

**CORPORATE GOVERNANCE:  
THE SAUDI ARABIAN CAPITAL MARKET AND INTERNATIONAL  
STANDARDS**

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## Abstract

This work discusses the extent to which the standards of corporate governance in Saudi Arabia correlate to international standards. In order to answer this question the analytical study looks at corporate governance standards in the United Kingdom and the United States. It also looks at the concept of wealth preservation in Islamic Sharia, in addition to the concept of corporate governance in Islamic Sharia from the perspective of modern Sharia specialists. The study also deals with the way in which the European Union deals with corporate governance issues among EU member nations. The study concludes that although corporate governance measures in Saudi Arabia are being implemented, they can still go further to reach international standards. The study closes by emphasizing the role of the Capital Market Authority in advancing corporate governance in Saudi Arabia and makes suggestions and recommendations aimed at improvement of these standards and the creation of an attractive investment environment for the Saudi capital market.

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## List of Journal Abbreviations

ABACUS	ABACUS
Academy of Management Journal	Acad MJ
Academy of Management Review	Acad M Rev
Accounting, Commerce & Finance: The Islamic Perspective Journal	AC & Fin
Accounting, Organizations and Society	Accounting Org Soc
Administrative Science Quarterly	Admin Sci Q
American Economic Review	Amer Econ Rev
Arab Law Quarterly	ALQ
Auditing	Auditing
Buffalo Criminal Law Review	Buff Crim L Rev
Business Ethics	Bus Ethics
Business	Business
Cambridge Journal of Regions, Economy and Society	Camb J Regions Econ & Soc
Cambridge Law Journal, The	Camb LJ
Cardozo Law Review	Cardozo L Rev
CESifo Economic Studies	CESifo Econ Stud
Chicago Journal of International Law	CJIL
Compensation & Benefits Review	Com & Ben Rev
Contributions to Political Economy	Cont Pol Econ
Corporate Governance - International Journal for Enhanced Board Performance	CGIJ Enh Brd Perf
Corporate Governance	CG
Corporate Governance: An International Review	CGAIR
Corporate Governance: The International Journal for Enhanced Board Performance	CGIJ Enh Brd Per
Corporate Governance: The International Journal of Business in Society	CG Int J B Soc
Critical Perspective on Accounting	Crit Pers On Acc
Delaware Journal of Corporate Law	Del J Corp L
DESA Working Papers	DESA Work Pap
Duke Law Journal	Duke LJ
Dusquesne Business Law Journal	Dusq BLJ
Economics of Governance	Econ Of Gov
Economy & Society	Econ & Soc
Emory International Law Review	Emory Int'l L.Rev.
European Business Law Review	EBLR
European Economic Review	Eur Econ Rev
European Financial Management	EFM
European	European
F&D	F&D
Federal Law Review	FL Rev
Financial Market Trends	Fin Mar Tre
Forum	Forum
Global Finance Journal	Glob Fin J
Global Perspectives on Accounting Education	Glob Pers Accounting Educ
Harvard Business Review	Har Bus Rev
Harvard Law Review	Harv L Rev
Indiana Law Journal	Ind L J
International Corporate Rescue	I Corp Resc

International Financial Law Review	IFL Rev
International Journal of Business Studies	IJ Bus Stud
International Journal of Law and Management	IJL Mgmt
International Review of Law and Economics	I Rev L & Econ
Journal of Accounting and Economics	J Accounting Econ
Journal of Applied Corporate Finance	J Appl Corp Fin
Journal of Banking and Finance	JBFin
Journal of Banking Regulation	J B Reg
Journal of Business Ethics	J Bus Ethics
Journal of Business Finance & Accounting	J Bus Fin Accounting
Journal of Business Strategy	J Bus Strategy
Journal of Business Venturing	J Bus Venturing
Journal of Corporate Accounting & Finance	J Corp Accounting & Fin
Journal of Corporate Citizenship	J Corp Cit
Journal of Corporate Finance	J Corp Fin
Journal of Corporate Law Studies	JCLS
Journal of Economic Geography	J Econ Geo
Journal of Economic Perspectives	J Econ Pers
Journal of Finance	J Fin
Journal of Financial and Quantitative Analysis	J Fin Quan Anal
Journal of Financial Economics	J Fin Econ
Journal of Financial Management & Analysis	J Fin Man & Anal
Journal of International Business Studies	JI Bus Stud
Journal of International Financial Management and Accounting	J Int'l Fin'l Mgmt Acc
Journal of International Trust and Corporate Planning	J Int'l Trust Corp P
Journal of King Abdul Aziz University: Islamic Econ.	JKAU Islam Econ
Journal of Law and Economics	JLE
Journal of Law and Society	JL & Soc
Journal of Management Studies	J Mgmt Stud
Journal of Management	J Mgmt
Journal of Money, Credit and Banking	JMCB
Journal of Policy Analysis and Management	J Pol Anal Mgmt
Journal of Political Economy	J Pol Econ
Journal of Public Health Policy	J Pub Health Pol
Journal of Public Policy	J Pub Pol
Journal of Small Business Management	J Smart Bus Mgmt
JURI Report	JURI Rep
Law and Contemporary Problems	LCP
Law and Policy in International Business	Law & Pol.Int.Bus.
Law and Policy	L & Pol
Legal Studies	LS
LegalWeek.com	LegalWeek
Majallat Jami'at al-Malik Abd al-Aziz. al-Iqtisad al-Islami	Majallat JMA
Management Science and Engineering	Mgmt Sci Engr
Managerial Auditing Journal	Man Aud J
Marketing Science	Market Sci
McGill Law Journal	Mcgill LJ
Mediterranean Politics	Medit Pol
Message of Thaqaalayn	Msg of Thaqaalayn
Middle East Executive Reports	Mid East Exec Rep
Middle East Policy Council Journal	Mid East Council J
Missouri Law Review	Mo L Rev

Modern Law Review	MLR
National Institute of Economic Review	NIER
New Horizon	New Hor
New Left Review	NLR
Notre Dame Law	Notre Dame L
Oxford Journal of Legal Studies	Oxf J L Stud
Oxford Review of Economic Policy	Oxf Rev Econ Policy
Politics & Society	Pol & Soc
Public Budgeting & Finance	Pub Budg & Fin
Public Choice	Pub Choice
Review of Financial Studies	Rev Fin Stud
Review of Islamic Economics	Rev Islam Econ
Serkiyat Mecmuasi	Ser Mecmuasi
SITE Working Paper	SITE Work Pap
SMU Law Review	SMU L Rev
South African Journal of International Affairs	SAJIA
SSRN eLibrary	SSRN eLib
Stanford Law Review	Stan L Rev
Strategic Management Journal	Strat Mgmt J
The Accounting Historian's Journal	A Hist J
The Accounting Review	AR
The American Economic Review	Amer Econ Rev
The American Journal of Comparative Law	Am J Comp L
The American Prospect	Amer Prosp
The George Washington Journal of International Law	Geo Wash J Int'l L
The International Journal of Business Studies	Int J Bus Stud
The International Journal of Not-for-Profit Law	Int J NFP L
The International Lawyer	Int'l Law
The Journal of Economic History	J Econ Hist
The Journal of Economic Perspectives	J Econ Pers
The Journal of Finance	J Fin
The Journal of Legal Studies	JLS
The Journal of Risk and Insurance	JR&I
The Journal of Socio-Economics	J SocEcon
The Quarterly Journal of Economics	QJ Econ
The University of Chicago Law Review	U Chi L Rev
The World Bank Research Observer	WB Res Obs
Thunderbird International Business Review	T'bird Int Bus Rev
U Illinois Law & Economics Research Papers	U Ill L& Econ Res Papers
University of Pennsylvania Law Review	U Pa L Rev
USC CLEO Research Paper Series	CLEO Res Paper Ser
Vital Speeches of the Day	Vital Sp Day
W.L.B.L Library of Congress	WLBL LC

## Table of Contents

Introduction and Methodology .....	10
1 Introduction .....	10
1.1 Purpose of the Study .....	12
1.2 Organization of the Study .....	13
2 Methodology.....	15
2.1 Descriptive and Analytical study of the theoretical aspect .....	16
2.2 Descriptive and Analytical study of the Sharia aspect .....	16
2.3 Descriptive and Analytical study of the legal aspect: .....	16
2.4 Personal Interview .....	16
2.5 Scope and limitations of the paper.....	17
1 Chapter One: Corporate Governance Between the Islamic and Western Perspectives.....	19
1.1 Introduction .....	19
1.2 Governance Framework in Western Perspective .....	20
1.2.1 Western Theories of Corporate Governance.....	21
1.2.2 Differences in Corporate Governance Between Common Law and Civil Countries	27
1.3 The Islamic Perspective of Corporate Governance.....	31
1.4 Sharia Rulings.....	35
1.4.1 Sources of Sharia Ruling .....	35
1.4.2 Characteristics of Sharia Rulings.....	40
1.4.3 Science of Sharia Objectives .....	41
1.4.4 Wealth Concept According to Sharia.....	46
1.4.5 Wealth Management According to Sharia .....	49
1.4.6 Islam and Management .....	60
1.4.7 Islamic Guidelines and Perceptions Applicable to Management .....	61
1.4.8 Consultation ( <i>Al-Shura</i> ).....	61
1.4.9 Teamwork ( <i>Al-Amal Al-Jamae'e</i> ).....	62
1.4.10 Planning ( <i>Al-Takhteet</i> ).....	62
1.4.11 Other Functions of Management and Islamic Culture .....	62
1.5 Financial Risk and the Sharia System.....	63
1.5.1 Definitions of Risk in Islamic Law .....	63
1.5.2 Risk Taking and Banking in Islamic Law.....	64
1.5.3 Risk Assessment in Islamic Law .....	65
1.5.4 Legality of Risk Themes.....	68
1.6 Sharia Supervisory Boards (SSB).....	69
1.6.1 Membership of Sharia Supervisory Boards .....	70
1.6.2 Evolution of Sharia Supervisory Boards.....	71
1.6.3 The Role of SSBs in Financial Service Products .....	72
1.6.4 Reasons for the Rejection of a Fatwa of SSB by Customers .....	73
1.7 Summary and Conclusion.....	73
2 Chapter Two: Corporate Governance: EU and UK Measures .....	75
2.1 Introduction .....	75
2.2 The G8 and G20 Initiatives.....	76
2.3 The European Commission Response .....	80
2.3.1 Evolution of Corporate Governance Principles in the EU – a Background .....	81
2.3.2 Progress in Corporate Governance Measures .....	84
2.3.3 New Proposals of European Commission in the Area of Corporate Governance .....	84
2.4 The EU Corporate Governance Forum .....	87
2.5 Corporate Governance in the EU and the Effect of Corporate Scandals .....	88
2.5.1 Corporate Scandal in the EU – the Parmalat Affair – Views on Corporate Governance .....	90
2.6 Corporate Governance and Harmonization of Legislation in the EU Context.....	93
2.7 Corporate Governance and Disclosure Requirements in the EU .....	94
2.7.1 Principles of European Court of Justice in Corporate Disclosure Requirements .....	95
2.7.2 Corporate Governance and Modernizing the Structure of Boards .....	96
2.7.3 Board Balance and Board Committees .....	96
2.7.4 Corporate Governance and Audit Committees in the EU Context .....	97

2.8	UK Responses to Application of Corporate Governance Principles.....	98
2.8.1	Various Committee Reports and the Development of Corporate Governance in the UK Context	
	100	
2.8.2	Corporate Governance in the UK Financial and Banking Sectors.....	102
2.8.3	Corporate Governance under the UK Financial Services and Markets Act 2000 ...	104
2.8.4	Financial Services Authority and Corporate Governance.....	105
2.8.5	Recent Developments in Corporate Governance in the UK .....	107
2.8.6	Role of Institutional Investors in the UK .....	108
2.8.7	New Combined Code for the UK: The Combined Code on Corporate Governance (Revised June 2008)	
	108	
2.8.8	The Combined Code on Corporate Governance June 2006.....	109
2.8.9	Good Practice from the Higgs Report June 2006.....	110
2.8.10	Internal Control: Revised Guidance for Directors on the Combined Code .....	110
2.8.11	The Combined Code on Corporate Governance 2003.....	111
2.8.12	Audit Committees - Combined Code Guidance (the Smith Report) January 2003	112
2.8.13	The Higgs Report: Review of the Role and Effectiveness of Non-executive Directors January 2003	
	112	
2.8.14	The Combined Code: Principles of Good Governance and Code of Best Practice May 2000	113
2.8.15	Internal Control: Guidance for Directors on the Combined Code (Turnbull Report) September 1999	
	114	
2.8.16	Hampel Report (Final) January 1998 .....	114
2.8.17	Greenbury Report (Study Group on Directors Remuneration) 15 July 1995 .....	115
2.8.18	Cadbury Report (The Financial Aspects of Corporate Governance) 1 December 1992	116
2.8.19	Remarks on Corporate Governance in the UK .....	118
2.9	Banking Corporate Governance in the Aftermath of the Recent Financial Crisis .....	119
2.9.1	Bank Crisis in the UK.....	120
2.9.2	UK Response: Sir David Walker Reports and Recommendations.....	122
2.9.3	The Case of BCCI.....	124
2.10	Conclusion.....	128
3	Chapter Three: Corporate Governance in the United States .....	131
3.1	Introduction .....	131
3.2	Corporate Governance Legislation in the United States .....	133
3.3	US Perspective on Corporate Governance Measures.....	135
3.3.1	Development of Corporate Governance in the United States .....	136
3.4	US Corporate Scandals .....	139
3.4.1	Events Leading to the Bankruptcy of Enron .....	139
3.4.2	Corporate Scandals – Difference in US and European Contexts .....	141
3.5	Sarbanes-Oxley Act.....	145
3.5.1	Purposes of the Sarbanes-Oxley Act.....	146
3.5.2	Salient Features of the Act.....	147
3.5.3	After-effects of the Act .....	163
3.5.4	Effects of Passing of the Sarbanes – Oxley Act on Executive Compensation .....	165
3.5.5	Alternative Forms of Executive Compensation .....	166
3.6	Public Company Accounting Oversight Board.....	167
3.6.1	Corporate Governance and the Structure of the Board of Directors .....	168
3.6.2	Corporate Governance and the Duties of Directors in the US Context.....	169
3.6.3	Corporate Governance and Audit Committees in the US Context.....	171
3.6.4	Role of Accounting in Corporate Governance.....	172
3.7	Corporate Governance and Transparency.....	176
3.8	Impact of Corporate Governance Reforms on Company Performance in the US .....	177
3.8.1	Corporate Governance and Merger Activity in the US.....	180
3.8.2	Fears of Personal Liability and Harm to the Reputation of Directors.....	181
3.8.3	Shareholder Activism and Institutional Investors .....	182
3.8.4	Success of Corporate Governance Systems in the US .....	182
3.8.5	Impact of Sarbanes-Oxley Act and Private Equity Funding .....	184
3.9	The World Financial Crisis and Banking Corporate Governance in the US.....	185

