mutual funds; that is, they should also look into the funds’ governance practices. Such practices

¹⁴⁸ R Radin and W Stevenson, ‘Comparing Mutual Fund Governance and Corporate Governance’ (2006) 14 Corporate Governance 372 <<http://ssrn.com/abstract=930774>>[Accessed on 05/03/2014].

would serve as a platform for investors to gauge whether fund managers perform their fiduciary obligations in the best interests of their shareholders.¹⁴⁹

6.6.4.2 Islamic institutional investors

As to Islamic institutional investors, encouraging better internal governance may become crucial for them, particularly in light of the recent evolution of different types of Islamic institutional investment such as Islamic cooperative insurance companies and Islamic mutual funds; Saudi Arabia, as discussed in chapter 5,¹⁵⁰ has become the world's leading incubator of this growing industry and there is a need to consider carefully some proposed changes in the way that these Islamic institutional investors manage their investments, in order to achieve more transparency regarding their activism.

It can be argued that Islamic corporate governance (ICG) may share many principles with various Western corporate governance models, but it has a different application, which requires a different structure.¹⁵¹ While ICG is still at an early stage compared to Western models and little has been written on its structure, it clearly needs an infrastructure to be built, able to comply with the full requirements of corporate governance and its duties, especially with respect to the Shariah supervisory board. The Shariah Foundation addresses the need for activism, arguing that it should not be exceptional, but part of the normal role of the Islamic fund model, which encourages activism as an element of socially responsible investment (SRI) in terms of both Shariah and financial return.

On the other hand, funds on the Islamic model are ordinarily structured using the accepted types of Islamic finance contracts, particularly of *mudarabah*, *musharaka* and *wakala*.¹⁵² These types reflect the complete separation between asset managers and

¹⁴⁹ Julia Chou, Lilian Ng and Qinghai Wang, 'Do Governance Mechanisms Matter for Mutual Funds?' (2007) 22-23 <<http://ssrn.com/abstract=972235>>[Accessed on 05/03/2014].

¹⁵⁰ Section 5.4.3.2.

¹⁵¹ Z Hasan, 'Corporate Governance: Western and Islamic Perspective' (2009) 5(1) *International Review of Business Research Papers* 1 <<http://kantakji.com/fiqh/Files/Companies/w119.pdf>>[Accessed on 05/03/2014].

¹⁵² IOSCO, 'Analysis of The Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products' (2008) Executive Committee of the International Organization of Securities Commissions 12 <<http://iosco.org/library/pubdocs/pdf/IOSCOPD280.pdf>>[Accessed on 05/03/2014].

investors, which highlights the fundamental need for a corporate governance model to be designed for investment funds, especially to cover the role of the Shariah supervisory board, whose importance is often overlooked, although the board is considered to be an internal or external mechanism for monitoring corporate governance that may be seen as a more significant attempt to alleviate the agency problem between the interests of asset managers and of investors. This is important when it is considered that its role is not only to ensure a clear set of SRI rules, particularly the avoidance of *gharar*, *riba* (interest), *maisir* (gambling) and other prohibited business activities, but also at the most general level to ensure good management, which in turn promotes social and economic efficiency, productivity, social welfare and the performance of managers in implementing Shariah principles at each level. Indeed, a major difference between conventional and ICG structures is this board, which ensures that the financial activities are in conformity with Shariah. Such supervisory boards are mandatory for Islamic banks and financial institutions. While their existence is not the only difference, Shariah supervisory boards should operate within the Islamic finance environment and exercise their main functions. DeLorenzo emphasises that they not only advise on Shariah compliance but also act as monitoring tools and respond to a need

... for impartiality and independence. In the same way that independent auditors are brought in to review the finances of a business, Shari'ah Supervisory Boards review compliance to Shari'ah precepts. Independent audits are understood as ways to gain and maintain the trust of investors and consumers. Independent Shari'ah supervision is the best way to gain and maintain the trust of Muslim investors and consumers.¹⁵³

While the Shariah supervisory board is one element of the ICG principles and a key element of good corporate governance, the latter needs to be clearly understood in order for its impact to be valued; and there is no general rule of Islamic good corporate governance. Finally, there is not enough coverage of clearly developed standards in the recent Saudi corporate governance model, specifically of the part that deals with and strengthens Islamic mutual funds and cooperative insurance companies, to make sure that these Islamic institutional investors manage their investment capabilities so as to

¹⁵³ Y DeLorenzo, 'Shari'ah Supervision of Islamic Mutual Funds' (2000) 4th Annual Harvard Forum on Islamic Finance 12 <<http://failaka.com/downloads/Sharia%20Supervision%20of%20Funds%20-%20DeLorenzo%202000.pdf>> [Accessed on 05/03/2014].

achieve a more transparent framework for monitoring and evaluating investee companies, thus safeguarding the best financial interests of their beneficiaries.

6.6.4.3 Public institutional investors

As indicated in chapter 5,¹⁵⁴ public institutional investors often do not exercise good corporate governance within their own organisations and this disregard for the maintenance of appropriate standards may be said to weaken their potential as major players in the Saudi capital market to promote standards of corporate governance in the companies in which they invest, and to weaken those who are minority activists. Indeed, Demarco argues that governments impede the corporate governance of pension funds in many MENA countries, including Saudi Arabia,¹⁵⁵ reducing the impact of these funds on the development of the local capital markets.¹⁵⁶ Conversely, CalPERS has developed an activist strategy over time and its own governance standards are reflected in the good corporate governance and business practice that it encourages in the companies in which it holds large shares. Meanwhile, it has created a culture of accountability and transparency among government officials or representatives and has sole fiduciary responsibility for the management of its assets,¹⁵⁷ in contrast to the situation of Saudi government pension funds. Rock and Kahan contend that the government interferes in decision-making through its indirect controlling ownership of pension funds, which may become a complicated issue as fiduciary duties becomes less effective, since it is difficult to be sure that government representatives on the boards of public holding companies will apply the general legal standards in respect of alleged breaches of fiduciary duty.¹⁵⁸ However, the next section goes beyond this suggestion of the necessity to develop a comprehensive set of internal corporate governance regulations for public institutional investors in Saudi Arabia, adding a further dimension to the discussion of institutional investors' activism by taking a more rational view of

¹⁵⁴ Section 5.4.1.

¹⁵⁵ G Demarco, 'Retirement Saving in MENA' (World Bank 2010) 10
<http://siteresources.worldbank.org/INTMNAREGTOPPOVRED/Resources/MENAFIflagshipPensions_3_10_11.pdf>[Accessed on 05/03/2014].

¹⁵⁶ Dimitri Vittas, 'Public Pension Fund Management in MENA' (PowerPoint presentation, World Bank, Financial Sector Development, undated) 22-33
<1.worldbank.org/finance/assets/images/Dimitri_Vittas.ppt>.

¹⁵⁷ For further details see the CalPERS web page
<calpers.ca.gov/index.jsp?bc=/investments/riskmanagesystem.xml>[Accessed on 05/03/2014].

¹⁵⁸ E Rock and M Kahan, 'When the Government is the Controlling Shareholder' (2010) 35 Delaware J Corporate Law 409-437 <<http://ssrn.com/abstract=1681744>>[Accessed on 05/03/2014].

institutional investors as responsible actors in the Saudi context. Indeed, it can be assumed that the Saudi policymakers would have an incentive to accept a stronger role for institutional investors, establishing board structures reflecting the benefits of pursuing long-term corporate performance, which inevitably entails the consideration of stakeholders' interests in defining directors' duties toward stakeholders and their social and environmental responsibilities.

6.7 Towards Socially Responsible Investment

The abovementioned need for improved internal corporate governance is directly connected with the modern trend among institutional investors toward activism, while CSR is another related stream of contemporary corporate governance, as it stresses the importance for corporations of adopting responsible business practice and of taking full account of stakeholders and of social and environmental responsibilities towards the public at large.¹⁵⁹ The assumption is that in practice there is poor awareness among most Saudi publicly-traded companies of their stakeholders, as little account has been taken of social and environmental concerns over the decades since the first regulation of the Saudi capital market in 1984. The predominance of family ownership in most Saudi publicly-traded companies is likely to lead to their directors acting to maximize the financial benefits to them and it is assumed that in the absence of supervisory boards in such companies, they will be able to use their dominant position to influence the management so that it acts to improve the company's financial performance with little consideration of the interests of the wider society. This imbalance will have been worsened recently by the presence of a large percentage of retail investors who are not at all concerned to be activists and have no interest in the running of the companies in which they hold shares, since their only interest is to maximize their financial return. This may in some way aggravate the pressure on directors towards the single-minded pursuit of profit, at the expense of stakeholders' interests and of social considerations, especially given the weakness or absence of various influential factors, some of which are mentioned above.¹⁶⁰ (1) the absence of certain interpretive guidance to the board of directors on how to protect the interests of stakeholders, (2) the absence of a supervisory

¹⁵⁹ RV Aguilera, CA Williams, JM Conley and DE Rupp, 'Corporate Governance and Social Responsibility: A Comparative Analysis of the UK and the US' (2006) 14(3) *Corporate Governance* <<http://dx.doi.org/10.1111/j.1467-8683.2006.00495.x>>[Accessed on 05/03/2014].