3.9.1	The Bank Crisis in the US .....	185
3.9.2	The US Response.....	187
3.10	Other corporate Governance Concerns .....	189
3.10.1	The Legal Origin of Corporate Governance .....	190
3.11	Conclusion .....	192
4	Chapter Four: Saudi Capital Market Law and Corporate Governance .....	193
4.1	Introduction .....	193
4.2	The Legal System in Saudi Arabia .....	195
4.2.1	The Basic System of Governance .....	198
4.3	Ownership Structure in Saudi Arabia .....	204
4.4	Capital Market Authority.....	206
4.4.1	Duties and Responsibilities of the Capital Markets Authority.....	207
4.4.2	Functioning of the Capital Markets Authority.....	208
4.5	The Saudi Stock Market .....	209
4.6	Saudi Corporate Governance Rules .....	211
4.6.1	Corporate Governance in the Saudi Arabian Banking Sector.....	214
4.6.2	Role of Capital Market Authority in Corporate Governance .....	216
4.6.3	Further Initiatives in Corporate Governance.....	216
4.7	Disclosure and Transparency under Saudi Capital Market Authority .....	219
4.8	Saudi Companies Law of 1965.....	222
4.9	Rights of Shareholders in Saudi Arabia.....	224
4.10	Duties and Responsibilities of the Board of Directors in Saudi Arabia.....	226
4.10.1	Functions of the Board of Directors .....	227
4.10.2	Responsibilities of the Board of Directors.....	230
4.11	Role of Audit Committees in Saudi Arabia .....	233
4.11.1	Formation of the Audit Committee .....	233
4.11.2	Duties and Responsibilities of Audit Committees.....	235
4.11.3	Interview with the Board General Secretary of the National Commercial Bank	236
4.12	Saudi Capital Market Law Regulation and Codes that Meet International Standards .....	240
5	Chapter Five: Summary and Conclusion .....	244
5.1	Summary.....	244
5.2	Conclusion and Recommendations .....	246
	Bibliography .....	261

# Introduction and Methodology

## 1 Introduction

We have all become increasingly aware of the major role played by corporations at national and global levels, a state of affairs that has led the majority of governments to develop systems of market regulation with which these companies have to comply, such as the United States' Sarbanes-Oxley Act of 2002 and United Kingdom's Financial Services Act 2010.<sup>1</sup> They in turn have had a considerable impact on local and international economies. As a result, there has been an increasing interest in the rules of corporate governance globally, particularly in the wake of the collapses and economic crises that befell some East Asian and Latin American countries, in addition to Russia, in the late 1990s.<sup>2</sup> Add to that, the money market scandals among certain US corporations in 2002, following the financial collapses of such giants as Enron and WorldCom that are considered the biggest bankruptcies in US corporate history yet.<sup>3</sup>

Consequently, and as a result of all these events, research and reports on corporate governance preoccupied the interest and attention of governments aimed at developing their systems of market regulation and follow up to protect the liquid assets of corporations from loss and pilferage caused by manipulation, fraud, non-disclosure, lack of transparency in corporate

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<sup>1</sup> See Linklaters, 'FSA Consults on the Financial Services Act 2010' (2010) <<http://www.linklaters.com/pdfs/publications/FinancialServicesAct2010.pdf>> accessed 11 February 2011.

<sup>2</sup> For a discussion of the East Asian financial crisis, see S Radelet, *The Onset of the East Asian Financial Crisis* (NBER Working Paper Series, National Bureau of Economic Research, Cambridge, MA 1998) For details on the Latin American financial that ensued after the East Asian crisis, see L Hastings, 'Financial Crisis and Capital Controls: Latin America' (2000) 7 SAJIA 173-196. For details on the Russian financial crisis of 1998, see T Jithendranathan and N Kravchenko, *Integration of Russian Equity Markets with the World Equity Markets: Effects of the Russian Financial Crisis of 1998* (EFMA 2002 London Meetings, EFMA, London 2002)

<sup>3</sup> G Vinten, 'The Corporate Governance Lessons of Enron' (2002) 2 CG 4-9. For a discussion of the failures of auditors at Enron, see G Cunningham, 'Enron and Arthur Andersen: The Case of the Crooked E and the Fallen A' (2006) 3 Glob Pers Acct Edn 27-48; H Laga and F Parrein, 'Corporate Governance in a European Perspective' (2010) <<http://ssrn.com/abstract=1547722>> accessed 6 December 2010.

financial reporting, and conflicts of interest between personal gain and shareholder primacy.<sup>4</sup> All these were accompanied by disintegration of wealth and complicity in financial crises with national, regional and global ramifications.<sup>5</sup>

Corporate governance issues have been the focus of mostly government departments, agencies and non-government organizations (NGO's) that undertake the overseeing and following up of money markets and those corporations which are involved in a similar sphere, extending to organizations that monitor the financial and monetary behaviour of corporations.<sup>6</sup> This endless and big interest can be logically explained by the importance of corporations, specifically those engaged in money markets, and their effect on individual national economies. It becomes incumbent upon regulatory and supervisory bodies to urge money markets to develop and adopt systems and rules of corporate governance that guarantee the safeguarding of financial assets of companies and money markets against disintegration and collapse.<sup>7</sup> Recently, corporate governance literature has veered the way corporations work.<sup>8</sup> In addition, many studies on corporate governance focus on internal mechanisms. In spite of this fact, this paper will examine both internal and external aspects of corporate governance. The paper will however not focus on offering a critical analysis of the existing standards of corporate governance. Further, the paper

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<sup>4</sup> For a description of the efforts of diverse governments in improving corporate governance policies and practices: House of Commons: Treasury Committee, 'Banking Crisis: Dealing with the Failure of the UK Banks' (HC 416 House of Commons, 2009). See also House of Commons: Treasury Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City' (HC 462 2009).

<sup>5</sup> For a discussion of the international and local forces that combined to produce the 2007-2008 global financial crisis see S French, A Leyshon and N Thrift, 'A Very Geographical Crisis: The Making and Breaking of the 2007-2008 Financial Crisis' (2009) 2 *Camb J Regions Econ & Soc* 287-302.

<sup>6</sup> A Georgosouli, 'Regulatory Interpretation: Conventional or Constructive?' (2010) 30 *Oxf J L Stud* 361. See also A Georgosouli, 'The Nature of the FSA Policy of Rule Use: A Critical Overview' (2008) 28 *Legal Studies* 119-139.

<sup>7</sup> This article argues that internal controls are no longer adequate in the post-Enron and the global financial crisis: M Darrough, 'The FCPA and the OECD Convention: Some Lessons from the U.S. Experience' (2010) 93 *J Bus Ethics* 255-276.

<sup>8</sup> MP Bhasa, 'Understanding the Governance Quadrilateral' (2004) IV *Corporate Governance: The International Journal of Business in Society* 7-15.

will be biased to bank corporate governance rather than the issue of corporate governance in general. The analysis will be based on happening up to recent years, with a clear point on the most recent post financial crisis corporate governance developments in the banking system will also be addressed extensively.

In the Middle East, and particularly in the oil-rich state of Saudi Arabia, the increase in Islamic financial transactions and Islamic stock exchanges in the recent decade has achieved enormous successes and left its mark globally. This phenomenon has led numerous western banks, financial and investment institutions to strive to be competitive in Islamic financial transactions through the establishment of ad hoc channels and divisions. Today we find such terms as ‘Islamic investment’ and ‘Islamic loans’ in the portfolios of several traditional western banks.

It is important to clarify that the enormous development in Islamic banking and finance was caused mainly by the private sector, as represented by Moslem businessmen from Saudi Arabia and the Gulf countries such as Kuwait, Bahrain and the United Arab Emirates, in addition to some Islamic and Arab countries which participated in the development, growth and consolidation of Islamic banks and financial institutions, which put them in the renowned position that they occupy today.

## **1.1 Purpose of the Study**

The aim of this thesis is to answer the question, do the laws and rules of corporate governance in the Kingdom of Saudi Arabia meet minimum international standards, in the light of the reforms in EU, UK and the US? This paper refers to the specific bank corporate governance in the UK/EU, in the US and in the Kingdom of Saudi Arabia and how these jurisdictions implemented international standards. The international standards that are commonly applied by these

nations/regions are Basel II<sup>9</sup> and the OECD Convention.<sup>10</sup> Furthermore, in the event that they do not, what advice can be proposed, which also supports and promotes rules and regulations for corporate governance in Saudi Arabia?

## **1.2 Organization of the Study**

In this thesis we will try to carry out an analytical study of the theories and laws of corporate governance in certain countries and institutions, which are considered global benchmarks and which are used by the majority of countries which seek to develop their monitoring systems and supervision and follow-up on corporations in general and companies in money markets in particular. We have surveyed the European Commission's measures, in addition to countries such as the United Kingdom and the United States as far as corporate governance legislation and codes settings are concerned, and the development of systems of market regulation, follow-up, disclosure and transparency with companies. These are followed by an analytical study of corporate governance in Saudi Arabia and the interplay among the various entities, both governmental and private, in trying to achieve standards that would foster confidence in the Saudi Arabian market.

The study is divided into five chapters. Chapter One provides a brief survey of corporate governance theories in the West, aimed at offering a background description of the concept as it emerged in industrialized nations. The Chapter continues to discuss the concept of wealth in Islamic Sharia. As the Saudi Arabian constitution adopts Islamic Sharia in all its laws,

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<sup>9</sup> See discussion of Basel II and its historical development at DW Arner, 'The Global Credit Crisis of 2008: Causes and Consequences' (2009) 43 Int'l Law 91-136.

<sup>10</sup> For the OECD principles and convention, see these studies: See Darrough (n 7) and A Cornford, 'Enron and Internationally Agreed Principles for Corporate Governance and the Financial Sector' (United Nations Conference on Trade and Development 2004) <[http://www.unctad.org/en/docs/gdsmdpbg2420046\\_en.pdf](http://www.unctad.org/en/docs/gdsmdpbg2420046_en.pdf)> accessed 12 February 2011.

legislations and policies at the legislative, political and economic levels, it was necessary to dedicate a chapter to the study of Islamic Sharia in relation to corporate governance, with special emphasis on the preservation and growth of wealth and its safeguarding.

Chapter Two is divided into two parts; the first deals with measures taken by The European Commission with respect to corporate governance, especially following the financial collapses in Asia, Europe and the United States, while the second part discusses the rules, legislation and codes of corporate governance in the United Kingdom, considered to be one of the most concerned and developed countries in matters pertaining to corporate governance.

Chapter Three is a discussion of corporate governance measures in the United States during the aftermath of financial scandals precipitated by the collapse of Enron and WorldCom, and the legislation that followed in the form of the Sarbanes-Oxley Act of 2002, the details of which reflect the regulatory role played by the federal government in the enforcement of corporate governance laws in the US.

Chapter Four discusses corporate governance in Saudi Arabia, starting with a review of the legal system in the Kingdom, followed by a discussion of the Capital Market Authority and through its partnership with the Ministry of Commerce, its functions and role in regulating various aspects of corporate governance. The chapter also discusses the role of the board of directors and audit committees in shaping the corporate behaviour of companies.

The study ends with Chapter Five and a summary of the previous chapters and makes general recommendations that would enhance Saudi corporate governance and make the system more successful.

## 2 Methodology

The methodological process of this study entails the collection, organization and integration of the collected data. It follows a descriptive and comparative approach, which is also relatively empirical, because of the analysis viewpoint that highly depends on primary sources. Data collection will be the most important step in the success of this thesis, since it will lead to viable and credible findings. This study was based on research into several issues relating to the implementation of corporate governance practices in the EU, United Kingdom, United States and the Kingdom of Saudi Arabia. The dissertation has also drawn information and data from previous research conducted in the field of corporate governance. In this type of study, there are many previous researches by scholars, which are invariably supported by their own primary data. The secondary research draws from those primary sources. Therefore, the data collected through secondary research can have equal reliability with those data collected through the primary sources.

Secondary research consists of the analysis of information and data gathered previously by other people such as researchers, institutions and other non-governmental organizations. The data are usually collected for some other purposes other than the author's, or it may help the collection of data for both studies.<sup>11</sup> When undertaken with proper care and diligence secondary research can prove to be a cost-effective method in gaining better understanding of the specific issue being studied and conducting assessments of issues that do not need the collection of primary data. The main advantage of secondary data is that it provides the basis for designing the primary research,

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<sup>11</sup> C Cnossen, *Secondary Research: Learning Paper 7* (Robert Gordon University, Aberdeen 1997)

and often, it is possible to compare the results of the primary research with secondary research results.<sup>12</sup> Three aspects of research methodology are considered:

### **2.1 Descriptive and Analytical study of the theoretical aspect**

This means that we carried out the theoretical aspects related to the topic of the study by going through monographs and scholarly journal articles on law, economics, accounting and finance, as well as previous dissertations.

### **2.2 Descriptive and Analytical study of the Sharia aspect**

The references used cover monographs and scholarly articles on Islamic law, Islamic finance and banking, previous dissertations, also articles and reports published on reliable sites on the World Wide Web.

### **2.3 Descriptive and Analytical study of the legal aspect:**

This was achieved by the use of both primary and secondary sources represented by monographic publications, scholarly journals and reports and articles published on reliable sites on the World Wide Web.

### **2.4 Personal Interview**

We found it necessary to enrich our research with a personal interview of one of the specialized and experienced figures in corporate governance, to add his perspectives. We were able to conduct such an interview with the Secretary General of the Board of Directors of the National Commercial Bank, one of the largest banks in the Middle East.

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<sup>12</sup> PT Novak, *Secondary Data Analysis Lecture Notes* (Vanderbilt University, 1996)

## 2.5 Scope and limitations of the paper

Corporate governance can be defined according to the strict and broad sense. On the one hand, the ‘strict sense’ of corporate governance pertains to the “agency problems” between shareholders and managers or between majority and minority shareholders.<sup>13</sup> This is a narrow treatment of corporate governance that focuses only on shareholder profit maximization. On the other hand, corporate governance has increasingly expanded to include the consideration of other stakeholders, which follows the ‘broad sense’ of this term.

Numerous sources discuss only a strict sense of corporate governance, such as focusing on the role of board structure, directors’ role and duties, shareholders’ rights and protection.<sup>14</sup> These have been the common themes of corporate governance research.<sup>15</sup> Other articles tackle the peripheral issues, such as disclosure requirements and conduct of business.<sup>16</sup> This paper, however, takes a more holistic approach by examining the internal and external aspects of corporate governance. In analysing the laws and rules of corporate governance in the Kingdom of Saudi Arabia, in relation to the reforms in EU, UK and the US, it examines the broad and strict sense of corporate governance measures of the latter nations/region. The holistic approach has been chosen, because this paper believes that corporate governance cannot be separated from its specific and broad-ranging aims. In essence, this paper asserts that companies have to be both responsible for shareholder profit growth, without completely overlooking the interests of other

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<sup>13</sup> I Love, 'Corporate Governance and Performance around the World: What We Know and What We Don't' (2010) 26 WB Res Obs 45.

<sup>14</sup> See these articles that discuss corporate governance in the strict sense: M Ojo, 'Risk Monitoring Tools in Bank Regulation and Supervision: Developments since the Collapse of Barings Plc' (2010) SSRN eLib 1-24; M Ojo, 'The Role of External Auditors in Corporate Governance: Agency Problems and the Management of Risk' (2009) SSRN eLib 1-8.

<sup>15</sup> Love (n 13)

<sup>16</sup> See K Eriksson and AH Persson, 'Financial Crises and European Regulatory Frameworks'. It critically analyses the European Framework for Safeguarding Financial Stability.

shareholders. The underlying theoretical framework is that companies must strive for the broad sense of corporate social responsibility (CSR), wherein CSR stands for ‘...a model of extended corporate governance whereby who runs a firm (entrepreneurs, directors, managers) have responsibilities that range from fulfilment of their fiduciary duties towards the owners to fulfilment of analogous fiduciary duties toward all the firm’s stakeholders.’<sup>17</sup>

This paper contributes to this theme of corporate governance that other studies have not properly discussed and analysed.<sup>18</sup> Despite the holistic scope of this paper, other issues would no longer be covered, not because they are not important, but because they are beyond the scope of this paper. This paper does not intent to offer a critical analysis of the existing standards of corporate governance. The primary focus is on bank corporate governance rather than on the issue of corporate governance in general. Finally, the timescale of the paper’s inquiry concentrates on the most recent post financial crisis corporate governance developments in the banking system.

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<sup>17</sup> L Sacconi, 'Corporate Social Responsibility (CSR) as a Model of 'Extended' Corporate Governance: An Explanation Based on the Economic Theories of Social Contract, Reputation and Reciprocal Conformism' (2004) SSRN eLib 1.

<sup>18</sup> Ibid

# **1 Chapter One: Corporate Governance Between the Islamic and Western Perspectives**

## **1.1 Introduction**

Though this study covers an extensive analysis of corporate governance literature, it narrows down its scrutiny on corporate governance of banking institutions. Specifically, it draws from contemporary corporate governance practices by the US and UK financial markets and juxtaposes such with the situation in the Saudi banking industry. Moreover, it offers an extensive account of what ought to be done so as to position the Saudi banking institutions in the US and UK league in terms of corporate governance.

This chapter begins with a quick overview of some of the corporate governance theories in the Western school. It is followed by an analytical study of the concept of governance in Islamic Sharia and how its jurists view money as the property of God only and how we were created by God to build this world with the money we are entrusted with. In their view it is our duty to preserve it for the purpose of building the earth and ensuring that it is not invested or squandered in ways proscribed by Sharia, as money is a means and not an end; its purpose being the building of our societies.<sup>19</sup>

In addition to this, we will present some explanation of the basics and sources of Islamic Sharia, such as the Holy Koran, the Hadith and others which we shall try to explain, in addition to a quick survey of the leading schools of Islamic Sharia. We will also look at some of the transactions which are proscribed by Sharia, such as interest, and clarify what is known as the goals of Islamic Sharia and their influence on commercial transactions.

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<sup>19</sup> FM Almajid, 'A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: A Comparative and Analytical Study from a Legal Perspective' (DPhil thesis University of Manchester 2008) 152.

Through our study of the corporate governance concept in Sharia, we will survey the classical and modern jurists in Islamic Sharia and look at the latest developments that came about as a result of the flourishing of what is known as Islamic finance and banking. These phenomena were able to develop mechanisms and concepts akin to Western banking and finance concepts, but within an Islamic framework abiding by Sharia rules governing investment and wealth protection and preservation.

We will also discuss the formation and functions of what is known as the Sharia Supervisory Board, a monitoring entity founded in recent years to oversee most companies dealing in Islamic finance, investment and banking. The main purpose of these entities is to ensure that the rules of Sharia are not violated.

## **1.2 Governance Framework in Western Perspective**

Corporate Governance plays a vital role in the overall robustness of a corporation or company, as it involves the direction, administration, and control of various processes within an organization. In line with this, corporate governance also give due importance to the relationship that exists among the stakeholders of the company.<sup>20</sup> This being the case, the concept of corporate governance is given due attention, which is observable in the huge body of literature that has evolved about it. In relation to this, the development of corporate governance, especially in terms of using it as a means in understanding the relationship among stakeholders in a corporation has developed. There are various and often times, competing analyses that tend to explain the problem involved in corporate governance and also, the corresponding solutions to address it. The existing analyses provide various perspectives on what is amiss or perceived to be amiss

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<sup>20</sup> A Al-Harkan, 'An Investigation into the Emerging Corporate Governance Framework in Saudi Arabia' (DPhil thesis University of Wales 2005)

with the system. In addition, the effects of the flaws of corporate governance on economic prosperity and the ways system could be reformed in order to become more effective are also given due attention and importance in the evolution of the literature about corporate governance.<sup>21</sup>

## **1.2.1 Western Theories of Corporate Governance**

According to Blair, there are four major perspectives about corporate governance problem, which are: the agency theory, transaction cost theory, market myopia theory, and stakeholder theory. Moreover, there are also other theories about corporate governance, which have also provided information about the problems and suggested solution in the area of corporate governance, which are: principal agent problem, stewardship theory, signalling theory, and resource dependency theory.<sup>22</sup> As such, this section will discuss the main theories about corporate governance, which are previously mentioned.

### **1.2.1.1 Agency Theory**

The concept of the agency theory is rooted from the work of Adolf Augustus Berle and Gardiner Coit Means, who engaged in the study about the problems of the agent and principal way back in 1932.<sup>23</sup> Berle and Means continued their exploration of the concept of agency by applying it in the development of large corporations. In doing so, both theorists found out that directors and managers of firms have different interests as compared to the owner, which enables them to use the concepts of agency and principal in order to make sense of the causes of the aforementioned conflict. The agency theory was further developed by Michael C. Jensen and William Meckling,

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<sup>21</sup> Ibid 17.

<sup>22</sup> Ibid

<sup>23</sup> A Berle and G Means, *The Modern Corporation and Private Property* (4th edn Transaction Publications, New Brunswick, NJ 2002).

as they were able to shape the work of Berle and Means by means of associating it with risk-sharing research. Jensen and Meckling were able to make the agency theory a formal concept.<sup>24</sup>

The agency theory explains the differences in the behaviour and decisions of members of a group. Simply put, the aforementioned theory explains the relationship between one party, which is referred to as the principal and who has the responsibility of delegating work to another individual, who are called as the agent. The theory asserts that the variation in the decisions and actions of the two parties are caused by the different and respective goals of the parties, which resulted to their various attitudes about a certain situation.<sup>25</sup>

### **1.2.1.2 Transaction Cost Theory**

Transaction cost theory became widely known through the efforts of Oliver Williamson. The aforementioned theory states that on every transaction carried out by corporations, they experience corresponding economic costs and economic advantages. According to Williamson, transaction cost theory has been developed in order to analyze the comparative costs involved in planning, adapting and monitoring the completion of a certain task under an alternative governance structure. In line with this, the unit of analysis in transaction cost theory is a transaction, which takes place when a good or service is transferred through technologically separate interface. The transaction cost theory is grounded on the fact that companies have developed into large and complex entities, which caused the price movements outside companies to dictate production and for markets to coordinate transaction.<sup>26</sup>

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<sup>24</sup> MC Jensen and WH Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 J Fin Econ 305-360.

<sup>25</sup> Al-Harkan (n 20) 17.

<sup>26</sup> Ibid 24.

### **1.2.1.3 Market Myopia Theory**

The Market Myopia Theory is an important concept in corporate governance that was introduced by a United States marketing academician by the name of Theodore Levitt. The theory was first introduced by Levitt in his article entitled: 'Marketing Myopia' that was published in the Harvard Business Review in 1960. According to Levitt, most corporations do not reach their full potential and eventually resulted to their downfall because the myopic approach that they practiced. The term 'myopic' embodies the short sighted and self centred view of the market myopia theory. Corporations that practiced the aforementioned theory only give emphasis on their firms and the products and services that they render in order to fulfil the needs and wants of clients. Moreover, Levitt pointed out in his article that companies should also give due consideration an importance to the customers' view of marketing and not merely on their own. He asserted that sustained growth is dependent upon how broadly a corporation defines its business and gauge customers' needs.<sup>27</sup>

### **1.2.1.4 Stakeholder Theory**

The stakeholder theory originated from the detailed work of Edward Freeman in his book *Strategic Management: A Stakeholder Approach*. The stakeholder theory is a combination of organizational management and business ethics, which aims to address the morals and values that are involved in managing a corporation. Based on the work of Freeman, he identifies the groups which he regarded as the stakeholders of a corporation and he gives recommendations on the way by which management could provide the interests of these groups. Simply put, Freeman emphasizes the 'Principle of Who or What Really Counts' in the stakeholder theory. In line with this, the shareholder approach emphasizes that the shareholders or the stockholders are the actual

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<sup>27</sup> T Levitt, 'Marketing Myopia' (1960) 38 Har Bus Rev 45-56.

owners of the company, which is why the firm has the responsibility to attend to their needs first and increase the value of their money. Nevertheless, the stakeholder theory highlights the duty of the firm in addressing the needs and wishes of four parties, namely: investors, employees, suppliers, and customers. In addition, the theory also points out that other parties are also regarded as stakeholders, which include governmental bodies, political groups, trade unions, communities, prospective employees and clients, the general public, and sometimes, even competitors.<sup>28</sup>

#### **1.2.1.5 Principal Agent Problem**

The principal-agent problem also known as the agency dilemma deals with the problems that arise from conditions of incomplete and asymmetric information. Asymmetric information is described to be a process wherein a principal hires an agent and in such situation, potential dilemmas of moral hazards and conflict of interest are often observable.<sup>29</sup> Despite the fact that the principal is presumed to hire the agent in order to accomplish the interests of the principal, difficulties still arise. The principal-agent problem often takes place in employer/employee relationships. As a result, different mechanisms are used in order to make the interests of the principal and the agent compatible with each other. These mechanisms include ‘piece rates/commissions, profit sharing, efficiency wages, performance measurement (including financial statements), the agent posting a bond, or fear of firing’.<sup>30</sup>

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<sup>28</sup> RE Freeman, *Strategic Management: A Stakeholder Approach* (Pitman, Boston 1984).

<sup>29</sup> K Alexander, 'Corporate Governance and Banks: The Role of Regulation in Reducing the Principal-Agent Problem' (2006) 7 J B Reg 19.

<sup>30</sup> SAGIA, 'Inverstor Services' <<http://www.sagia.gov.sa/english/index.php?page=vision-and-mission-2>> accessed 27 March 2009.

### **1.2.1.6 Stewardship Theory**

The Stewardship Theory states that managers, who are given the independent control of the corporation, will act as responsible stewards in terms of controlling the assets of the firm. The stewardship approach is actually an alternative of the Agency Theory, which assumes that managers will act on their own vested interests at the expense of the shareholders, once the independent authority is given to them.<sup>31</sup> Moreover, the stewardship theory asserts that the interests of shareholders will be maximized by sharing their authority and roles with managers of the firm. In addition, the accountability of managers is also given due importance in this theory because they are held responsible in the accounting of corporate assets.<sup>32</sup>

### **1.2.1.7 Signalling Theory**

Signalling Theory is recognized as a body of theoretical work, which aims to analyze the communication between individuals. The main question that this theory is trying to address is, when would individuals with various and conflicting interests would communicate honestly with each other.<sup>33</sup> In relation to this, signalling theory has been used in order to explain the problem behind information imbalance in labour markets and the means by which these could be addressed. Signalling theory is almost similar with the agency theory because it adheres to the separation of ownership and control in modern corporations. However, the signalling theory is slightly different from the agency theory because of the existence of signalling costs, which have an inverse relationship with information.<sup>34</sup>

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<sup>31</sup> Wikipedia, 'Stewardship Theory' (Wikipedia The Free Encyclopedia)  
<[http://en.wikipedia.org/wiki/Stewardship\\_Theory](http://en.wikipedia.org/wiki/Stewardship_Theory)> accessed 3 January 2010.

<sup>32</sup> Al-Harkan (n 20) 31.

<sup>33</sup> Wikipedia, 'Signalling Theory' (Wikipedia The Free Encyclopedia)  
<[http://en.wikipedia.org/wiki/Signalling\\_theory](http://en.wikipedia.org/wiki/Signalling_theory)> accessed 3 January 2010.

<sup>34</sup> Al-Harkan (n 20) 29.

### **1.2.1.8 Resource Dependency Theory**

The Resource Dependence Theory (RDT) became a formal concept in the late 1970s by Pfeffer and Salancik. RDT provides an explanation of the way external resources of corporations affects the behaviour of the firm. This theory emphasizes the important role of external resources in both the strategic and tactical management of corporations. RDT has a huge influence in the optimal divisional structure of corporations and also in other processes such as: ‘recruitment of board members and employees, production strategies, contract structure, external organizational links, and many other aspects of organizational strategy’.<sup>35</sup> Furthermore, RDT states that resources are a basis of power, wherein power and resource are directly related.<sup>36</sup>

### **1.2.1.9 Accounting and Corporate Governance**

The process of identifying, measuring and communicating information for facilitating the user to make meaningful decisions is provided by accounting. Accounting disclosures in the ‘managed corporation model’ are often limited to the extent that individuals controlling the resources need the disclosure. However, the fact remains that corporate governance issues can be addressed and explained by detailed financial statements, since these issues are normally concentrated among those agencies having a wider financial stake in the entity. This explains why the terms ‘what resources?’ and ‘to whom the accountability is directed?’ are asked.<sup>37</sup>

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<sup>35</sup> J Pfeffer and GR Salancik, *The External Control of Organizations: A Resource Dependence Perspective* (Harper & Row, New York 1978)

<sup>36</sup> Al-Harkan (n 20) 31.

<sup>37</sup> N Baydoun and R Willett, 'Islamic Corporate Reports' (2000) 36 ABACUS cited in Lewis (n 56) 11.

## 1.2.2 Differences in Corporate Governance Between Common Law and Civil Countries

Corporate governance varies in terms of its foundation and application among countries. Differences such as culture, country's constitution, and politics are some of the major demarcations used in modern researches. The same will be done in this research paper; however, corporate governance will be studied in a very different perspective- the differences within similarities. This research paper will focus its discussions in understanding the different corporate governance regimes in countries under Common Law and Civil Law. It is academically intriguing to find out how a very law-based issue such as corporate governance can differ in countries that appear to share similar experiences and underwent similar crises.