¹⁶⁰ Section 6.5.2 .

board in Saudi publicly-traded companies, so that control over management lies in the hands of shareholders only, (3) the absence of a single definition of directors' duties that can be expected to influence them towards furthering stakeholders' interests, (4) the absence of provisions in the SCR or the CGR granting stakeholders the right to provide input on matters related to company governance and of any whistle-blower tool allowing stakeholders to report any unlawful or unethical behaviour, (5) the lack of employee presence on boards to involve them in the strategic decisions of the company and to allow them to report their concerns about unlawful or unprincipled practice to the members of the board and (6) the fact that NGOs are not common in Saudi Arabia, in contrast to Western countries, where their existence may be assumed to influence companies and their directors to take into consideration stakeholders' interests and corporate social engagement. All these factors can be expected to influence the extent to which a company and its board members have the motivation and willingness to pursue the interests of stakeholders and the company's social and environmental responsibilities.

Therefore, encouraging the responsible activism of institutional investors in the Saudi capital market would make them significantly more likely to help to resolve the difficulties caused by inconsistencies in emphasis in the running of the company's business and to play an important role as SRI activists, influencing the attitudes of the boardroom and hence the practical likelihood of Saudi publicly-traded companies embracing CSR and improving their transparency. Such investors would have the incentive to serve on the board and to advance shareholders' interests without disregarding the board's responsibilities towards stakeholders, society and the environment. They might endorse different means to ensure that appropriate and comprehensive standards were maintained in the company's written policy regarding stakeholders and in the foundation, development and shaping of CSR, reflecting the success of the executive departments in the adoption of the modern concept of social responsibility and the success of their companies in remaining at the forefront of such developments. This raises questions regarding Saudi institutional investors and the responsiveness of their attitude towards endorsing SRI. It can be said that the SRI concept has not yet become the norm among the community of Saudi public institutional investors. It may be assumed that although large institutional investors such as GOSI and SPPF probably have greater incentives to avoid free riding and could

engage actively with the companies in which they invest, they unfortunately appear merely to pursue the government's agenda and to have no incentive to engage in responsible activism; SRI is not likely to be a priority for them, nor is their investment agenda comprehensive enough to reflect any move towards it. This means that they lack the initiative to implement CSR as part of their corporate social objectives in companies in which they invest and there is no sign of a change in their investment decision-making practice in the near future.

Correspondingly, although the Shariah foundation addresses a wide range of social responsibility issues, the adherence to SRI among cooperative insurance companies and Islamic mutual funds has been perceived as relatively weak and they implement no functional policy to foster CSR; their adherence is more to economic motivation than to the socio-economic dimension and it seems that they are not expected ultimately to persuade Saudi publicly-traded companies to embrace CSR and improve their transparency.¹⁶¹

With respect to this apparent lack of a substantial appetite for CSR among institutional investors in Saudi Arabia, it is reasonable to expect Saudi public pension funds to be a driving force in realising socially responsible corporate activities, as they have been present in the Saudi capital market for many years, with large holdings, making them well positioned to produce broad social welfare alongside economic wellbeing. It would not be adequate, however, to suggest that they might simply choose to incorporate into their investment practice the existing tendency of international institutional investors to engage in shareholder activism in favour of CSR; perhaps it would also be beneficial if the Saudi government were to encourage a culture of SRI amongst them, to maintain a high diversification of their portfolios and particularly to enhance their active involvement in corporate governance. This would tend to promote the growth of CSR in the business of Saudi companies in which they invest and to further the balanced integration of social and environmental considerations in business strategy and operations, which is widely supposed to be desirable in order to secure long-term competitiveness in an environment where there is an increasing proportion of

¹⁶¹ S Ullah and D Jamali, 'Institutional Investors and Corporate Social Responsibility: The Role of Islamic Financial Institutions' (2010) 6 *International Review of Business Research Papers* 622 <<http://bizresearchpapers.com/44.Shakir.pdf>>[Accessed on 05/03/2014].

individual retail investors and a high concentration of family ownership and where these shareholders seek to influence management and boards of directors to maximize their financial return.

6.8 Conclusion

This chapter has discussed a wide range of issues related to the legal framework of corporate governance and the protection of shareholders' interests. It began by discussing the Saudi legal system and its origins, since this is an important factor that has shaped the corporate governance system and an indicator of the extent and quality of shareholder protection. It was found that the Kingdom's legal system is based neither on common law nor on civil law, since Shariah underlies the constitution. But the legal system has maintained its uniqueness through its dualism and the flexibility of its voluntary legal transplantation, which implies that Saudi policymakers are free to decide which modern Western traditions and principles to emulate in different areas of concern such as the financial and commercial sectors. The thesis found an emphasis in the recent development of the Saudi judicial system on ensuring the independence of judges and the appropriate enforcement of laws, but Shariah judges in the commercial court may face a problem in relation to corporate governance. The chapter has asserted that their training in corporate governance and acquaintance with its practice is vital, as they should be able address corporate governance cases and need to be more familiar with the recent reforms of Saudi corporate governance under the CGR; they should also become better acquainted with the new global context and culture of corporate governance and with developments in investment.

It was found that the Saudi corporate governance model has been influenced by aspects of the Anglo-American model and that many corporate governance provisions under the SCR and CGR focus on maximizing owners' wealth, while Shariah principles preserve essential ethical and moral business standards, which may be said to place the Saudi approach to corporate governance midway between the shareholder and stakeholder approaches. Thus, in comparison with the UK, the Saudi approach to corporate governance and directors' duties can be seen as less comprehensive. There is no single regulation that specifically requires directors to consider the interests of stakeholders in the Saudi context; their obligation to uphold stakeholders' interests

exists and is preserved as one of the board's main functions only through a specific written policy decided by the board itself under article 11 of the CGR to shape relations between the company and its stakeholders, including a method of indemnifying and settling any complaints or disputes that might arise between the company and the stakeholders or in relation to its social responsibilities. However, it is important to avoid any misperception as to what legal rules the board of directors must consider when drawing up its written policy concerning the respective interests of stakeholders: its only duties under the CGR are to consider shareholders' interests and social responsibilities which might affect the directors' decisions on the financial and non-financial interests of stakeholders. In other words, on this basis the board of directors may decide to take any reasonable measures to protect the interests and rights of the stakeholders, or to identify suitable methods of indemnifying them and the best mechanism to settle any complaints or disputes that might arise between the company and its stakeholders. To our knowledge, no further details or guidance have been given by the CMA as to what these mechanisms should be, nor does it make distinctions among such mechanisms for different types of stakeholders.

However, an examination of the effectiveness of various corporate governance disciplining mechanisms for the thesis finds that such internal and external mechanisms have a limited ability to solve the agency problem and to reduce agency costs. It therefore suggests that institutional shareholder activism would strengthen the ability of the various monitoring mechanisms to build an effective corporate governance framework in the Saudi capital market. Given the inadequacies in the Saudi culture of corporate governance pertaining to the protection of institutional investors as minority shareholders and to holding controlling owners accountable to their companies, suggestions were made to encourage activism on the part of institutional investors as minority shareholders, on the one hand by improving the provisions for litigation (derivative action) under the SCR to impose a threat of accountability on dishonest or negligent to managers and controlling owners, as well as giving judges in the commercial court more power to decline to grant leave, thus preventing multiple legal actions by individual shareholders, and on the other by enabling institutional investors, as minority shareholders, to make use of proxy voting more easily, since institutional investors regard it as a measure which positively influences corporate governance. Indeed, the thesis finds that the requirement to submit proxy votes in writing is a key

hurdle that may weaken the influence of institutional shareholders as an external corporate governance mechanism and their participation in decision making in investee companies. Such obstructions weaken the development of activism among institutional investors in Saudi Arabia and generally keep them on the sidelines, while most of them, especially the public institutional investors and Islamic mutual funds, are typically concerned with longer-term monitoring and significantly do not intervene or show an interest in governance issues in the companies in which they invest.