First things first, corporate governance as an issue worth of academic research can be defined as the collection of due processes, laws, rules, and even punitive elements that is used by economic subsectors, mainly the business subsector, in terms of its operations, protective mechanisms and even corporate control strategies.<sup>38</sup> Corporate governance plays a very important role in the economy of any country; it can even be assumed that failure in this aspect assures national breakdown. Researches generally classify corporate governance in to two main categories, internal and external factors. The internal factors of corporate governance are the businesses and companies' officers, the public and private stockholders and the businesses and companies' constitution.<sup>39</sup> Obviously, these factors are classified as internal because any interaction among these factors will also result to an implication within the subject business or company. On the other hand, corporate governance external factors are the clientele, consumer

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<sup>38</sup> SearchFinancialSecurity.com, 'Definition: Corporate Governance' <[http://searchfinancialsecurity.techtarget.com/sDefinition/0,,sid185\\_gci1174602,00.html](http://searchfinancialsecurity.techtarget.com/sDefinition/0,,sid185_gci1174602,00.html)> accessed 3 January 2011.

<sup>39</sup> Ibid

groups, and government interventions. These factors influence corporate governance from the outside. Nonetheless, the magnitude of the effect or influence of both external and internal factors depends on the importance of the part of the business or company they affect. Having said these definitions and important aspects of corporate governance, the discussions on the foci of this research paper are deemed to be put into their proper contexts.

Leading researches on corporate governance, such as that of La Porta, automatically assume that the paths taken by countries under the Common Law and Civil Law are universal and in its own way –linear.<sup>40</sup> La Porta’s general view of corporate governance gave birth to the requirement that stock market development can only develop on a country with its corporate governance focused on the legal protection it offers to its shareholders.<sup>41</sup> However, the generalization pushed forth by La Porta up to date is being challenged by other researchers with the main contestation that stock development is not positively related to the legal protection offered to the shareholder by the state.<sup>42</sup> The contestations put up against La Porta’s generalization involve the lack of correlative proof of the supposed relationships of the elements of corporate governance such as in the aspect of improved shareholder rights and ownership dispersion.<sup>43</sup> Other contestations include blatant counter theses that put La Porta’s generalization on the divergent paths taken by countries under Civil Law and Common Law that serve as the counterproof needed to debunk La Porta’s generalization.

United States of America, Great Britain, Italy, France and Germany represent the most divergent paths of countries when it comes down to corporate governance. USA and Great Britain belong

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<sup>40</sup> RK Morck and L Steier, *The Global History of Corporate Governance: An Introduction* (NBER Working Paper Series, National Bureau of Economic Research, Cambridge, MA 2005) 25.

<sup>41</sup> Ibid

<sup>42</sup> Ibid

<sup>43</sup> Ibid

to the political block that follows Common Law; while Italy, Germany and France fall on the Civil Law political block. Up to today, corporate insiders in the United States of America are exploiting shareholders regardless of USA's massive and detailed legal rights protection in its corporate governance regime.<sup>44</sup> The shareholders of Italy experienced the same when a corporate family sued for being corporate insiders in their companies was acquitted.<sup>45</sup> German shareholder statistics moved from vicissitudes without the prerequisite set by La Porta. In fact, Germany's legal systems minutely evolved even if it showed noticeable stock development.<sup>46</sup> In the same way, Great Britain showed stock development without the legal protection required by La Porta. History dictates that stock development in Great Britain has long started even prior to the development of the legal protective measures in its corporate governance.<sup>47</sup> For the sake of comparison, Civil Law abiding country such as France took a very different path as compared to the preselected countries because it opted to strengthen its investors making the state the fall entity during economic crises; thus making the shareholders less and less important in the long run.<sup>48</sup> Following these historical accounts, leads to the assumption that countries under Common Law (particularly Great Britain) are successful in sustaining their economies even in the long run as compared to the countries under Civil Law that tend to change its corporate governance from time to time in the hopes of mitigating the chances of crises' reoccurrence<sup>49</sup>. Nevertheless, it should be noted that countries under either set of laws are successful in creating and attracting new markets and investors in to their existing economies. The Common Law's adherence to

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<sup>44</sup> Ibid 26

<sup>45</sup> Ibid

<sup>46</sup> Ibid

<sup>47</sup> Ibid

<sup>48</sup> Ibid

<sup>49</sup> Ibid

pursuing equity leads to a greater realization that this set of laws protects the people from the state; on the other hand, Civil Law seeks to protect the state from the people<sup>50</sup>. The distinction between these sets of laws is clearer in pre-globalization era. As globalization took its course, the distinction between these sets of laws became too historic to have any bearing in contemporary researches on corporate governance. As a by-product, differences in the corporate governance regimes of countries even adhering to the same set of laws became more important and relevant. Additionally, the events that took place in these countries even if they occurred in different times show similarities even between countries belonging to different sets of laws. These events prove that discussing the differences between countries under Common Law and countries adhering to Civil Law requires distinct grounds for comparison.

The shared experiences of the countries from both sets of laws put into question the validity of the claim that Common Law and Civil Law determines the corporate governance in a country. This research paper argues in a fashion similar but different from La Porta, corporate governance in countries in either set of laws is the result of the interaction of the legal and corporate systems existing in that country<sup>51</sup>. The need of all countries to evolve and find the set-up of perfect fit between its legal and corporate systems will always be imminent but those changes do not need to be different from the original stance of the country's government. As for the case of the countries chosen in this research paper, their differences can be rooted from the main principles of the set of laws that they adhere. These principles are the most probable causes for the different treatments and stances made by countries in certain situations that could differ

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<sup>50</sup> Ibid 27

<sup>51</sup> Z Xia, 'Could the Different Countries' Corporate Governance Regimes Be Harmonized?' (2009) 3 Mgmt Sci Engr 26.

from the path taken by a country under the same situation<sup>52</sup>. Setting these assumptions in line with the major differences between Common Law and Civil Law, leads to the major difference in the manner of solving cases. Common Law arrives at decisions through analogy and precedence, making cases the primary source of decisions<sup>53</sup>. On the other hand, Civil Law arrives at decisions through the legislative background of the cases, regardless of the precedent actions taken to resolve the case<sup>54</sup>. This difference made cases in countries under the Civil Law more winnable by the accused such as business entities; this makes the corporate governance regime in Civil Law abiding countries coined as biased against the ordinary stakeholders. On the other hand, Common Law abiding countries are seen to favour ordinary stakeholders over business entities; this makes such countries less conducive to external investments.

The differences between Common Law and Civil Law abiding countries would go on if the technicalities would be involved. The complexities of the relationship between the legal and corporate laws of these countries are more than enough to make the process of comparing them more and more laborious. Nonetheless, these differences will all boil down to the hard truth that they are the result of the continuous changes in the legal and corporate laws of the countries in their attempt to find a perfect fit between the two; regardless of the set of laws the country follows.

### **1.3 The Islamic Perspective of Corporate Governance**

The important principles of good corporate governance and the codes of best practice developed during the last decade imply that directing companies leads them to function according to

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<sup>52</sup> Ibid 27.

<sup>53</sup> BJ Alexis, T Sensebat-Cirtma and A-R Stouthuysen, '501 Common Differences between Civil & Common Law Jurisdictions' (ACC Europe's 2005 Annual Conference 2005) 3.

<sup>54</sup> Ibid 4.

defined moral standards which are acceptable to the community in general.<sup>55</sup> The principles do not just recognize the achievement of economic efficiency or earning maximum profitability as the best practice.

According to Mervyn K Lewis there are two aspects which particularly shape the nature of Islamic corporate governance. One is Sharia's claim of sovereignty over all aspects of human life. Its extensive coverage includes ethical and social issues, in addition to having control over civil and criminal jurisdiction. Sharia lays down the principle that every believer of Islam must conform to the basic principles of Islamic Law. Each one of them is expected to observe the ethical standards derived from economic principles, irrespective of status or social position. It defines what is truly fair and just, the nature of corporate responsibilities, and determines the company's priorities to society, in addition to standards covering governance in general.<sup>56</sup>

The second aspect of Sharia provides specific Islamic economic and financial principles along with ethical business standards, which have a larger influence upon corporate practices and principles. These are manifested through the institution of *zakat* (the alms tax), the ban on *riba* (usury) and the prohibition on speculation, calling for the development of an economic system based on profit and loss sharing.<sup>57</sup>

### **1.3.1.1 Dimensions of Decision Making and the Islamic Perspective on Corporate Governance**

Three dimensions of decision making in corporate governance from the Islamic perspective have been identified:

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<sup>55</sup> S Gooden, 'Participation of Stakeholders in the Corporate Governance of Islamic Financial Institutions' (2001) 114 *New Hor* cited in Lewis (n 56) 13-14.

<sup>56</sup> MK Lewis, 'Islamic Corporate Governance' (2005) 9 *Rev Islam Econ* 16.

<sup>57</sup> *Ibid* 15.

#### **1.3.1.1.1 By Whom?**

The Holy Koran is seen as the source of decision making, which promotes mutual consultations. Once a decision is made, there has to be a firm belief that it will do good to everyone concerned. When the basic principles of *Shura* (consultation) are followed the Koran requires the leaders to encourage others to take part in the process of decision making. On the level of day to day practices, it would be expected of an employee to contribute her or his knowledge to realization of the organization's vision, and a consultative approach is thereafter adopted by the shareholders, suppliers, customers, workers and the community.<sup>58</sup>

#### **1.3.1.1.2 For Whom?**

Under the Islamic perspective of the decision making process the clear answer to the question 'for whom?' stems from the premise that the ultimate end of any business and economic activity is that it is done in the grace of Allah and the ways and means employed to accomplish such an activity should never deviate from Islamic law as quoted by Sharia.<sup>59</sup>

#### **1.3.1.1.3 With Whom and to Whom?**

The third requirement for ensuring corporate governance principles in an Islamic perspective involves the process by which an effective religious supervision is undertaken.<sup>60</sup> The objective of this supervision is to ensure that the operations, contracts, and procedures of the enterprise are in conformity with the Islamic code. This practice is typically followed in Islamic financial institutions.<sup>61</sup>

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<sup>58</sup> Ibid 16.

<sup>59</sup> Ibid

<sup>60</sup> Ibid

<sup>61</sup> L Algaoud and M Lewis, 'Corporate Governance in Islamic Banking: The Case of Bahrain' (1999) 7 IJ Bus Stud cited in Lewis (n 56) 18.

Religious auditors also provide a comprehensive report on the adherence to Islamic principles across the full spectrum of business activities. The religious audit helps to improve the functioning of any corporation to achieve compliance to Islamic principles by undertaking three functions: (1) advising the board and management that the firm's contractual arrangements and new product development conform to religious rules and standards; (2) providing an independent report to shareholders informing them of the firm's adherence to Islamic principles; and (3), performing an audit to ensure the correct assessment, administration and distribution of the Islamic special alms levy (*zakah*).<sup>62</sup>

#### **1.3.1.1.4 Points of Difference**

Haniffa and Hudaib identify the following difficulties that the Islamic perspective of corporate governance faces while adopting best corporate governance practices in the Western approach.

Under the Western approach to corporate governance business morality is primarily based on 'secular humanist' values governing the ethical foundations of the business, while the Islamic perspective of corporate governance follows the principles laid down by Sharia as the guiding force.

In Western corporate culture self-interest of the firm figures predominately in its vision and forms an integral part of its strategic goals, tending to overshadow the broader interests of society as a whole. Such a concept is unacceptable to Islamic principles.<sup>63</sup>

Finally, the Western model of corporate governance is based on agency theory and there is no place for stewardship theory. The basic difference lies in the actors who are agents with a self-

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<sup>62</sup> Ibid

<sup>63</sup> R Haniffa and M Hudaib, 'A Theoretical Framework for the Development of the Islamic Perspective of Accounting' (2002) 6 AC & Fin cited in Lewis (n 56) 14.

interested opportunistic approach who cannot be motivated to be stewards to act in the best interest of the principals. In the Islamic perspective there is no place for self-interest of the agents.<sup>64</sup>

## 1.4 Sharia Rulings

Sharia comes from the Arabic word *shari'ah* which means the path to be followed, and its literal translation is the path to a watering place.<sup>65</sup> Sharia ruling is based on the first and main source of the Islamic jurisprudence which is the Holy [Koran](#). In addition, no Muslim will be considered a believer unless he believes in the 'Sunna'<sup>66</sup> of the Prophet as the second main source that goes along with the Holy Koran. Both sources are indispensable and people cannot practice Islam without consulting both of them.<sup>67</sup>

Based on the knowledge, understanding and comprehension of the two abovementioned sources of Sharia, the third source refers to the legal rulings of the Muslim scholars, *fiqh* (Islamic jurisprudence). The Arabic word *fiqh* means knowledge.

### 1.4.1 Sources of Sharia Ruling

There are primary and secondary sources from which Sharia is derived. As mentioned above, the primary sources are the Holy Koran and the Sunna.<sup>68</sup> The secondary sources are important because the primary sources do not cover economics, banking, interest and other financial aspects of human life.

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<sup>64</sup> J Davis, F Schoorman and L Donaldson, 'Towards a Stewardship Theory of Management' (1997) 22 Acad M Rev cited in Lewis (n 56) 14.

<sup>65</sup> See AR Doi, *Shariah: The Islamic Law* (Taha Publishers, 1987)

<sup>66</sup> The 'Sunna' of the Prophet is based on his life and his sayings.

<sup>67</sup> University of Southern California, 'Shari'ah and Fiqh' <<http://www.usc.edu/dept/MSA/law/shariahintroduction.html>> accessed 3 April 2007.

<sup>68</sup> Doi (n 65) 21, 45.

#### **1.4.1.1 Koran:**

According to Muslim Sharia scholars the creator of this universe revealed the Koran to mankind.<sup>69</sup> The Koran was transmitted in sequence from Allah Almighty Himself to Gabriel the angel, to the [Prophet Muhammad](#). These messages were given respectively to Muhammad, the messenger, throughout a period of approximately 23 years (610 CE to 622 CE).

The Prophet Muhammad was 40 years old when the Koran began to be revealed to him, and he was 63 when the revelation was completed. The source language of the message is Arabic, but it has been translated into many other languages. Wording of the Koran is, letter for letter, set only by Allah. According to Islamic belief, the Prophet Muhammad was the final Messenger of Allah to humanity, and therefore the Koran is the last Message sent to us. Allah has guaranteed that He will protect the Koran from human tampering and today's readers can find exact copies of it all over the world. The Koran of today is the same as the one revealed to Muhammad.<sup>70</sup>

#### **1.4.1.2 Sunna**

Koran is literally the Word of Allah, whereas Sunna is related to the Messenger. It was inspired by Allah but the wording and actions are those of the Messenger. The Arabic word Sunna refers to the way Prophet Muhammad, the Messenger, lived his life. Muslims know Sunna according to the Arabic word '*Hadith*' (plural *ahadith*).

The scholars of *Hadith* (*Muhaddithin*) define *Hadith* as standing for 'What was transmitted on the authority of the Prophet; his deeds, sayings, tacit approval, or description of his features

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<sup>69</sup> M Tahlawi, 'Do You Know This Book?' (University of Southern California) <<http://www.usc.edu/dept/MSA/quran/dyktb.html>> accessed April 2007.

<sup>70</sup> As it is mentioned in the Koran (Al-Buruj 85: 21-22), 'Nay, but it is a glorious Koran, upon an imperishable tablet.'

(*sifaat*), meaning his physical appearance. However, the physical appearance of the Prophet is not included in the definition used by the jurists.’

Thus, *Hadith* literature means the literature which consists of the Prophet’s life narrations and the things approved by him. However, the term *Hadith* was used sometimes in a much broader sense to cover narrations about the Companions of the Prophet and Successors to the Companions as well.

In his infinite mercy, Allah has not left mankind to wander, searching for the correct path. Koran and Sunna comprise a code that is to be followed by all Muslims. It covers all aspects of mankind such as those related to beliefs and stories of all predecessors; messengers starting from Adam, to Noah, Abraham, Moses, Jesus and ending with Mohammed; in addition to all social, economic, political, educational and military facets of life.

#### **1.4.1.3 Islamic Jurisprudence (*Fiqh*)**

Islamic *fiqh* preoccupied the minds of the Islamic world since it was guided by Allah to the faultless, sufficient and beneficent religion for all places and times. The Companions of the Prophet used to ask him about what was presented to them. The revelation would come down to him from heaven with definite sayings and judgment which were not subject to distortion and exegesis.

By the time the revelations stopped after the death of the Prophet, his companions had become conversant in their religion, and some of them had become important sources in dealing with problems among Muslims. The banner of Islam passed from one authority to another, dealing with the issues and problems that preoccupied their lives, by referring to their predecessors. In addition to that, they would arrive at their conclusions by deducing from the Book of Allah and

the teachings (Sunna) of His Messenger. Eventually they constructed a huge and well-founded corpus of tracts in Islamic *fiqh* which accompanied the Islamic Nation (*umma*) in its long history. It included the studies, foundations, laws, examinations and conditions for all substantive problems in life.

The diversity of viewpoints and the geographical expansion of the Islamic world led to the emergence of the science of *fiqh* in the second century after *Hijrah* (9<sup>th</sup> Century CE). This diversity led to the emergence of doctrines of *fiqh* with their corresponding schools. Each doctrine was adopted by Islamic scholars and jurists over the ages that refined the sayings of the founder of the doctrine and were guided by him. There were differences among the schools. Although there were numerous doctrines with their respective schools of *fiqh*,<sup>71</sup> the most famous of these doctrines are four; the Hanafite, Malikite, Shafi'ite and the Hanbalite. These efforts enriched the outcome of Islamic *fiqh* with discourse and study, enabling the *umma* to deal with its problems and rules in all matters, especially those which were not covered by the Koran or the Sunna.

The above doctrines were engendered in their corresponding schools, which were named after their respective founders; the Hanafite, referring to Imam Abu Hanifa (699-767); the Malikite, named after Imam Malik Ibn Anas (711-795); the Shafi'ite, named after Imam Muhammad Ibn Idris al-Shafi'i (767-819); and the Hanbalite, named after Imam Ahmad Ibn Hanbal (780-855).<sup>72</sup>

These schools have almost identical conclusions, but they do vary. The difference is based on the practical issues of understanding or authentication of the primary textual evidence. Differing

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<sup>71</sup> Listing all the doctrines and schools is beyond the scope of this study.

<sup>72</sup> , 'Shari'ah and Fiqh' <[http://www.geocities.com/to\\_islam/fiqh.htm](http://www.geocities.com/to_islam/fiqh.htm)> accessed 24 September 2007. See also the following thread: <<http://uiforum.uaeforum.org/showthread.php?t=2274>>.

viewpoints sometimes exist even within a single school of thought. Rulings based on the unanimity of Muslim scholars and direct analogies are binding. As mentioned earlier, the secondary sources for Sharia are used to add the complex laws needed for the various social and economic aspects of a Muslim's life. It is for this reason that Islamic jurisprudence became the basis for the large array of laws in Islam. The main secondary source is *ijtihad*, which means independent reasoning, or 'an exercise to arrive at one's own judgement.'<sup>73</sup> It is a process that entails reviewing the texts of the Koran and the Sunna and has five main sources.<sup>74</sup> These are:

#### **1.4.1.3.1 Ijma'(Consensus)**

Consensus is basically an incorporated source that binds Muslims incontestably whenever it arises. Accordingly, the jurists turn to the primary textual sources such as the holy Koran and *Hadith* to attain their conclusions.<sup>75</sup> It is also defined as 'the consensus of opinion of the companions of the Prophet and the agreement reached on the decisions taken... by the Jurists on various Islamic matters.'<sup>76</sup>

#### **1.4.1.3.2 Qiyas (Analogical Deductions or Reasoning)**

*Qiyas* is an application of known regulations to new situations. 'The function of *qiyas* is to discover the cause behind the regulation and broaden it to similar cases.'<sup>77</sup> It is also a method by

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<sup>73</sup> Doi, (n 65) 78.

<sup>74</sup> GAS Aly, *An Introduction to Legislation Principles in Saudi Arabia* (Dar al-Kitab al-Jami'i, Cairo 1983) 80. In Arabic.

<sup>75</sup> MO Farooq, 'Islamic Fiqh (Law) and the Neglected Empirical Foundation' 2006.

<sup>76</sup> Doi (n 65) 78.

<sup>77</sup> MO Farooq, 'Qiyas (Analogical Reasoning) and Some Problematic Issues in Islamic Law' 2006 4.

which ‘the principles established by Koran, Sunna and Ijma are to be extended and applied to the solution of new problems not expressly regulated before.’<sup>78</sup>

#### **1.4.1.3.3 Masalih al-Murasalah (Public Interest)**

Public interest is considered in Sharia as a basis for Islamic law.<sup>79</sup>

#### **1.4.1.3.4 Istishab (Presumption of Continuity)**

*Istishab* means ‘a rule of evidence or a legal presumption of continuance of conditions.’<sup>80</sup> An example of that is the presumption of ‘permissiveness, which means that specific situations or legal transactions should be allowed as long as there is no express evidence for otherwise.’<sup>81</sup>

#### **1.4.1.3.5 Sadd al-Dharai’ (Prohibition of Evasive Legal Devices)**

In a general sense, this means that actions that lead to something illegal according to Sharia become illegal themselves.<sup>82</sup>

### **1.4.2 Characteristics of Sharia Rulings**

The rulings of Sharia intended for all our daily actions are five in number, and differ for their performance (P) and non-performance (NP). Actions may be rewarded, not rewarded, punished or not punished.<sup>83</sup>

- 1- **Prescribed:** This refers to compulsory (*wajib*), mandatory (*muhattam*) and required (*lazim*). The category is divided into two sub-categories :

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<sup>78</sup> Doi, (n 65) 78.

<sup>79</sup> Ibid 81.

<sup>80</sup> Ibid 83.

<sup>81</sup> AD Marar, 'Saudi Arabia: The Duality of the Legal System and Its Implications on Financial Related Transactions' (DPhil thesis University of London) 51.

<sup>82</sup> Ibid 59.

<sup>83</sup> Farooq (n 77).

- a- Personally compulsory (*fard al-'ayn*). It is carried out by every Muslim, and includes prayers ‘*salah*’ and compulsory almsgiving ‘*zakat*,’ etc.
  - b- Communally compulsory (*fard al- kifaya*). It is carried out by some Muslims, but not others. An example of this is funeral prayers.
- 2- **Recommended (mandub)** is also referred to as *Sunna*: preferable (*mustahabb*), meritorious (*fadila*), and desirable (*marghub fih*). Night vigil (*tahajjud*) prayers and remembrance of God (*zikr*) are examples.
  - 3- **Permissible:** The performance and non-performance of the permissible/allowed (*mubah*) is neither rewarded nor punished.
  - 4- **Disliked:** Non-performance of both the disliked (*makruh*) and the unlawful/prohibited (*haram* ) is rewarded
  - 5- **Unlawful:** Performance of the unlawful is punished, but that of the disliked is not punished.

On the grounds of Islamic Jurisprudence, the researchers and scholars lean on the Islamic religious sciences that transmit the basics of conclusions and deductions from the above-mentioned sources. Conceivably, the common science that shall be treated is the Science of Sharia Objectives.

### 1.4.3 Science of Sharia Objectives

The Science of Sharia Objectives was treated by different scholars and jurists and was defined in different terms, all of which reflected the same meaning. Allal El Fassi defines it as ‘The purpose of Sharia and the secrets behind each of its stipulations that were submitted by the legislator.’<sup>84</sup>

#### 1.4.3.1 The Impact of the Science of Islamic Religious Objectives:

The recognition of the science of Sharia objectives singles out the deepening of the understanding of the objectives that Sharia aims to attain. Accordingly, the researcher will

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<sup>84</sup> A well-known Moroccan scholar (1910-1974), recognized as one of the modern Islamic spiritual leaders who trace the path for the political and cultural liberalization, <<http://www.allalalfassi.free.fr/allal.htm>> (April 2007).

enhance his knowledge by discovering the general path of Sharia and its stipulations. Moreover, it brings the position of the scholars of jurisprudence closer to him for matters that were not covered expressly in the Holy Koran and Sunna.

Furthermore, the Science of Sharia objectives intends to trace back to similar cases and to the cohesive requisites. Its objectives have generated results to strengthen certainty, increase faith and approve the veracity of the Islamic message of the Prophet.

Conversely, the science of Sharia objectives is considered as the master key of Sharia ruling and is taking it to new challenges in life. Consequently, this science leads and guides individuals and private enterprises to achieve the right provisions in financial transactions, directly controlling and conducting the directives and the decisions of the Islamic economists, experts and jurists in general.

In this respect, The jurist Juwani in his book *al-Burhan* said: ‘Who failed to realise that the objectives shall enclose the orders and forbiddances, so he shall be considered as ignorant of Sharia provisions.’<sup>85</sup>

It is worth mentioning that despite the massive amounts of study and analysis by scholars and jurists regarding the science of Sharia objectives, unfortunately these efforts did not focus adequately on their effects on modern Islamic jurisprudence related to financial transactions.

Nevertheless, we will try to illustrate these effects and point up their role in protecting, increasing and exploiting the funds according to the Order of Almighty Allah.

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<sup>85</sup> AMiAA Juwayni, *Burhan Fi Usul Al-Fiqh* (Dar al-Ansar, Cairo 2003) An Ashari and Persian scholar, (also called Imam of the Two Sanctuaries). Born on 18 Mouharam 419 A.H. = 12 February 1028 A.D, died August 20, 1185). Recognized by his religious compliance and wide knowledge in Shariah.

### **1.4.3.2 The Effects of the Science of Islamic Religious Objectives on Financial Transactions and Jurisprudence**

The process of the Islamic economic system endeavours to identify, assume and manage risks, in addition to providing the relevant means to act upon internal controls. In this respect, good governance requires a harmonious application of these principles with the different transactions and support for the interests of all stakeholders despite their conflicting nature. This enables meeting the obligations with integrity in compliance with Sharia principles, and builds an appropriate governance framework for active checks and balances without breaching the roles of shareholders or board of directors, while at the same time not diminishing the roles of the other stakeholders.

A robust and effective corporate governance framework is built on the shareholders' conscientious selection of competent and expert members of the board of directors. The latter is able to protect the long-term objectives, provide leadership and monitor effective implementation of the governance framework.<sup>86</sup> The Islamic perspective takes into consideration four essential factors within the governance framework.

#### **1.4.3.2.1 Honesty and Integrity**

The core values of honesty and integrity are the key factors of the governance framework of any Islamic financial transaction, along with a heavy reliance on trust. The significance of these core values is clearly highlighted in the Koran, Sunna and '*fiqh*.'<sup>87</sup> If there is any lack of honesty,

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<sup>86</sup> Bd Luxembourg, 'Corporate Governance: The Ten Principles of Corporate Governance of the Luxembourg Stock Exchange' (2006) 9  
<<http://www.auditcommittee.lu/Documents/10PrinciplesofCorporateGovernanceofLuxembourgStockExchange.pdf>> accessed April 2007.

<sup>87</sup> "Literally, *fiqh* means understanding; It refers to the study of sharia/sharia ruling and usually defined in jurisprudence textbooks as the knowledge of the rights and duties whereby human beings are enabled to observe right conduct in this life and to prepare themselves for the world to come. Whereas Sharia refers to the divine law itself, *fiqh* denotes the human interpretation of the divine commands; it constitutes the discipline of deriving and

efficiency and equity, a durable equilibrium fails to be established. Thus, the mutual interest of all parties in general and stakeholders in particular is not served. In one important verse, *Amanaat* is the plural of *Amana* and it refers to all the duties which Allah has ordained; honesty, moral responsibility and trust, etc.<sup>88</sup>

#### 1.4.3.2.2 Justice

The framework of governance takes into consideration the various interests and treats all stakeholders reasonably. It is the quintessence of the concept of justice in Islam as stated in the Koran, which considers it as nearest to righteousness (*taqwa*).<sup>89</sup> Everybody shall keep his measures and scales properly and justly. Moreover, God forbids the depreciation of the people's properties and corruption in the earth.<sup>90</sup> Everybody shall keep his measures and scales properly and justly. Moreover, God forbids the depreciation of the people's properties and corruption in the earth.<sup>91</sup>

#### 1.4.3.2.3 Credibility

Although Islamic finance becomes more and more sophisticated, a complete Islamic financial system is still at an early stage of development, both on the level of markets or financial

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formulating positive law in a number of branches (*furu*), including worship (*ibadat*), contractual law (*mu'amalat*), criminal law (*ta'zir* and *hudud*), and family and personal law (*ahwal shakhsiyya*)” Cf <<http://www.answers.com/topic/fiqh>> (April 2007).

<sup>88</sup> Qur'an 9:119.

<sup>89</sup> Qur'an 16:90.

<sup>90</sup> Qur'an 7:85.