Another central issue that deters effective activism and where the thesis has made some suggestions is the need for a disclosure system as a good indicator of the levels of transparency among institutional shareholders. Public disclosure of their voting practices and policies and of their potential business-relational conflicts is necessary to promote the independence of institutional investors and their affiliates in the Saudi environment of highly concentrated ownership, to develop a self-regulation framework, to strengthen the engagement of institutional investors in activism and to encourage them to behave responsibly in the Saudi capital market. Indeed, the role of financial institutions in corporate governance in Saudi Arabia has attracted much less attention than the role of institutional investors in corporate governance in the UK, although Saudi Arabia has unique advantages among developing countries in the drive to build the internationalization of capital markets. Nevertheless, there is a need to reduce regulatory impediments and to establish other elements such as institutions of self-regulation and a framework within which the Saudi government could reduce its political and administrative control over the shaping of a culture of activism among institutional investors.

Chapter 7

Conclusion

7.1 Introduction

This thesis has examined the scope for shareholder activism and the protection of minority shareholders in Saudi Arabia, a developing economy, which is a destination of great economic interest for foreign investors, due to its position as the largest global oil exporter and holder of the world's largest proven conventional oil reserves. Both shareholder activism and the protection of minority shareholders have become widely debated topics in the Western academic literature, particularly since the financial crisis of 2007, yet the role of institutional investors' activism and minority shareholder protection in Saudi Arabia have hitherto been the subject of almost no discussion. The thesis has sought to determine the extent to which the Saudi regulatory framework provides the right conditions to support the activism of institutional investors, to solve the agency problem and to protect the interests and rights of minority shareholders. In order to avoid repetition, this chapter summarizes the findings with regard to these main questions and draws conclusions on a wide variety of issues. In doing so, it proposes a framework to foster institutional investor activism and to improve minority shareholder protection in the Saudi context.

7.2 Summary of findings

7.2.1 The Agency Problem in Corporate Ownership

In chapter 5, the corporate ownership structure in Saudi Arabia was examined and placed within the context of the historical development of the Saudi capital market in order to provide a local perspective on the agency problem. The thesis found that the Saudi capital market differed little from that of other developing and emerging countries, being characterized by ownership concentrated in the hands of the government and a number of families, the agency problem arising mainly between controlling shareholders and minority shareholders. The development of a new and distinctive ownership structure since the establishment of the CMA in 2003 may lead to

the introduction of a more effective regulatory regime, to guide the modernization of the emerging Saudi capital market. Meanwhile, the presence of a number of rich Saudi families and individuals who own large numbers of shares through cross-ownership and pyramid structures reflects a strong concentration of ownership and a complete lock on the control of many firms, which creates very large agency costs in the Saudi capital market. However, a more dispersed ownership pattern is slowly emerging in the Saudi capital market as a result of the increasing value of the market and the large number of retail investors, which means that the separation of management from ownership control is not as rare as in some developing countries. The agency problem is relatively deep between dominant shareholders and minority shareholders but somewhat less severe between managers and shareholders. This suggests that a legitimate role of institutional investors in the Saudi market is to mitigate these agency problems and to restore the equilibrium of the capital market by reducing the divergence of interests between minority investors and dominant owners, or between dispersed investors and managers.

7.2.2 The Role of Public Institutional Investors in Corporate Governance

Moving on to consider the role of public and private institutional investors in corporate governance and beginning with the former, chapter 5 reported the finding that although the Saudi government has no direct control of ownership, it has invested heavily through public institutional investors, owning the largest concentration of shares in various large and medium publicly-traded companies.¹ Hence, these public institutions are most likely to be passive shareholders, as they are managed by government representatives whose investment strategy is driven by the government's agenda and are thus infrequently involved in monitoring activities, while their contribution to decision-making in companies is limited to promoting the government's political policy rather than extending to the implementation of an independent investment strategy. They do not exercise good corporate governance within their own organisations and there is no indication that they establish a culture of accountability and transparency, nor any evidence of the existence of fiduciary responsibility standards among government representatives. This disregard for the maintenance of appropriate standards may be said

¹ Section 5.4.

to weaken their potential for encouraging their application in the companies in which they invest, including those where they have minority ownership.

7.2.3 The Role of Private Institutional Investors in Corporate Governance

The thesis has found that cooperative and Islamic mutual funds have recently begun to shape the overall private institutional investment market, as reported in chapter 5,² focusing for equity investments on Shariah-based structures, which account for an increasing proportion of the country's growth. However, a number of factors hinder their role in the capital market. For example, it has been found that there is no absolute divorce between these investment funds and their affiliates such as banks, given that many funds are managed indirectly by commercial banks. Therefore, the possibility that these asset managers will neglect their fiduciary responsibilities to their owners or investors remains very strong. There is little evidence that the asset managers of these investment funds have changed their practice of cautious passivity and responded to a more positive motivation by using their voting rights to pursue good corporate governance or nominating directors in the companies in which they invest. One suggested explanation for these investment funds deciding cautiously not to be activist and choosing to limit their ownership to minority holdings is the risk of being held legally liable for insider trading for any information obtained in regard to their relationships with their business affiliates; hence the need to construct an appropriate Chinese wall and other safeguarding mechanisms. In addition, it has been found that there are reasonable grounds for individual Saudi investors to prefer direct investment in the capital market over Islamic mutual funds; such investors' anxieties are reinforced by the long investment horizon of these investment funds, by the high cost of investing in them and by the negative returns of many such funds since the 2006 bubble. This obviously affects the confidence of individual investors; there are indications of an assumption by many Saudi individuals that the skills of the asset managers of these investment funds are not satisfactory and of an acceptance that they may have gained personal benefits at the expense of individual owners or investors.

² Section 5.4.3.2 .

The thesis also found that the role of cooperative insurance companies had been correspondingly limited since the formation of the first such company in 2005. Given the nature of their operations, their Islamic character has led them to take particular care over their investment selections and decisions and to be aware that there is still a limited set of asset classes compatible with the provisions of Shariah. As a result, cooperative insurance companies face the risks associated with the appropriate investment allocation and liquidity management of the takaful fund. Thus, although the Saudi regulators have not recognized the importance of the role that they should play in the recently published Investment Regulations, the thesis assumes that the growth of the cooperative insurance market in Saudi Arabia indicates that such companies will play a much stronger role in the Saudi capital market in the near future, especially in the case of Islamic family insurance funds, which are similar to conventional life insurance.

7.2.4 The Saudi Legal System and its Origins

The primary focus of chapter 6 was on corporate governance regimes and on the protection of minority shareholders in particular. It was important to begin with an exploration of the origins of the Saudi legal system, a fundamental aspect of any academic study of corporate governance, as a large body of empirical literature provides convincing evidence that the country's legal origins strongly affect the protection of shareholders and capital market growth. The thesis found that Saudi Arabia has a distinctive legal system, unique in some of its fundamentals and thus unrelated to the models of common law and civil law, being based on Shariah as the main and default source of law. Therefore, it was important to evaluate the possibility of the country adapting for its own use any of the modern legal rules and traditions of the West in the area of corporate governance. It was found that there have been periods in the history of Saudi Arabia which have witnessed a major transplantation of various rules and traditions in the financial and commercial fields, since the emergence in 1927 of conventional financial banking; such transplantation must be in conformity with the Islamic principles inherent in Shariah, encompassing a degree of morality and business ethics. This trend was found to have been particularly clear since the promulgation in 1992 of the country's first written constitution, which gave rise to the notion of a duality in the legal system. The strength of this trend made it inevitable for the thesis to argue

that Shariah judges in the new commercial court would need to build and develop a body of law, not only based to some extent on the country's transformation of a body of modern rules and traditions, but also through the new Saudi commercial court contributing to the development of company regulations in different circumstances, aiming to create a responsive legal doctrine similar to that of the UK and other common law countries.

Indeed, the functioning of the judicial system is closely interrelated with that of the corporate governance regime, which is believed to provide a more valid indicator of the extent to which shareholders will chose to engage in activism.