<sup>91</sup> “Al-Adl refers to Justice and worshipping none but Allah Alone – Islamic Monotheism); Al-Ihsan [i.e. to be patient in performing your duties to Allah, totally for Allah's sake and in accordance with the Sunna (legal ways) of the Prophet SAW in a perfect manner]; kith and kin (i.e. all that Allah has ordered you to give them e.g., wealth, visiting, looking after them, or any other kind of help, etc.); Al-Fahsha' (i.e. all evil deeds, e.g. illegal sexual acts, disobedience of parents, polytheism, to tell lies, to give false witness, to kill a life without right, etc.); Al-Munkar (i.e. all that is prohibited by Islamic law: polytheism of every kind, disbelief and every kind of evil deeds, etc.); Al-Baghy (i.e. all kinds of oppression)” Available at <[http://www.searchtruth.com/chapter\\_display.php?chapter=16&translator=5](http://www.searchtruth.com/chapter_display.php?chapter=16&translator=5)>, accessed 3 April 2007.

instruments. Such matters, in addition to financial markets and regulations, are addressed and resolved according to Sharia rulings. Specialists in both Sharia rulings and financial matters are needed to ensure that the institution's operations are in compliance with such rulings, to strip the firm's transactions of any proscribed processes and decisions, provide credibility and bolster public confidence in the operation of Islamic institutions. To meet these standards, institutions have to take specific measures within their framework of governance.<sup>92</sup> Such measures require the establishment of an independent body, namely the Sharia Supervisory Board, to oversee that these measures are taken within the operations of the institutions, whilst taking into consideration the financial requirements of the present day. Such measures translate into executive decisions and become part of the firm's management. Equally, the firm's decisions would have to specify that those measures have been taken to meet the requirements of the Sharia Supervisory Board.<sup>93</sup>

#### **1.4.3.2.4 Transparency and Disclosure**

Transparency and disclosure are interrelated features of Islamic institutions which promote greater financial services and safeguard the interests of stakeholders. Strengthening transparency in general and accountability in particular is critical in combating efforts to put wealth beyond the reach of law enforcement. An economy characterized by high standards of disclosure, one in which managers are accountable to their board and where the board is accountable to its shareholders – including minority shareholders – is one where financial fraud and other financial crimes will be less likely to flourish.<sup>94</sup> Similarly, disclosure allows the market to assign

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<sup>92</sup> Z Iqbal and A Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (John Wiley & Sons Pte Ltd, Singapore 2007) 292. The structure and functions of the Sharia Supervisory Board are discussed in more detail in a later section of this chapter.

<sup>93</sup> N Yaqubi, 'Shariah Requirements for Conventional Banks' <[http://www.islamic-banking.com/aom/shariah/sn\\_yaqubi.php](http://www.islamic-banking.com/aom/shariah/sn_yaqubi.php)> accessed 3 April 2007.

<sup>94</sup> UA Karofi and J Mwanza, 'Globalization and Crime' <<http://www.bangladeshsociology.org/BEJS%203.1%20Karofi.htm>> accessed April 2007.

appropriate risk premiums to companies, thereby ensuring effective market discipline. It also provides adequate information regarding investment strategy and results, as well as the applicable rate of return. Transparency would be revealed when addressing the information asymmetry of different stakeholders in the different transaction structures and facilitating an efficient market discipline function.<sup>95</sup>

What characterizes the Islamic governance system is that it must be in concert with Islamic rules regarding contracts and property ownership, in addition to the principles of rights and obligations of individuals, society and the state. Therefore, meeting the above-mentioned requirements and fulfilling those objectives should neither infringe upon the property rights of any party, nor should it encroach upon the social order.<sup>96</sup>

#### **1.4.4 Wealth Concept According to Sharia**

A firm analysed as a 'nexus-of-contracts' aims at minimizing transaction costs and maximizing profits and returns to the stakeholders. Islamic financial institutions, in their interpretation of Sharia, offer comprehensive structures to identify, recognise, respect and protect the rights of others in Islamic society.<sup>97</sup>

Different levels of property rights exist in Islam. Some things can be owned only by God. Common properties such as the oceans and common land are owned by the entire human race. The last type of property right is possession by one particular individual or by a number of

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<sup>95</sup> Iqbal and Mirakhor, (n 92) 292.

<sup>96</sup> Ibid 277.

<sup>97</sup> Ibid 276.

individuals. All these properties that people own come with duties and responsibilities which are imposed by the restrictions of Islamic law.<sup>98</sup>

Sharia also recognises the importance of private property, with the right to own, acquire, use and dispose of such property. In this respect, the term 'right' refers to the privileges to claim and to gain benefit from the relevant claims. Consequently, the right is in the property that has beneficial uses and can be possessed. Accordingly, any breach of these principles is considered as a contravention and disturbance of the social order.<sup>99</sup> The significance of this principle is shown in the Prophet's saying in his Farewell Sermon on the occasion of his last pilgrimage.<sup>100</sup> The owner is entitled to enjoy his property, the fruits of his labour. In the same context, defending one's property is like defending honour, as the Prophet observed.<sup>101</sup>

To recognize the individual's God given right to own and defend personal property, it would have to satisfy two conditions: first is that it is acquired through legitimate means, while the second is that it is forbidden to use property in a way that may cause harm or problems to others.<sup>102</sup> This requires consideration of the benefit of others while using one's property. For example, monopolizing people's basic necessities is restricted in Islamic law.<sup>103</sup>

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<sup>98</sup> Ibid .

<sup>99</sup> Ibid 276-77.

<sup>100</sup> S Chowdry, 'Intellectual Property Rights in Islam' (2006) <<http://www.dinarstandard.com/management/IPinIslam020306.htm>> accessed 3 April 2007. This is reflected in a Hadith transmission by Bukhari: 'Verily your blood, your property is as sacred and inviolable as the sacredness of this day of yours, in this month of yours, in this town of yours.'

<sup>101</sup> 'He who dies in protecting his property is a martyr.' Hadith narrated in Bukhari and Muslim on the authority of Thabit, p. or no. 2480.

<sup>102</sup> This is mentioned in the Sunna and was narrated by Muslim in which the text states, 'One should not harm himself or others.'

<sup>103</sup> J Badawi, 'Property Rights in Islam' (2005) <<http://www.islamonline.net/english/introducingislam/Economics/article05.shtml>> accessed 3 April 2007.

Referring to the Islamic concept regarding property and wealth, absolute ownership in this world belongs to the Almighty Allah. Ownership rights originate from the concept of *Khilafah* (stewardship). The Koran and Sunna clearly state that Allah is the sole owner of property. According to these sources, in the corporeal world men are entrusted with this wealth in the capacity of custodians and trustees.<sup>104</sup>

Property is not an end itself, but a means to discharge effectively men's responsibilities as the vice-regent of *Allah*.<sup>105</sup> However, once individuals meet these conditions, according to Sharia restrictions no one will be allowed to force the expropriation of the person's property.<sup>106</sup>

Sharia condones the acquisition, possession, usage and disposal of property as long as it is done in compliance with the teachings of the Prophet mentioned above. On the other hand, it proscribes and forbids the acquisitions of property through un-permissible means such as gambling (*maysir*), bribery, stealing, cheating, forgery, coercion, or illegal trading. Sharia does not impose limits on the amount of property ownership or wealth an individual can accumulate, as long as the individual fulfils its requirements.

Islam recognises two ways to obtain rights to property; either through one's own creative labour and/or through transfer via exchange, contract, grants or inheritance of property rights from another individual, who has in turn gained title to the property or asset through his own labour. Islam considers wealth as a trust and a bounty from God. Thus, it is not scarce or limited. Men are accountable for whatever they have done to earn trust and the ways to carry out this trust

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<sup>104</sup> Iqbal and Mirakhor, (n 92) 277.

<sup>105</sup> Ibid

<sup>106</sup> According to the Hadith transmission it was narrated that the Prophet said, 'Muslims' blood, property and dignity are protected against each other.'

have been clearly prescribed in Sharia. Their responsibility is based on managing property in compliance with Sharia.<sup>107</sup>

### **1.4.5 Wealth Management According to Sharia**

Since men are not the absolute owners of the wealth of this world, the management concepts in this context show that the relevant duties and obligations of management should be performed in the best possible way within the Islamic framework. Managing wealth should be executed according to Sharia stipulations and restrictions. Note that property rights do not endow man with an individual right of possession, but that possession is based on a collective right whereas individuals are only allowed to acquire the right of priority to use and enjoy this property.<sup>108</sup> In addition, individuals should gain the benefit of labour and the results it generates, without ignoring the rights of others and without either subverting the principle of sharing or doing anything that leads to the infringements of the rights of society, or those of the state.

#### **1.4.5.1 Sharia Obligations in Wealth Management**

There are several restrictions on wealth management. Some are based on Islamic deeds and Muslim missions, and others are binding upon the obligations as viceregents. Islam holds that all acts of human beings should be for nothing other than for pleasing God in worship. Note that these acts include ritual actions, deeds and transactions.

##### **a) Work**

The term 'work' is called in Koran '*amal or fi'l*', both are translated as 'work'. All verses stress the necessity for work and action by mankind. A human being should profit from his 'time' and

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<sup>107</sup> M Ma'sum Billah, 'Islamic Wealth Management & World View' 2007? 2. Sharia bases this on the following verse: 'Give them of the wealth of Allah which He has given you' Qur'an 24:33.

<sup>108</sup> Ibid

pronounce that God has made the day as a means to get benefit from the daylight, to seek the interest of the individual and the community and to get sustenance.<sup>109</sup> Moreover, the Koran considers sloth or squandering of time in pursuit of unproductive and non-beneficial work as the manifestation of lack of faith, unbelief, and corruption.<sup>110</sup>

All healthy men must act meaningfully and earn their living in order to seek God's 'bounty'.<sup>111</sup> Men should avoid dependence on others unless they have a physical or mental disability, so they maintain a right to what society produces and in addition a proportion for poor and needy people.<sup>112</sup> A true believer is thus always prepared, after meeting his needs, to assist other people in need.<sup>113</sup> In this context the word '*Haq*' in Arabic refers to the rights of the poor in the wealth of rich. Accordingly this position excludes the charity act and considers it as a matter of right.<sup>114</sup>

In this respect, the principle of property rights' immutable claim to ownership retains the precept that all human beings have a right in the resources which God allowed mankind to manage as a trustee and vice-regent.

On the other hand, work should be 'good' or 'beneficial' (*al- 'amal al-salih*), and one should reap whatever recompense or retribution that is done as a result of this work. Consequently, any property which is considered counter-productive or non-beneficial loses its legitimacy and its

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<sup>109</sup> IslamReligion.Com, 'Work and Wealth' (2006) <<http://www.islamreligion.com/articles/295/>> accessed April 2007. The Koran mentions this in Chapter 78, verse 11: 'And have appointed the day for livelihood.'

<sup>110</sup> Qur'an 29:77.

<sup>111</sup> IslamReligion.Com (n 109).

<sup>112</sup> Qur'an 9:60.

<sup>113</sup> Qur'an 51:19.

<sup>114</sup> This is narrated by both Bukhari and Muslim. According to their accounts, Zar Ghifari, a companion of the Prophet, reported that the Prophet, while sitting in the shade of the Kabah wall, said, 'They are the losers.' Abu Zar enquired, 'Who are they, O Messenger of God?' The Prophet replied, 'Those who pile up heaps of wealth and (pointing in all directions with his hands) do not spend like this and this.'

associated rights.<sup>115</sup> Man is therefore free to find the type of work he desires, provided that it does not conflict with Sharia principles and without ignoring the needs of society.

Under these terms, work is considered not only a right, but a duty and an obligation. So men should perform their duty in just terms which demands that everyone should be recompensed adequately according to his productivity.<sup>116</sup> Moreover, Islam considers wealth as the life-blood of the community which must be constantly in circulation; therefore, its possession excludes the right of hoarding.<sup>117</sup> In this respect, wealth should be invested within the community to improve its economic welfare and increase the benefit to society.

#### **b) Debt Documentations, Affidavit and Pledge:**

According to Sharia, debts and contracts should be notarised and documented to protect rights and to avoid forfeitures. Note that the documentation is be written by the one who owes the money and legitimised by the testimony of two witnesses. It does not matter whether the amount is high or low, unless the debt generates from a commercial transaction where the contractors may be satisfied with just testimony. There are eighty verses in the Koran which go into full detail concerning the whole dynamic of the debts and contracts procedure.<sup>118</sup>

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<sup>115</sup> Qur'an 99:6-8.

<sup>116</sup> Qur'an 11:85.

<sup>117</sup> Qur'an 9:34.

<sup>118</sup> RM Khulayfi, 'Al-Maqasid Al-Shari'yah Wa-Atharuha Fi Fiqh Al-Mu'amalat Al-Maliyah' (2004) 17 Majallat JMA. 'O ye who believe! When ye contract a debt for a fixed term, record it in writing. Let a scribe record it in writing between you in (terms of) equity. No scribe should refuse to write as Allah hath taught him, so let him write, and let him who incurreth the debt dictate, and let him observe his duty to Allah his Lord, and diminish naught thereof. But if he who oweth the debt is of low understanding, or weak, or unable himself to dictate, then let the guardian of his interests dictate in (terms of) equity. And call to witness, from among your men, two witnesses. And if two men be not (at hand) then a man and two women, of such as ye approve as witnesses, so that if the one erreth (through forgetfulness) the other will remind her. And the witnesses must not refuse when they are summoned. Be not averse to writing down (the contract) whether it be small or great, with (record of) the term thereof. That is more equitable in the sight of Allah and surer for testimony, and the best way of avoiding doubt between you; save only in the case when it is actual merchandise which ye transfer among yourselves from hand to hand. In that case it is no

Moreover, the Koran recognizes that businesses and transactions were undertaken while travelling, so contractors may conclude the contracts according to pledge form in addition to testimony, as a method to lessen the procedures during the journey.<sup>119</sup>

### c) Zakat El- Mal

*Zakat-El-Mal* is an annual Islamic obligation levied on Muslims that grants a particular amount of their wealth to the beneficiaries called *al-mustahiqqin*, which translates as the ‘people of merit’.<sup>120</sup> It is one of the five pillars of Islam. Its imposition aims at purification of oneself as well as one’s own property.<sup>121</sup> This concept reflects the strong position of Islam with regard to social and economic justice as an ‘equitable redistribution of wealth and income.’ After calculating the basic needs of the payer, his financial obligations and debts due, every Muslim whose wealth exceeds a certain threshold (*nisab*) should pay *zakat*. Furthermore, the minimum threshold of *zakat* on savings or investments was 85 grams of gold, and the rate of *zakat* is 2.5%. As for livestock, both the minimum threshold and the rate depend upon the type and the number of animals. Islam believes that if a wealthy person is accustomed to paying *Zakat*, his infatuation for wealth would be softened and it will be a source of advantage to him and society in the end.<sup>122</sup>

The Prophet said that ‘*Zakat* is not permissible for someone who is not in need except in five cases: someone fighting in the way of Allah, someone who collects *Zakat*, someone who has

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sin for you if ye write it not. And have witnesses when ye sell one to another, and let no harm be done to scribe or witness. If ye do (harm to them) lo! It is a sin in you. Observe your duty to Allah. Allah is teaching you. And Allah is Knower of all things.’ Qur’an 2:2-82.