7.2.5 Limitations of Internal and External Corporate Governance

Against this background, it was crucial for the thesis to focus more closely on the causes of the failures of internal and external corporate governance mechanisms and to emphasise the important role of institutional investors as an external mechanism of corporate governance appropriate to the Saudi context. This was done in chapter 6,³ where an assessment was made of the effectiveness of internal and external corporate governance mechanisms selected from among those discussed in chapter 2, such as external audits and the inclusion on the board of non-executive and independent directors. The main finding was that the existence of various causes and influential factors, such as the prevalent culture of Saudi society and the position in it of controlling shareholders, which are likely to weaken existing internal and external corporate governance mechanisms, reducing their effectiveness in addressing the agency problem, confirms the assertion made in chapter 2 that such mechanisms alone do not constitute an effective regime of corporate governance and that there is a need for institutional shareholder activism to reinforce the existing mechanisms and for such shareholders to work collectively to build an effective corporate governance monitoring framework.

³ Section 6.4.

7.2.6 Corporate Governance Approach to Directors' Duties

Chapter 6 next considered the responsibilities and duties of the board of directors, beginning with its fundamental duty to act so as to best promote the interests of the shareholders.⁴ It was found that although the Saudi approach was distinctive in merging elements of the shareholder primacy model and the stakeholder approach, thus to some extent sharing the ideology of the new UK approach of enlightened shareholder value, this approach could still not be considered comprehensive. There was also an awareness of linguistic limitations; the splitting of the specification of directors' duties between the SCR and the CGR was seen to make interpretation of the language challenging, so that it would be difficult for directors to understand it clearly. Furthermore, those directors who do appreciate the board's duty to pursue stakeholders' interests and social engagement may well find that their capacity to influence it towards the exercise of these responsibilities is diminished by the growing dominance of family ownership and the presence in most Saudi publicly-traded companies of a large percentage of retail investors, whose sole interest is to maximize their financial return. This encourages the role that institutional investors may play in stimulating CSR through responsible investment practice and influencing the boards of the companies in which they invest.

7.2.7 Institutional Investors' Preference in Shareholder Protection

One of the main conditions discussed throughout chapter 6 as being necessary in order to encourage the activism of institutional investors is the protection of minority shareholders' rights. Although the SCR and CGR incorporate several provisions in favour of the minority shareholders, they fail to protect minority shareholders adequately; the thesis has found that the Saudi culture of corporate governance pertaining to the protection of minority shareholders rights is very limited. In particular, the thesis challenges the behaviour of institutional investors regarding the protection of minority shareholders in the country, which has been found to be consistent with the anti-self-dealing index.⁵ The overall conclusion from these theoretical considerations was that the protection of minority shareholders in Saudi Arabia is weak and that

⁴ Section 6.5.2.

⁵ S Djankov et al, 'The Law and Economics of Self-Dealing' (2008) 88 J Financial Economics 454 <sciedirect.com/science/article/pii/S0304405X08000160>, [Accessed on 05/03/2014].

reforms are necessary to protect their interests. For example, proxy voting should be made easier by removing the requirement for proxy votes to be submitted in writing, especially given the assertion that institutional investors view proxy voting very positively as likely to influence the company's governance.

7.2.8 Shareholder Remedies

It was noted in chapter 6 that the SCR is a fundamental element of corporate governance legislation and a good example of its development in the Kingdom, helping to explain the country's propensity to respond to various developments in the global economic and investment fields by replicating them in its financial and business environment in order to build the legal framework necessary to cope with these developments.⁶ This is particularly true when it is recognized that litigation is considered a legitimate external corporate governance mechanism, appreciated as a substitute and an effective monitoring tool in the hands of institutional investors as minority shareholders. Furthermore, enhanced transparency is desirable to prevent the risk of exploitation by self-dealing directors, in the light of the inadequacies of the legal rights granted by the SCR and the CGR to protect minority shareholders' interests. Such rights could be enforced by the use of derivative actions; suing the company directors and holding them liable for any breach of duty could compensate for the inadequacies of the legal rights granted by the SCR and CGR, and loosen the control currently enjoyed by directors. But the thesis finds that derivative action has not strengthened the position of minority shareholders functionally and effectively, as the agency problem between shareholders and managers is not considered a major issue; rather, conflict between minority shareholders and controlling corporate owners is the principal concern in Saudi Arabia and certain amendments to the derivative action provisions under the SCR are necessary if this remedy is to offer a good level of protection for minority shareholders. There is a need to establish new grounds for minority shareholders to take derivative action against controlling shareholders who may engage in tunnelling activity, such as imposing their influence on the company to benefit themselves at the expense of the minority, stealing the company's assets or benefiting themselves in other ways.⁷ In such

⁶ Section 6.3.1.

⁷ Tunnelling is principally to be explained as 'the transfer of assets and profits out of firms for the benefit of their controlling shareholders. ... [T]he term tunnelling, coined originally to characterize

circumstances, the derivative procedures against the controlling owners would be the use of broader grounds, accommodating more wrongs that would be subject to litigation for the aggravated minority shareholders, including for instance the abuse of minority shareholders, recklessness, negligence and expropriation, when committed by controlling owners. In this case and in order to prevent multiple legal actions being taken by minority shareholders, the Saudi commercial court should be given full discretion under certain criteria and guidance, such as that the court should take into account all the related circumstances, including the good faith of the minority shareholders and the company' interests, to determine whether the aggravated minority shareholder would be granted permission to pursue an action.⁸

7.2.9 Institutional Investors as an External Corporate Governance Mechanism

A related issue addressed by chapter 6 is the need to identify elements of the Saudi corporate governance regulatory framework that would encourage and support the activism of institutional investors. Here, the central finding was that the current framework does not provide such encouragement and that its support for shareholder activism is relatively weak; nor has such activism been obvious in the investment practice of various institutional shareholders. Therefore, the thesis next undertook a deeper analysis of the factors that might weaken the influence of institutional investors and their role as an acceptable corporate governance mechanism to reduce agency costs in Saudi publicly-traded companies. The first obstacle is the requirement to submit proxy votes in writing and the poor availability of options such as electronic proxy voting; the use of agencies providing proxy voting services not only adds direct costs for institutional investors who attempt to engage in corporate governance, but appears to be deliberately intended to prevent them from using a preferred channel of engagement to elect directors of their choice or to vote against resolutions of the controlling shareholders. Secondly, the thesis identified an absence of comprehensive provisions imposing detailed requirements on institutional investors or even of guidance to

the expropriation of minority shareholders in the Czech Republic (as in removing assets through an underground tunnel), to describe the transfer of assets and profits out of firms for the benefit of those who control them.' Simon Johnson et al, 'Tunnelling', (2000) NBER Working Paper No.7523, 1-2, <<http://nber.org/papers/w7523.pdf>>, [Accessed on 05/03/2014].

⁸ Shariah principles require persons in positions of responsibility or authority, including controlling owners, to act with morality, truthfulness, trustworthiness, generosity and leniency, which may be assumed to create the sense of a general duty to exercise reasonable care.

encourage them to disclose their voting practices and policies publicly on their websites. A third related weakness was found to be a general lack of willingness to disclose ways of dealing with any material considered to represent a conflict of interest, especially as it was assumed that many institutional investors are under the influence of their affiliates or business-relational conflict and that potential conflicts of interest may be identifiable in many ways in the Saudi environment of concentrated ownership, where the indirect costs of activism will be correspondingly high.

7.2.10 Institutions as Responsible Investors

Consequently, the thesis found strong reasons to support institutional investors' possible decisions to adopt socially responsible policies, as they would have the incentive to ensure that the board acted to advance shareholders' interests without disregarding its duties towards other stakeholders or its wider social and environmental responsibilities. The thesis argued that since most institutional investors showed no concern for shareholder activism to promote social welfare, it would perhaps be appropriate to provide guidance in an attempt to boost social responsibility amongst those with long-term investment horizons, particularly government pension funds, since they are well positioned as dominant owners in the Saudi capital market to produce economy-wide social benefits alongside financial returns.

7.3 Proposed Framework for Institutional Activism

It was noted in chapter 6 that the UK corporate governance regime is seen as the gold standard for tougher implementation of corporate governance regulatory frameworks and mechanisms,⁹ leading various other countries to adopt it as their model for developing good corporate governance regimes.¹⁰ One indication that the UK regime is considered to foster the protection of minority shareholders and long-term capital market stability, making UK publicly-traded companies more attractive, is the strong presence in the UK market of foreign institutional investors, who would normally account for only a small minority of holdings; indeed, the UK's success in this field is

⁹ Section 6.3.1.