<sup>119</sup> Qur’an 2:283.

<sup>120</sup> Qur’an 24:56.

<sup>121</sup> Qur’an 9:103.

<sup>122</sup> Alfitri, ‘The Law of Zakat Management and Non-Governmental Zakat Collectors in Indonesia’ (2006) Int J NFP L <[http://www.icnl.org/knowledge/ijnl/vol8iss2/art\\_3.htm](http://www.icnl.org/knowledge/ijnl/vol8iss2/art_3.htm)> accessed 3 April 2007.

suffered (financial) loss (at the hands of debtors), someone who buys it with his own money, and someone who has a poor neighbour who receives some *Zakat* and gives some as a present to the one who is not in need.’<sup>123</sup>

#### **1.4.5.2 Sharia Restrictions in Wealth management**

In addition to the aforementioned conditions, extravagance, opulence, waste or general abuse of wealth are forbidden. Wealth cannot be used with the intention to damage others’ interests or to acquire political powers aiming at political corruption.<sup>124</sup> In this case, the community should consider the person who perpetrates damages, corruption, extravagance, waste or any type of general abuse of wealth as ‘*safih*’ or ‘prodigal’, a person who along with his own financial and moral loss is damaging the interest of the community.

So the right to property of the collective is further protected in Sharia by restrictions concerning the right of disposal by the person who is endowed with the use and enjoyment of the property. Sharia ruling prohibits any exclusive and absolute disposal of the different facets of the property, which is called ‘*israf*’ and ‘*tabdhir*’<sup>125</sup> (wasting and squandering). Otherwise, this person shall be subject to ‘*hajr*’ or ‘quarantine system’ whereby his wealth becomes the ward of the community, which through its legal representatives shall limit his right to use his property, except for a part of it to meet his basic needs.<sup>126</sup> That wealth, therefore, is considered as good and as support for

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<sup>123</sup> *Al-Muwatta of Imam Malik Ibn Anas: The First Formulation of Islamic Law Revised in Whole* (Medinah Press, Inverness 2001)

<sup>124</sup> Qur’an 2:77.

<sup>125</sup> AMA Taskhiri, ‘Islamic Economy: Its Ideological and Legal Foundations’ *Msg of Thaqaalayn* <<http://www.al-islam.org/mot/default.asp?url=20Islamc.HTM>> accessed June 2007.

<sup>126</sup> Qur’an 4:5.

the community, as long as it observes the rules of Sharia with respect to its attainment, possession and disposal.<sup>127</sup>

On the other hand, man shall avoid any alteration in the property that could inflict damage to his neighbour.<sup>128</sup> In such a case and if the property owner was powerless to use the property appropriately within restrictions, he may be deprived of his ownership rights. Under such conditions, the legitimate authority is fully justified in withdrawing the rights of usage of that property in order to protect it from misuse by the owner. This position of Sharia is in conformity with the Islamic concepts of justice (*al-adl* and *al-ihsan*) and the rights and responsibilities of the individual and the community. Sharia also forbids making unlawful inroads into 'one another's property' just as it forbids obtaining a decision in favour of the concerned party by means of bribery.<sup>129</sup> By the same token, it is forbidden to expend the property of orphans during the period of stewardship and requires appropriate conduct in managing their property until they reach the age of maturity. Such a stewardship is deemed a legal and binding covenant.<sup>130</sup>

#### **a) Bribery**

It is forbidden to bribe judges or rulers in order to bring injustice upon others. This is considered a crime which could lead to reducing people's rights and then spread corruption.<sup>131</sup> However, bribes given by persons to take back what rightfully belongs to them, or to ward off an injustice

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<sup>127</sup> Qur'an 17:29.

<sup>128</sup> SHM Al-Lahim, 'The Principles of Islam' <<http://www.al-sunnah.com/principles.htm>> accessed 3 April 2007.

<sup>129</sup> Qur'an 2:188.

<sup>130</sup> Qur'an 33:34.

<sup>131</sup> H Khadodia, 'What Sharia Says About Bribery' *Daily Sun* (1 April 2005) <<http://www.sunnewsonline.com/webpages/features/sunlightofislam/2005/April/01/sunofislam-01-04-2005-002.htm>> accessed April 2007. In the Hadith narration of Abu Hurairah, the Prophet Muhammad said: 'Allah curses the bribe giver and the bribe taker in ruling cases.'

which could not be accomplished otherwise, are not included in this type of cursed bribes. In contrast, it is considered a means of regaining one's rights. Nowadays, bribes are deemed a legitimate source of additional income for some employees, and to some extent provision is made in many a company's budgets under different names such as 'miscellaneous' or other terms. This issue has generated corruption in many companies and affected employees' attitude. Consequently, good service is presented only to the one who gives a bribe and the others are neglected or their service is delayed. Once the fear of Allah is absent, then power and cunning are abused in wrongdoings, such as to lay claim to people's property, and to confiscate their land.<sup>132</sup>

**b) Easy money (*maisir*):**

The term '*maisir*' encompasses gambling, raffles, lotteries and any other easy way to collect money that is generated by others' losses and damages. Note

**c) Denying the Employees salaries:**

The Prophet Muhammad stressed the importance of paying the worker as soon as he finishes his task. It is prohibited to delay paying workers and employees, either by denying their entire salary or part of it, with or without proof of their rights. Seeing that, even if the employee's right is lost in this life, it will never be lost on the Day of Judgment. The Arabic term is '*Al-Mutaffifeen*'

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<sup>132</sup> A Oladeinde, 'Financial Prohibitions in Islam: 1' (2007)  
<<http://www.sunnewsonline.com/webpages/features/sunlightofislam/2007/apr/06/sunofislam-06-04-2007-002.htm>>  
accessed 3 April 2007. The punishment for this deed is severe, for the Prophet Muhammad said: 'Whoever wrongfully takes away a land, will sink into the seventh earth on the Day of Judgment.' (Bukhari). Also: The Prophet Muhammad also said: 'Whoever wrongfully takes even a span of the hand from a land, Allah will order him to dig it down to the seventh earth, then He will fence it on the Day of Judgment until He judges between people.'

(those who decrease the rights of others). Another example is to assign the employee additional tasks or to make him work overtime without giving him any compensation.<sup>133</sup>

#### **d) Usury and Interest**

Unlike conventional financial systems, Sharia does not attach an intrinsic value to money, thus it does not recognize the trade of money as a trade. Money is only deemed a means to pay in exchange for goods and services. It does not increase in value when it changes hands. However, we can make a profit by exchanging one form of currency for another, and in the buying and selling of goods.<sup>134</sup>

*Riba* (usury and interest) is prohibited in Islam as it appears explicitly in the Holy Koran. All scholars from different jurisprudence schools have prohibited *riba* according to verses and terms of the Koran, although there have been some debates that differentiate between usury and interest. According to Islam it is forbidden to exploit the need of the borrower and force him to accept the payment of interest in order that he can meet the constraints and conditions of his life. This is considered as contrary to the principles of fairness and justice.<sup>135</sup>

The term '*riba*' in the Arabic language is derived from the verb 'raba,' to increase or to add. So the term '*riba*' means literally increase, growth, rise or addition. However, not every increase or growth is prohibited in Sharia. The latter refers to '*riba*' technically as the premium that must be paid by the borrower to the lender in addition to the main amount of the loan, as a condition to be endowed with the extension of the loan upon maturity. In this sense '*riba*' has the same meaning

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<sup>133</sup> Qur'an 83:1.

<sup>134</sup> MT Usmani, *An Introduction to Islamic Finance* (Kluwer Law International, The Hague 2002) xiv.

<sup>135</sup> Z Zamir, 'Prohibition of Interest (Riba) in Islam : The Social, Moral and Economic Rationale (Pt 1)' <[http://www.shodalap.com/Interest\\_Zamir\\_I.htm](http://www.shodalap.com/Interest_Zamir_I.htm)> accessed April 2007.

as ‘interest’ in accordance with the consensus of all jurists without exception. So the Holy Koran and *Hadith* do not differ between usury and interest. Interest and usury are both taken as synonymous for the Arabic word ‘*riba*’.<sup>136</sup> However, it is important to note here that the charging of interest on loans in financial transactions did not exist at the time of the primary sources of Sharia, namely the Koran and the Sunna.<sup>137</sup>

Historically, it has been shown that Islamic countries have accommodated conventional financial principles, and lived with the concept of interest, regardless of what the Sharia taught.<sup>138</sup> Islamic countries with varying degrees had no alternative but to borrow Western-based laws. This changed in the 1970s, as a result of political and economic events, and some Islamic countries challenged these facts and helped to forge an original Islamic identity and collectively looked at Sharia as a guide not only for personal and family matters, but extended it to govern the lives of Muslims in all daily transactions. This led to a re-evaluation and reinterpretation of the application of Sharia’s principles, recognizing it as a valid and viable body of commercial as well as civil law.<sup>139</sup>

#### **A- Prohibition of *Riba* in The Holy Koran**

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<sup>136</sup> Ibid

<sup>137</sup> I Shihata, ‘Some Observations on the Question of Riba and the Challenges Facing Islamic Banking’ in Joseph Norton et al. (ed) *Yearbook of International and Financial and Economic Law (2000-2001)* (British Institute of International and Comparative Law, London 2003) 25.

<sup>138</sup> I Warde, *Islamic Finance in the Global Economy* (Edinburgh University Press, Edinburgh 2000) 49.

<sup>139</sup> N Saleh, ‘How Will Sharia Influence Middle East Contract Law over the Next 20 Years?’ (2001) 24 *Mid East Exec Rep* 11.

In several verses of the Holy Koran, Allah (SWT) mentioned the consequences of *Riba*. The main consequences of *Riba* in the Koran is punishment, since it is seen as wrongful increase in one's property, without bringing him closer to Allah.<sup>140</sup>

### **B- Prohibition Of Riba In The Hadith**

Jabir reported that The Prophet cursed both the receiver and the payer of interest, the one who records it (the contract) and the two witnesses to the transaction and said, 'they are all alike (in guilt).'<sup>141</sup>

### **C- Riba Types**

Although the Koran did not enumerate the types of *riba*, Islamic jurists have classified it into two types: *riba al-nasi'ah*, and *riba al-fadl*.<sup>142</sup>

#### **1- Riba al-Nasi'ah**

The term '*nasi'ah*' means to postpone or to wait. It refers to the time period within which the borrower is allowed to pay back the loan, in addition to the premium. Hence it refers to the interest on loans. *Riba al nasi'ah* is effectively forbidden as a premium is payable in return for the delay in settling the loan.

#### **2- Riba al-Fadl**

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<sup>140</sup> Qur'an 30:39. This is repeated, with variations, in various verses in the Koran.

<sup>141</sup> Zamir (n 135).

<sup>142</sup> K Zaheer, 'Why Is Riba Al-Fadl Unacceptable?' <<http://www.renaissance.com.pk/Septrefl2y4.html>> accessed April 2007.

Islam, however, wishes to eliminate not merely the exploitation that is intrinsic in the institution of interest, but also that which is inherent in all forms of unjust exchange in business transactions.

*Riba al-fadl* is the excess over and above the loan, paid in kind. It lies in the payment of an additional amount by the debtor to the creditor in exchange for commodities of the same kind. The following tradition of the Prophet Muhammad is cited as evidence. It is related that Abu Said al-Khurdi said:

‘The Prophet Muhammad has said that gold in return for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, can be traded if and only if they are in the same quantity and that it should be hand to hand. If someone gives more or takes more, then he is engaged in *riba* and accordingly has committed a sin.’

To sum up, *riba al-nasi'ah* and *riba al-fadl* are both covered by the above-mentioned verse in the Koran.<sup>143</sup>

#### **1.4.5.3 Role of Stakeholders in the Islamic Perspective of Corporate Governance:**

A look at the shareholder model of corporate governance shows that the focal point is the relationship between investors and managers, characterized by certain processes based on the expectation that shareholders exercise control over the affairs of the units that comprise the corporation. As a result of these processes, another emerges where the firm's sole objective is the maximization of shareholder wealth.

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<sup>143</sup> Qur'an 2:275.

Taking into consideration the Islamic view of property rights and contracts, the Islamic economic system is characterized by a core concept that affects the perception of the role played by all the stakeholders in a corporation. Under this system, while the firm's objective is to maximize profits for the investors, it can only do so when it does not infringe the property rights of any individual, irrespective of her or his relationship with the firm.<sup>144</sup>

#### **1.4.5.4 Contracts under Islam and Corporate Governance**

Islam does not look any differently at contracts than any other system which engages in this form of agreements between parties. Taking it a step further, Sharia looks at contracts the same way as it looks at the concept of property rights, in that the intentions to enter into a contract and its execution takes into consideration that it would not cause harm to the property rights of any individuals or groups which comprise the stakeholders, extending its confines to the community, society and the state. Under the Islamic system, a guarantee of the property rights of all stakeholders is inherent in any contract. The Islamic framework also establishes guidelines that determine eligibility not only to be a stakeholder, but also whether such an individual has any right to influence the decision making and governance in the firm.<sup>145</sup>

#### **1.4.6 Islam and Management**

‘The combination of religion and nationality is a form of identification for the majority of Middle Eastern cultures. The synthesized identity has, for centuries, influenced the sense of belonging, political lifestyle and communal cohesion’.<sup>146</sup> As a logical consequence, this dependence on religion has influenced social behaviour and the nature of the interactions of the

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<sup>144</sup> Iqbal and Mirakhor (n 92) 283.

<sup>145</sup> Ibid 282-283.

<sup>146</sup> S Abuznaid, 'Islam and Management: What Can Be Learned?' (2005) 48 *T'bird Int Bus Rev* 125.

people among themselves. It has also resulted in special relations. With such an impact on human behaviour, religion has also affected the managerial capabilities of people to a large extent.

Though Islam cannot be expected to provide a comprehensive theory of management, it encompasses several guidelines which could easily be adopted for an efficient management system.

#### **1.4.7 Islamic Guidelines and Perceptions Applicable to Management**

Based on the conceptualization of the principles governing human interrelations, it is possible to provide certain basic guidelines that could be applied to the field of management. Some of these principles are presented below.

#### **1.4.8 Consultation (*Al-Shura*)**

‘The merit of consultation in management, as well as in other spheres of collective activities, cannot be overestimated. Consultation enhances the spirit of solidarity between employees and their managers. Traditionally, Islam has promoted consultation, as described by the Koranic verses, which elaborate the characteristic features of the relationship between leaders and subordinates. Al-Gefeili described Islamic management as a consultative process.<sup>147</sup> According to an Arabian proverb, the consultative process enhances the chances of sharing the minds while we consult others. Furthermore, the tradition of consultation in Islam exists at the opposite end of the continuum when compared to authoritarianism.<sup>148</sup>

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<sup>147</sup> Ibid 133.