¹⁰ P Montagnon, 'The Role of the Shareholder' in K Rushton (ed), *The Business Case for Corporate Governance* (Law Practitioner Series, Cambridge University Press 2008) 5.

such that it can be seen to have become a global hub for institutional investors.¹¹ Although the Saudi corporate ownership structure differs from that of the UK in being dominated by the government and relatively rich families, recent years have seen the emergence of diffused ownership and substantial growth in institutional investment; indeed, the findings of the thesis indicate that Saudi Arabia has the potential to emulate the success of the UK, raising the possibility of its becoming a base for the activities of institutional investors in the Middle East and Gulf region, as its capital market becomes more attractive to international capital flows from institutional investors with a variety of investment objectives and approaches, as well as to companies wishing to raise money. The thesis has claimed that the presence of institutional investors in the Saudi capital market appears to serve as an effective corporate governance mechanism, among others, and has the potential to act as an incentive to reduce agency problems in Saudi publicly-traded companies by rebalancing the power of governance, thus assisting the efficient operation of the Saudi capital market, reinforcing good corporate governance practice and strengthening the performance of Saudi firms. The way to achieve these benefits, this thesis suggests, is to adopt the UK corporate governance regime and learn from its experience, which may provide beneficial lessons, specifically contributing to the growth of institutional shareholder activism and the protection of minority shareholders. However, this thesis does not aim to offer a full account of all the modifications that should be made, but rather to outline the general direction of an effective framework, formulating proposals that are important for institutional investors' activism and good corporate governance in Saudi Arabia, as set out in the remainder of this section.

7.3.1 A Quasi-mandatory Stewardship Code for Saudi Institutional Investors

Generally speaking, institutional investors in Saudi Arabia have typically made a long-term commitment and had a long-term investment horizon, which shows clearly the role that should be given to them as a potential incentive in promoting good corporate governance and the value of corporate change in enhancing long-term performance. Yet the impact of Saudi institutional shareholders' activism is limited by the deficiencies of

¹¹ John Kay, 'Kay Review of UK Equity Markets and Long-Term Decision Making' (2012) 31 <<http://bis.gov.uk/assets/BISCore/business-law/docs/K/12-917-kay-review-of-equity-markets-final-report.pdf>>[Accessed on 05/03/2014].

the Saudi regulatory framework, which has given insufficient attention to shareholder empowerment, leaving institutional shareholders relatively apathetic, weakening their otherwise powerful position and reducing the extent of their interest in the long-term performance of Saudi companies. One of the most striking recent regulatory deficiencies impacting on institutional investors' activism is the Saudi cooperative insurance investment law, issued in 2012, which completely neglects their responsible role in activism. Another such deficiency is the failure of the Saudi government to recognize the need to regulate the investments of public pensions funds, indicating a lack of awareness of the exceptionally influential role that they can play as owners of large holdings in many publicly-traded companies and their long history of investment in the Saudi capital market. Perhaps more surprising is the ambiguity and lack of detail in article 6 of the SCR, as discussed in chapter 5, which is considered another weakness of the Saudi regulatory framework, as it does not give comprehensive guidance on the active engagement that Saudi institutional shareholders should consider, nor does it suggest what role they might be presumed to play in corporate governance. Such regulatory deficiencies raise the question of what lessons the Saudi government and regulators can learn from the UK in order to make more constructive use of the power and influence of Saudi institutional investors in promoting good corporate governance and changes to corporate practice in favour of long-term performance. Generally, it can be said that ethical guidance associated with article 6 of the CGR might appropriately emulate the UK stewardship model to resolve the problems arising from the various deficiencies of the Saudi regulatory framework. More particularly, there are many important elements of the UK Stewardship Code, encouraging institutional investors to use various corporate governance mechanisms, which could usefully be adopted by Saudi policymakers to improve article 6 and thus to give institutional investors a role in promoting good corporate governance practice in investee companies by encouraging them to adopt certain voting policies. For example, apart from disclosing their voting policies, the associated guidance should encourage institutional investors to consider carefully explaining how they carry out their duty to act in the best interests of their clients or owners, when considering their use of proxy voting as a way of making them more accountable to these clients and owners. They should also be encouraged to have regular meetings and dialogue with the boards of directors of the companies in which they invest, to help improve the companies' approach to seeking long-term returns.

It is not suggested that such guidance would offer a valid alternative to removing the ambiguities of article 6 of the CGR, however; the author propose that Saudi policymakers should take steps to bring this article into line with the high standard of modern principles by designing it to provide a foundation for a long-term perspective and SRI in the Saudi capital market. This could be done by considering the establishment of separate regulations, which might be found to be more fruitful in constructing and developing a platform for an activist culture and promoting long-term decision-making, especially in light of the lack of knowledge and awareness of many Saudi institutional investors of activist activities and good corporate governance practice.

However, while many important issues are addressed in the UK Stewardship Code through its comply-or-explain regime, a minimally mandatory approach may prove more appropriate to the purpose of the proposed institutional investors' engagement code, in order to promote more transparency and higher quality in Saudi institutional investors' activism. Indeed, apart from encouraging Saudi institutional investors to establish voting policies and to disclose their voting activities, it would be appropriate to encourage them to establish a policy on dealing with any conflicts of interest which may arise by means of a comply-or-explain regime. Close consideration should be given to adopting a minimally mandatory approach if necessary, to address the complex risk of conflicts of interest, which have seriously affected the Saudi business environment as a result of concentrated ownership and a long history of close business and cultural relationships among many financial institutions. Beside assisting institutional investors, as mentioned in chapter 6,¹² to establish their own internal governance practice, such an approach would be likely to help to reduce the complexity of any conflicts of interest.

7.3.2 The Internal Governance of Institutions

Adopting an effective framework of internal corporate governance and a system of better functioning internal controls, risk management systems and audit functions enhances corporate transparency and accountability, particularly in light of the high standards imposed by a Shariah supervisory board, which is considered an important

¹² Section 6.6.2.

part of the ICG principles and a key element of good corporate governance for Islamic institutional investors. The author believes that such corporate governance practice would satisfy the interests of all clients and owners and present a good image to potential Saudi investors. Moreover, a high standard of internal corporate governance might play a key role in the diagnosis of investment limitations in public pension funds and cooperative insurance companies, which are supposed to be in the forefront of SRI. It would have the potential to increase the quality of their investments in the Saudi capital market, to foster and stimulate their CSR initiatives and to increase the use of different corporate governance mechanisms in order to reflect the commitment of the board of directors to maintain a better balance between the shareholders' wealth on one hand and the diverse interests of various stakeholders and social objectives on the other.

7.3.3 Forming Representative Institutions and Monitoring Bodies

It would be optimistic to claim that establishing quasi-mandatory principles of institutional investors' engagement and encouraging internal governance would suffice to ensure a definitive move towards activism and good corporate governance practice among institutional investors. Institutions will determine their own policies on the basis of various industry-wide schemes and their diverse investment approaches. The author suggests that enhancing the establishment of industrial associations in Saudi Arabia would greatly strengthen the linkage between institutional investors' engagement and the corporate governance regulatory framework; such associations would have the ability to show Saudi institutional investors how their social engagement and good corporate governance practice could be properly achieved through a range of accessible and instructive guidelines and supporting statements, thus ensuring that individual institutions did not rely solely on publicly-traded companies adopting individual policies and acting in their own self-interest.

7.3.3.1 Saudi trade associations

Another suggestion is that the Saudi government should establish representative institutions and monitoring bodies to lobby for increased homogeneity among institutional industrial schemes, operating under one umbrella in order to promote institutional activism and good corporate governance practice. Indeed, a hallmark of

successful shareholder activism and good institutional governance practice in the UK is the establishment of trade associations such as PIRC, the ABI and the IIC, which have all been active to varying degrees in promoting institutional shareholder engagement in corporate governance. The author suggests that establishing such associations in Saudi Arabia would be realistic, would maintain a high level of economic development and growth in the institutional investment industry and would be consistent with the Saudi government's economic objectives of reducing government control and increasing the importance of the free market in the financial and trade sectors. These associations might be established first under the control of the CMA and SAMA, as they are the main government bodies that regulate and control the operation of cooperative insurance companies and mutual funds, but the ultimate objective should be to create self-standing and independent associations with their own specialized professional staff and industrial experts, as there is no empirical evidence that PIRC, the ABI or the IIC should be controlled or managed by the UK government. Indeed, the CMA and SAMA, as regulators burdened with substantial supervising roles and bureaucratic functions, lack the flexibility and capacity to both adhere to the political agenda and to keep abreast of global developments in the institutional investment industry; their attempts to do so might actually undermine the establishment of representative institutions and monitoring bodies in Saudi Arabia and hinder the development of their effectiveness.

In light of the UK experience, it is suggested that such trade associations might attain success in promoting the engagement of institutional shareholders in corporate governance in Saudi Arabia in three ways: by assessing the routine actions of institutions in terms of activism and good corporate governance; by developing high-level engagement policies and good governance practice; and by maintaining a high level of growth in the Islamic financial investment market. Each of these is discussed below.

7.3.3.2 Assessing the routine actions of institutions in terms of activism and good corporate governance

It is assumed that representative institutions and monitoring bodies established in Saudi Arabia would pursue the same objectives as the equivalent UK trade associations: to encourage the foundation of a sound culture of activism among Saudi institutional

investors and to increase their awareness of good corporate governance practice, which would thus be strengthened in Saudi publicly-traded companies. the author suggest that establishing such trade associations would represent the first stage of inculcating an activism culture by developing a clear, rational and well-structured industrial network of communication and mutual understanding among Saudi institutional investors. They would publish recommendations and issue guidance to such investors to facilitate their exercise of their governance rights, to help them to adopt strategies of strong practical engagement with investee companies, to exercise the voting rights attached to their shares, to enhance corporate accountability and the use of various corporate governance mechanisms, to discipline managers and encourage successful intervention in the companies, to achieve and maintain high standards of corporate governance and to achieve the long-term financial stability of their investments.

7.3.3.3 Developing high-level engagement policy and good governance practice

Perhaps among the diverse achievements of which these bodies would be capable is the drawing up of policies of engagement to help institutional investors set out ways to use their voting to improve long-term returns and increase standards of governance in Saudi publicly-traded companies. An example of a statement of shareholder responsibilities published by a trade body in the UK is the IIC Statement of Principles on the Responsibilities of Institutional Shareholders and their Agents, which aims to help institutional investors in the UK to approach engagement with companies and to develop their own engagement policies in relation to their responsibilities in respect of investee companies. the author suggest that it would be of particular value for Saudi representative institutions and monitoring bodies to emulate this function and benefit from the experience of Western partners through a programme of communication and exchange with UK trade associations or with European organizations such as the European Corporate Governance Institute, which could provide professional training programmes to ensure that the Saudi institutions received appropriate support in establishing their engagement policies. As Saudi institutional investors are unfamiliar with the operation of such engagement policies, advice on this and guidelines on voting policy are believed to be necessary to help them to establish suitable policy standards. More practically, a key objective for Saudi representative institutions and monitoring bodies would be to enhance the quality of dialogue with Saudi institutional investors, so

that they might operate more efficiently and to enable them to voice their interests and concerns as a positive result of engagement and dialogue, thus reducing the free-riding problem in the Saudi capital market. For example, a framework should be developed to enhance the coordination and collation of the different engagement practices of institutional investors, especially public institutional investors, and to encourage dialogue on the progress of CSR in the companies in which they invest, thus ensuring that the boards of investee companies respond to their concerns and are in alignment with their interests.

7.3.3.4 Maintaining high growth in the Islamic financial investment market

The recent emergence of an Islamic institutional investment market in Saudi Arabia makes the establishment of representative institutions and monitoring bodies more beneficial in my view, as they would play a significant role in maintaining a high level of economic development and growth in that market, assisting restructuring, supporting the proper performance of activism, ensuring the compliance of Islamic institutional investors with their internal governance policies and initiating efforts to improve them by providing a sound framework of corporate governance and fostering CSR. The author suggest that such associations might play an academic role by sponsoring research and facilitating the development of alternative Shariah institutions such as Islamic hedge funds, which are essential to meet the demand for alternative portfolio investments and to stimulate the tendency of conventional hedge funds to adopt activism. These representative institutions and monitoring bodies might also play a vital role as external monitors of Shariah compliance, providing Islamic institutional investors with comprehensive lists of equities or companies for compliance with Shariah-based criteria. A key objective that could be given to them is to act as Shariah monitoring specialists where there is no central Shariah regulator or advisory body to issue generally applicable interpretations of Shariah (*fatawa*) with which the management of Islamic institutional investors must comply. They could also be involved in setting up standards and guidance for the Shariah supervisory board, as a key part of the governance structure of Islamic institutional investors, ensuring their good practice and working closely with fund managers on policies and guidelines to cover adequately all aspect of Shariah investment.

Finally, foreign experience might have the beneficial effect of helping to develop a positive activism culture and to motivate good corporate governance practice among Saudi institutional investors. For example, UK pension funds, as long-term pooled investments, seems instinctively to have the potential to inspire and help to develop a positive activism culture in Saudi Arabia, since they have been urged under the Stewardship Code to use their best efforts to apply the Code's principles to overseas equity holdings.¹³ It has been argued that foreign institutions from countries with strong shareholder protection can play a role in promoting good governance practice in the host countries.¹⁴ Other scholars have asserted that foreign institutional investors are more willing to play a special role in changing corporate culture and practice than are local institutional investors, who may be restrained by loyalty and business relationships with the company concerned.¹⁵ Such a contribution could be made by foreign institutional investors if the Saudi government and regulators were to allow foreign institutional investors to invest directly in the Saudi capital market, instead of having to do so through swap agreements whereby they are prohibited from exercising the voting rights attached to their shares. Indeed, the author propose that the Saudi government and regulators should encourage FDI by institutions which may have an interest in investing in Saudi Arabia, particularly foreign institutional investors with a long-term investment horizon, as they are more likely to play a unique role in exporting good governance to many Saudi investee companies and can potentially apply their experience of activism to inculcate a more attractive engagement culture in the Saudi capital market.

7.3.4 Protection of Minority Shareholders' Rights

As Saudi Arabia is a developing country with a corporate environment of highly concentrated ownership, the level of protection of minority shareholders is critical in providing the necessary conditions for greater engagement by institutional shareholders and in strengthening their position by making directors accountable for their decisions. The thesis has found that the rights granted to minority shareholders under Saudi

¹³ Financial Reporting Council, 'The UK Stewardship Code' (2012) 3
<frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx>[Accessed on 05/03/2014].

¹⁴ R Aggarwal, PAC Saffi and J Sturgess, 'The Role of Institutional Investors in Voting: Evidence from the Securities Lending Market' (2012) Georgetown University Working Paper 178
<<http://ssrn.com/abstract=2023480>>[Accessed on 05/03/2014].

¹⁵ SL Gillan and L Starks, 'A Survey of Shareholder Activism: Motivation and Empirical Evidence' (1998) 16-29 <<http://ssrn.com/abstract=663523>>[Accessed on 05/03/2014].

legislation are broadly similar to those of their UK counterparts, such as the default rules of the voting system: one vote per share, proxy voting, the right of the holders of a small percentage of shares to call for an EGM and the right to submit proposals and add items to the AGSM agenda. Within this context, the most pressing issue raised in this thesis and considered most significant in enabling and encouraging institutional investors to act responsibly in relation to the companies whose shares they hold concerns a specific aspect of proxy voting: the need for Saudi policymakers to allow all shareholders to use electronic methods to submit their proxy votes, instead of having to do so in writing.

It has also been noted that UK institutional investors are able to outsource their proxy voting to third-party providers such as RREV, PIRC and Euroclear. The author suggests that one important function of the representative institutions and monitoring bodies in Saudi Arabia could be to provide such services to enhance the exercise by Saudi institutional investors of their proxy voting rights, which might help to minimize potential conflicts of interest among institutional investors differing in investment perspectives and philosophies according to their fiduciary responsibilities.¹⁶ It might be convenient for them to work initially with outside proxy voting experts, who could offer a high level of professional guidance, report to Saudi institutional investors and increase their understanding of how to use proxy voting appropriately to influence investees' operational performance and to practise their engagement efficiently.

This thesis has also noted that most of the rights of minority shareholders are specified either under the SCR or the CGR, the latter comprising both a separate set of regulations which exist independently of the former and others whose purpose is to supplement substantial segments of the SCR. While the fundamental purpose of the universal norms set out in the CGR may be supposed to be to embody extensive guidance for the practice of good corporate governance while avoiding any potential conflict with the rules embodied in the SCR, it appears to focus more on specifying lapses than on important areas of best governance practice. For example, the CGR fails to cover many key components of effective principles and governance procedures considered necessary to strengthen corporate governance culture in the light of the highly concentrated nature of Saudi corporate ownership. The author proposes that its

¹⁶ B Bushee, ME Carter and J Gerakos, 'Institutional Investor Preferences for Corporate Governance Mechanisms' (2009) 5 <<http://ssrn.com/abstract=1070168>>[Accessed on 05/03/2014].

rules and standards should therefore be extended to encourage companies to facilitate the exercise of ownership rights by minority shareholders, such as by adopting the principles laid down in Section E of the UK Corporate Governance Code of 2010, which sets a clear example to Saudi policymakers to adopt a tripartite focus: on stipulating in greater detail how company boards should ensure that dialogue of a satisfactory quality takes place with shareholders; on explaining how to use the AGSM to communicate with investors and to encourage their participation; and on determining how the company should deal with proxy voting in the AGSM.¹⁷

7.3.5 Corporate Governance Approach to Directors' Duties

On the other hand, although the CGR contains various additional important provisions related to directors' duties and responsibilities, these could justifiably be seen as ordinary universal regulations in the company law field, to be embodied with other directors' duties and responsibilities under the umbrella of the SCR, while it would make more sense for the CGR to be replaced by an integrated framework of clear and meaningful guidance to directors as to their duties and what is expected of them. This would improve the quality of their decision-making in running the company and the exercise of their fiduciary and leadership functions, with the ultimate objective of realizing long-term shareholder value. It would promote more transparent and effective procedures and standards for appointing independent directors and reinforcing their independence of judgment, so as to avoid close relationships with other board members, whereas, as discussed in chapter 6,¹⁸ they are habitually selected by the majority owner of the company for their loyalty rather than their skills and objectivity, which affects the quality of independent directors so that they do not meet the expectations of institutional investors, many of whom see independent directors as important in ensuring good corporate governance and encouraging activism.¹⁹ Indeed, institutional investors, especially foreign ones, believe that in an ownership environment such as that of Saudi Arabia, the companies in which they invest, especially those dominated by families or

¹⁷ Section E 'Relations with Shareholders' of UK Corporate Governance Code 2010.

¹⁸ Section 6.4.3.

¹⁹ J McCahery, L Starks and Z Sautner, 'Behind the Scenes: The Corporate Governance Preferences of Institutional Investors' (December 13, 2010) AFA 2011 Denver Meetings Paper; Tilburg Law School Research Paper 010/2010, 22 <SSRN: <http://ssrn.com/abstract=1571046>>[Accessed on 05/03/2014].

the government, should have an effective structure of independent directors to protect the interests of minority shareholders.²⁰

The dependence upon the monitoring activities of independent directors is also called into question by the World Bank, which states in its assessment of corporate governance in Saudi Arabia that the independent directors' responsibilities for monitoring on company committees are left to be wholly decided by the articles of association.²¹ The author proposes that Saudi policymakers should instead draw up a comprehensive framework of guidance and supporting principles, based, for example, on sections A and B of the UK Corporate Governance Code of 2010, setting out how to achieve a clear division of responsibilities between the running of the board and the executive responsibility for the running of the company's business; under such guidance, the monitoring function of independent directors would be an effective tool helping board committees to promote the quality of business decisions and the ultimate interests of the company.

In response to the general comparative view of directors' duties, the Saudi legislators can learn from the recent set of UK statutes defining these duties in the Companies Act 2006. First, it can be said that directors' duties in Saudi Arabia are essentially similar to those of their UK counterparts. This thesis has found that the two countries share a belief in the value of a corporate governance approach to directors' duties, while the UK Companies Act 2006 reflects the enlightened shareholder value model, in response to the strong presence of institutional investors in the UK capital market and to UK membership of the EU; the 2006 Act thus takes 'a small step in the direction of the European stakeholder model'.²² In Saudi Arabia, the corporate governance approach to directors' duties is inspired by two factors: the Anglo-American shareholder primacy model and the influence of Shariah principles on attitudes to stakeholders and society as

²⁰ Jin Q Jeon and Juyoun Ryoo, 'How do Foreign Investors Affect Corporate Policy? Evidence from Korea' (2013) 25 *International Review of Economics and Finance* 63
<sciencedirect.com/science/article/pii/S1059056012000378>[Accessed on 05/03/2014].

²¹ World Bank, 'Report on the Observance of Standards and Codes (ROSC), Corporate Governance Country Assessment: Kingdom of Saudi Arabia' (2009) 34
<worldbank.org/ifa/rosc_cg_saudia_arabia.pdf>[Accessed on 05/03/2014].

²² VE Harper Ho 'Enlightened Shareholder Value: Corporate Governance beyond the Shareholder-Stakeholder Divide' (2010) 36 *J Corporation Law* <<http://ssrn.com/abstract=1476116>>[Accessed on 05/03/2014].

a whole.²³ Consequently, although article 1(a) of the CGR declares that its rules and standards reflect best governance practice that would ensure the protection of shareholders' rights as well as the rights of stakeholders, the author believe that Saudi policymakers would do better to be guided by the specification of directors' duties under the UK Companies Act 2006, particularly section 172, whose incorporation would be significant in requiring an extension of the duties of Saudi directors to consider the interests of various stakeholders and to focus on long-term performance. This would ensure a balance between the adoption of the shareholder primacy model and the Shariah as the main force governing the regulatory framework of Saudi Arabian company law. There is also an awareness of the limited language and the splitting of the directors' duties between the SCR and CGR, leaving broad scope for interpretation of the language and therefore making it difficult for the directors to understand it clearly.

It would appear necessary for Saudi policymakers to develop and formulate a specification of directors' duties couched in comprehensive and constructive language, so that the directors of Saudi publicly-traded companies can better comprehend what they are expected to achieve and to be conscious of, taking into account both the interests of shareholders and the broader interests of stakeholders.²⁴ Such a formulation should prevent any misperception of interests that may arise and any conflict between enhancing the personal interests of the shareholders and stakeholders' wellbeing. Therefore, this thesis recommend that Saudi policymakers should take into consideration and be inspired by the recent comprehensive common law approach to directors' general duties that has been developed under the UK Companies Act 2006,

²³ Hafeez states that 'The Islamic economic and corporate governance system entails implementation of a rule-based incentive system to ensure an efficient governance system to preserve social justice. The Islamic rule-based system of corporate governance inflicts the organisational framework to compel managers to internalise the welfare of all stakeholders. The observance of rules of behaviours ensures internalisation of stakeholders' rights that need institutional arrangements. The stakeholders-model of Islamic corporate governance envisaged the fiduciary duties to the corporate managers to run the affairs of companies in the best interest of all stakeholders.' Malik Hafeez, 'An Analysis Of Corporate Governance in Islamic and Western Perspectives' (2013) 2(3) IJBE 102 < <http://klibel.com/wp-content/uploads/2013/05/MALIK-M-HAFEEZ-An-Analysis-of-Corporate-Governance-in-Islamic-and-Western-Perspectives.pdf> > [Accessed on 05/03/2014].

²⁴ As discussed in chapter 1, Shariah recognises the interests and rights of stakeholders. The best institutional arrangements can protect their interests and rights to generate best results of corporate sustainability, social and economic justice. The Shariah principles of corporate governance include the protection of all stakeholders' interests through internal organisational arrangements in many forms, such as active participation in the processes and structures of corporate governance, or the duties and practices of directors that encompass the ultimate objective of considering long-term shareholder value, whilst taking into account the interests of other stakeholders.

where the board and its powers are more clearly understood in the UK, without reference to company by-laws for explanation. This should reflect a high level of transparency and responsibility among Saudi directors towards the company and particularly the interests of minority shareholders and stakeholders.

7.3.6 Maintaining Effective Minority Shareholders' Remedies

A final set of proposals concerns legal remedies available to aggrieved shareholders: this thesis considers facilitating litigation such as derivative action to be an important supplementary corporate governance tool in the hands of institutional investors as minority shareholders, helping them to solve corporate governance problems and to control managerial power. Although there is no provision explicitly designated under the SCR concerning the filing by minority shareholders of legal actions for liability against directors, the author believe that Saudi policymakers should consider emulating the new UK statutory provision for derivative action and carefully widening its scope with more effective mechanisms under which particular legal actions may be brought by minority shareholders against those running companies (generally the directors) for breaches of duty; these should include negligence, carelessness and recklessness, in order to add rigour to the remedies available to minority shareholders under the SCR. On the other hand, the Saudi commercial court should be given the power to issue or withhold permission to pursue derivative actions for genuine reasons, as the low cost of litigation in Saudi Arabia is likely to lead to the court facing a flood of shareholders pursuing litigation on their companies' behalf, with the risk of disrupting corporate business and of diverting the attention of directors from ensuring the success of their companies to defending such legal proceedings. Finally, the Shariah judges of the new commercial courts should be offered intensive training sessions in understanding the UK corporate governance regime and UK court rulings on various corporate governance issues; this would help considerably to improve and modernize the competence of those applying the SCR, including equality of judgment, avoiding legislative pitfalls and adopting a positively tolerant approach. It would increase the confidence of investors in the Saudi judicial system, especially as it would bring it into line with the objectives of recent development of the judicial system and with their important role in the commercial and economic development of the country.

7.4 Limitations

This thesis is limited by a lack of both primary and secondary data, as it is restricted in scope to institutional investors' activism and the protection of minority shareholders in developing countries. A critical and common problem facing any research set in developing countries is the low availability and reliability of data. Thus, a serious limitation of this thesis has been the lack of available data on the matter at hand, either in Saudi Arabia or in other developing countries. A related limitation is that most Western academic and empirical studies of the role of institutional investors' activism and the protection of minority shareholders have considered only developed countries and emerging markets, rarely touching on developing countries. While the present research could have been set in any Islamic country, its investigation and analysis have been mainly restricted to the case of Saudi Arabia.

7.5 Concluding Summary

Although Saudi Arabia's legal system is principally based on Shariah (Islamic law), which is religious in origin and nature, there is a body of modern statute which has been influenced by various modern western traditions, which does not fundamentally conflict with Shariah and which was necessary to develop the country's economy and its financial and capital market sectors. In the area of corporate governance, Saudi policymakers have been influenced by the market model, developed in the UK and the USA and designed to produce corporate governance mechanisms to resolve the agency problem between dispersed shareholders and managers of corporations. In Saudi Arabia, by contrast, concentrated ownership predominates and there is still a high level of controlling ownership by the government and families; thus the agency problem exists between minority shareholders and controlling owners. The primary aim of the corporate governance regime in common law countries, where the shareholder primacy model originated, was to give minority shareholders a greater voice in corporate affairs. Recently, since the global financial crisis of 2007, the focus has shifted towards other measures, such as those to encourage shareholder activism and corporate social responsibility.

Meanwhile, the Saudi corporate governance regime neither reflects a desire to protect minority shareholders by the inclusion of identifiable measures couched in clear

legal language, nor does it give a strong role to institutional investors to play in corporate governance. This has led this thesis to question Saudi policymakers' propensity and intention to solve the agency problem. It also raises the question of whether Saudi Arabia needs to develop and implement a new corporate governance model and mechanisms. The author argue that there is a need for Saudi policymakers to build a framework of institutional investors' activism and the protection of minority shareholders in order to shift the balance of corporate power, to reduce the agency problem in the context of highly concentrated ownership, to be in a better position to advance the interests of stakeholders other than individual investors and boards of directors and to restructure Saudi firms in order to maximize long-term shareholder value. It is important to keep in mind that building such a framework is unlikely to be achieved without reducing the high number of individual investors, whose shareholdings in Saudi publicly-traded companies have grown considerably since the bubble of 2006, placing more money in the hands of financial intermediaries. Taxing individual investors' returns might well discourage them from buying shares directly in the Saudi capital market; in the UK, the tax levied on individual investors after World War II was of central importance in building a 'wall of money' in the hands of institutional investors, as mentioned in chapter 4. However, such a tax measure might not be effective in the modern era, as current technology and high-speed internet access allow individuals to invest directly in any of the world's stock markets with ease.

It is thus imperative to concentrate on educating individual investors and on enhancing their opportunities to invest in financial intermediaries. Unfortunately, there are certain questions surrounding the credibility and transparency of these financial intermediaries towards their beneficiaries, and many individual investors are disillusioned with investment funds because they misunderstand their nature and purpose. In response, the author recommend the reform of regulatory hurdles to amplify the voice of institutional investors and to increase their influence over investee companies' affairs and decisions, intensifying stewardship and making regulatory changes to the diversification requirements and the size of holdings of institutional investors. Such measures would ensure that the potential benefits of activism to institutional investors would outweigh the predicted costs.

Moreover, building a framework to control the behaviour of all participants in the Saudi capital market and building relationships among them based on trust and confidence—such as establishing a clear legal concept of the fiduciary duty of all

institutional investors to act transparently towards their beneficiaries and not to use their position to advance political or business interests or other benefits not directly related to the benefit of their beneficiaries—is important in creating an overall culture more oriented towards long-term investment value and wealth, thus accelerating the future growth of the Saudi economy. Indeed, the current Investment Fund Regulations are silent on defining the fiduciary duties of investment funds. There is a substantial need to define fiduciary concepts and to explain how asset managers should discharge their duties and responsibilities within the boundaries of Shariah. Regulatory improvements should be made by Saudi policymakers to codify the fiduciary principles and practices, which need further enhancement in order to reinforce the development and growth of an Islamic finance industry better aligned to promote sustainable investment success as a means of encouraging investment funds to adopt the best long-term interests of their clients or beneficiaries. Attention should be given to codifying the various duties owed by fiduciaries to their principals, particularly to balance the interests of different groups of beneficiaries and their own interests, with the aim of reforming the governance and efficiency of investment funds, thereby instilling greater investor confidence. The consideration of environmental, social and governance factors should be among the explicit duties of these investment funds. It is important to establish a wide range of equitable legal remedies available to owners, who are presently encouraged to judge fund and asset managers on the basis of their very short-term performance. The court should be given the full discretion to restrict claims and ensure the good faith of the aggrieved owners, to determine whether they should be granted permission to pursue an action against the fund managers.

7.6 Contributions to Knowledge and Practice

The aim of this thesis was to contribute to the debate about mitigating agency problems in modern corporations. While the academic literature has discussed institutional investors' activism and the protection of minority shareholders in developed markets with diffused ownership and considerable institutional shareholding, the role of institutional investors in corporate governance in emerging and developing markets, particularly in the MENA region and in GCC countries including Saudi Arabia, has received little attention. This thesis has contributed by examining this role and the

reality of corporate governance practice in Saudi Arabia, where corporate ownership is highly concentrated in the hands of the government and certain families, evaluating the effectiveness of minority shareholder protection there. It has also contributed to remedying the legal and regulatory shortcomings of the relevant Saudi texts and practices by reference to the implications of influential developments in corporate governance in the UK.

Importantly, this thesis proposes a legal basis on which Saudi policymakers could improve the existing governance structure, promote market transparency, enhance directors' execution of their duties, offer unambiguous protection to minority shareholders and facilitate engagement between shareholders and companies, so as to enhance long-term shareholder value. It has contributed to an understanding of the role of major institutional investors in mitigating agency problems in the light of the highly concentrated nature of Saudi corporate ownership and their function as an external mechanism in fostering improved corporate governance practices to restore the balance of the Saudi capital market by reducing the divergence of interests between minority investors and dominant owners—and in different circumstances between dispersed investors and managers.

It will help Saudi regulators and policymakers to understand how institutional shareholders' activism can aid good governance, ensuring sustainable value for all stakeholders, underlining the need to empower their increased participation in Saudi corporate decision-making, thus mitigating agency costs by establishing a culture of accountability and transparency among institutional investors and developing clear fiduciary responsibility standards among owners and investors. It has provided evidence that the current regulatory framework, associated with the investment characteristics of pension funds, Islamic insurance companies and other Islamic investment portfolios, is not adequately supportive of institutional investors' activism.

It also offers Saudi regulators and policymakers a legal basis on which to address the shortcomings of Saudi legislation by learning from the UK's recent development of self-regulation relating to the responsibilities of institutional shareholders in corporate governance, helping to build an effective framework for institutional investors' activism and the long-term financial stability of their investments. The establishment of appropriate representative institutions and monitoring bodies, using an industry-wide

network of communication and mutual understanding, would mitigate the risks resulting from conflicts of interest, reduce monitoring costs and enhance the coordination and collation of engagement and intervention practices among Saudi institutional investors. The thesis has shown that the influence of foreign institutional investors in the governance of Saudi publicly-traded companies would significantly support the future development of activism practices among domestic institutional investors and improve overall corporate governance standards in the Saudi capital market.

Finally, this thesis is the first comparative study of institutional investors' activism and the protection of minority shareholders in Saudi publicly-traded companies from both legal and practical perspectives, offering clear guidelines to those wishing to research the subject further in order to improve corporate governance practice. Given the scarcity of research in this area, it is hoped that this work can serve as a reference point for future studies of shareholder activism and minority shareholder protection in the MENA region, especially the GCC countries.

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