<sup>148</sup> Ibid

#### **1.4.9 Teamwork (Al-Amal Al-Jamae'e)**

Just as Islam urges Muslims to hold fast onto the robe of God, it instructs its believers to follow a system of teamwork and cooperation. Islamic teachings urge Muslims to work in close cooperation with each other, and also to avoid discord among them. At the same time, Muslims are not supposed to interfere with others' work. The Prophet advocated teamwork by saying that people should help anyone who is unable to pay back money by using a collective method of subscriptions by neighbours, friends, colleagues and fellow citizens.

#### **1.4.10 Planning (Al-Takhteet)**

Planning is nothing new to Islamic culture. Islam urges believers to plan well ahead, and only when this is completed can they put their faith in God for the completion of the tasks they undertake. It is a common belief among Muslim managers that Allah the Almighty is the administrator, and that He knows how to control the sequences of things that have to happen. They also know that this belief doesn't absolve them from the responsibility to plan ahead.

#### **1.4.11 Other Functions of Management and Islamic Culture**

It is a belief in the Islamic tradition that God's supreme names have made a strong inroad into the functions of good management and leadership. Muslim managers are expected to adopt and follow these names as guidelines for their behaviour. 'It is noticed that most of these names, if not all, have business connotations and can therefore be applied to management functions and principles like planning, organizing, decision making, controlling and motivating'.<sup>149</sup> It is imperative that Muslim managers follow the names strictly, so that their endeavours to institute an Islamic management perspective will be fulfilled.

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<sup>149</sup> Ibid 136.

## 1.5 Financial Risk and the Sharia System

Corporations and banks under an Islamic economic system are subject to risk in various degrees, much as they are under conventional systems. Banks tend to be more prone to risk than other financial entities, due to the investment nature of their operations. In developing countries, this is more likely to happen due to the spread of corruption and to the destabilizing effect of globalization on national economies in these countries, especially in their initial stages.<sup>150</sup> While risk can refer to present experience, in financial terms it refers mainly to the uncertainty of future outcomes.<sup>151</sup> In more specific terms, risk has been identified as uncertainty of loss.<sup>152</sup>

### 1.5.1 Definitions of Risk in Islamic Law

In Islamic law terminology, two words are used in reference to risk, depending on the degree of uncertainty. *Khatar* (or *Mokhatara*), which means danger, and *Gharar*, for which no precise definition has been formulated. Literally it means fraud,<sup>153</sup> and has also been defined as a combination of speculation and uncertainty. Islamic law prohibits *Gharar* because it results in excessive loss to one party, while leading to a disproportionate increase in wealth in another. The elements of deception and uncertainty factor into the equation that creates *gharar*, thereby taking it beyond the element of risk.<sup>154</sup>

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<sup>150</sup> FM Atbani, 'Financial Risks in Islamic Banking Systems and the Regulatory Role of the New Basel Accord' (DPhil thesis University of London 2007) 51.

<sup>151</sup> J Hovden, 'Risk and Uncertainty Management Strategies' (6th International CRN Expert Workshop, Societal Security and Crisis Management in the 21st Century 2004) 1 <[http://www.crn.ethz.ch/\\_docs/Hovden\\_script.pdf](http://www.crn.ethz.ch/_docs/Hovden_script.pdf)> accessed 20 October 2007.

<sup>152</sup> R Crowe and R Horn, 'The Meaning of Risk' (1967) 34 JR&I 459-460.

<sup>153</sup> M Kamali, *Islamic Commercial Law: An Analysis of Futures and Options* (I. B. Taurus and Islamic Text Society, London 2000) 86.

<sup>154</sup> Atbani (n 150) 62-63.

Under conventional economic practices, uncertainty and possible harm are not prohibited by any law. This is where Islamic law takes a different stand and limits the excessive nature of harmful uncertainty. The schools of Islamic law have given their own definitions of *Gharar*. In the Hanafite School, *Gharar* is used in reference to the uncertainty of whether or not a given action will be performed, using a simple example of buying a fish before it is caught, as it is doubtful whether that action will be successfully completed. The occurrence of such an event is considered illegal.<sup>155</sup> According to the Shafiite School, it is an action the outcome of which is uncertain, or it may also have two possible outcomes, where the most likely one is very dangerous. *Gharar* has also been defined as ‘a situation where the buyer does not know exactly what he buys and seller does not know exactly what he sells.’<sup>156</sup> On the other hand, some contemporary Islamic academics have narrowed the distinction between risk and uncertainty in Islamic law by using the term *Gharar* to refer to both terms, with risk referring to manageable future events and uncertainty as ‘unknown and unpredictable future events.’<sup>157</sup> Atbani argues against such a merging of definitions of *Gharar* and instead refers to the divisions under Islamic law of *Gharar Yaseer* and *Gharar Fahish*, which according to him are appropriately parallel to risk and uncertainty, where the former is allowed and the latter is prohibited.<sup>158</sup>

### **1.5.2 Risk Taking and Banking in Islamic Law**

On a global level, most banking crises have emerged as a result of speculative activities in either currency exchange or lending transactions.<sup>159</sup> Speculation in currency transactions has been one

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<sup>155</sup> W Alzuhaili, *Islamic Jurisprudence and Authorities* (Dar al-Fikr al-Arabi, Beirut 1989) 436.

<sup>156</sup> Ibid

<sup>157</sup> A Al-Saati, 'The Permissible *Gharar* (Risk) in Classical Islamic Jurisprudence' (2003) JKAU Islam Econ 7-8. <[http://islamiccenter.kau.edu.sa/arabic/Magallah/Pdf/16\\_2/162-Al-Saati55.pdf](http://islamiccenter.kau.edu.sa/arabic/Magallah/Pdf/16_2/162-Al-Saati55.pdf)> accessed 20 October 2007.

<sup>158</sup> Atbani (n 150) 64.

<sup>159</sup> LH Summers, 'International Financial Crises: Causes, Prevention and Cures' (2000) 90 Amer Econ Rev 1, 8.

of the main causes of banking failures in Mexico and Asia.<sup>160</sup> Discussions of risk have been applied to very broad areas of economic behaviour, while in Islamic jurisprudence risk has been linked with specific instances, thus bypassing a wider range of risk activities. The jurists have focused on specific types of sales, exchanges and relations between individuals. A contemporary work of legal examination is the seminal and extensive tome of Al-Sanhuri, who wrote the Egyptian Civil Code. He discusses risk in two different situations. One is a mistake that breaks an obligation, resulting in negligence that requires liability.<sup>161</sup> The other situation is risk in *Gharar* contracts, such as insurance and gambling. Under these conditions, he considers risk as *Khatar*, but with a connection to speculation and uncertainty.<sup>162</sup>

### **1.5.3 Risk Assessment in Islamic Law**

Islamic law interprets risk in its narrower sense of the excessive category. Two trends in Islamic legal text have identified risk. One trend identifies risk as it has been revealed and worded by legal texts. In this case, there are fixed types of risks according to fixed types of transactions. In other words, risk is assessed according to an analogy with legal texts. This assessment can be viewed as a subjective norm. The other trend deals with the text by examining the purpose for which that text was revealed and comparing this purpose to different transactions. This can be considered an objective norm. Both trends may lead to similar conclusions, but they use different methodologies.

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<sup>160</sup> GL Kaminsky and CM Reinhart, 'The Twin Crises: The Causes of Banking and Balance-of-Payments Problems' (1999) *Amer Econ Rev* 473. <<http://200.32.4.58/~ely/Kaminski-Reinhart.pdf>> accessed 20 October 2007.

<sup>161</sup> A Al-Sanhuri, *Al-Wasit Fi Sharh Al-Qanun Al-Madani Al-Jadid* (Cairo 1952) 776-809. Sanhuri's work has not been translated into English. The closest translated title would be, *Explaining the New Civil Code*.

<sup>162</sup> *Ibid* v 7, 1216-1245.

The subjective trend looks at risk as the identifying characteristics of the transaction; i.e., topics and titles. The objective trend looks at the purpose in the legal text. While agreeing on the legal text, they diverge in its interpretation. An example would be the prohibition of interest. The subjective approach permits banking interest, since it is not explicitly prohibited in the legal text, where as the objectivists prohibit it.<sup>163</sup> What the objectivists are doing in this case is going beyond the literal wording of the original legal text, which linked it to specific situations, and adapting it to new forms of interest, such as that charged or paid by banks, a modern economic entity which did not exist during the times of the jurists. Others have argued that the two approaches can also be linked through politically from the subjective viewpoint, and quantitatively from the objective one.<sup>164</sup>

It can be seen that the objective approach takes into consideration ‘innovation and invention’ in development, whereas the subjective approach decides on the legality or illegality based on the content of the primary sources of Islamic jurisprudence. This makes the objective approach serve a better purpose in regulating and controlling activities prone to risk in Islamic banks.

Islamic law does not provide the tools and means for assessing risk, leaving such methods to reason and human endeavour. There are auditing and accountancy methods that Islamic banks can use in determining and evaluating financial risks. Such methods can assess the adequacy and effectiveness of controls, thereby evaluating the integrity of an entity's governance, operations and information systems, all of which impact the entity's financial information and the

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<sup>163</sup> Atbani (n 150) 71.

<sup>164</sup> JD Millar, 'Quantitative Risk Assessment: A Tool to Be Used Responsibly' (1992) 13 J Pub Health Pol 5, 8.

safeguarding of its assets.<sup>165</sup> In addition, Islamic banks should use the IIA principles as a model which they can modify to ensure that they do not contradict or compromise Sharia rulings. One such Islamic body that is already putting this into effect is the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which also states that Islamic banks can also use other standards, as long as they do not breach Islamic law.<sup>166</sup> It also becomes necessary that Islamic financial institutions measure their transactions at a fair and reasonable value in the manner they are applied internationally and at all levels.<sup>167</sup>

The common elements of risk that can be extrapolated from the various definitions of the term are probability and chance.<sup>168</sup> To achieve a scientific method of assessing risk, the now widely used technique of Quantitative Risk Assessment (QRA) has been applied in various financial activities. According to the recommendations of the Basel Accord, QRA can be used to assess estimating banks' financial outcomes.<sup>169</sup> Although deemed a scientific method, QRA uses objective techniques in classifying risks, as well as subjective methods when it uses 'experiences and beliefs'.<sup>170</sup> As an example,

... the assessment of the risk of 'loss' in a gambling game can be objectively calculated by the probability of a win, which is  $1/n$ . In a different way, the risk of

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<sup>165</sup> The Institute of Internal Auditors, 'The International Standards for the Professional Practice of Internal Auditing, Performance Standard 2120' <<http://www.theiia.org/guidance/standards-and-practices/professional-practices-framework/standards/standards-resources/?C=820&i=2386>> accessed 22 October 2007.

<sup>166</sup> AAOIFI, 'Accounting, Auditing & Governance Standards (for Islamic Financial Institutions)' (AAOIFI Publications 2003) <<http://www.aoifi.com/keypublications.html>> accessed 22 October 2007.

<sup>167</sup> Financial Accounting Standards Board, 'Fair Value Measurements' (FASB 2004-2005) <[http://www.fasb.org/project/fv\\_measurement.shtml](http://www.fasb.org/project/fv_measurement.shtml)> accessed 22 October 2007.

<sup>168</sup> J Steele, *Risks and Legal Theory* (Hart Publishing, Oxford 2004) 7-15.

<sup>169</sup> Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (BSBS, Basel 2004) paras. 156-161. Also available online at <<http://www.bis.org/publ/bcbs107.pdf>>.

<sup>170</sup> Steele (n 168) 21.

such a game is subjectively a matter of belief and conviction for a Muslim, as its prohibition is decided by the Holy texts.<sup>171</sup>

Another risk assessment method that can be used in Islamic banking is the feasibility study. As banks are involved in financial activities, such activities can lead to either an outcome of profit or loss. It would be prudent for a bank to measure the level of risk that such a venture is likely to involve. Projections and estimates are used to create forecasts for different scenarios. Detailed analyses of such scenarios, based on present facts, would quantify the amount of risk of loss or the likelihood of profit. The reason for such studies is to minimize the possibility of hazardous outcomes. A feasibility study can be defined as a ‘controlled process for identifying problems and opportunities, determining objectives, describing situations, defining successful outcomes and assessing the range of costs and benefits associated with several alternatives for solving the problem.’<sup>172</sup>

#### **1.5.4 Legality of Risk Themes**

In addition to defining the daily practices of the Muslim, Islamic law also aims at protecting five aspects of the Muslim’s life from severe and unacceptable risk. Life itself is at the top of the list, followed by religion, intellect or knowledge, family life and progeny and wealth.<sup>173</sup> Therefore we can only conclude that any action that entails the risk of jeopardizing any of these aspects is prohibited. Islam sets precautions and prohibitions against such practices to prevent man from deviating from the teachings of the Holy Koran and thereby obstructing his purity. Therefore, the

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<sup>171</sup> Atbani (n 150) 75.

<sup>172</sup> A Thompson, 'Business Feasibility Study Outline' (Murdoch University 2005) <[http://bestentrepreneur.murdoch.edu.au/Business\\_Feasibility\\_Study\\_Outline.pdf#search=%22feasibility%20study%20can%20be%20defined%22](http://bestentrepreneur.murdoch.edu.au/Business_Feasibility_Study_Outline.pdf#search=%22feasibility%20study%20can%20be%20defined%22)> accessed 22 October 2007.

<sup>173</sup> A Akgunduz, 'Norms and Values in Islam' <[http://www.uga.edu/islam/norms\\_values.html](http://www.uga.edu/islam/norms_values.html)> accessed 22 October 2007.

occurrence of risk can be involved in several aspects of human life—social, financial and commercial transactions.<sup>174</sup>

Another tenet of Islamic law is that breaches of the law are considered offences against God, and not against the law itself. Therefore, avoiding speculative risk becomes man's duty to uphold his faith and to avert the punishment at the end of time.<sup>175</sup> However, it is the duty of Muslim judges and jurists to uphold the theocratic law and are thus granted the authority to propose and evaluate proper punishment for violations involving excessive risk, as these occur most commonly in the financial field. The market becomes the playground where factors affecting social and economic conditions become subject to risk, and money becomes vulnerable to the risk of loss, bankruptcy and perpetual fluctuation in value.<sup>176</sup>

## **1.6 Sharia Supervisory Boards (SSB)**

The concept of operating SSBs is unique to the Islamic system. One function of SSBs is to oversee the operations of financial institutions. They undertake this function with a view to ensure that the institutions' operations are carried out within the broad framework of the rules prescribed by Sharia. In addition to ensuring Sharia compliance, they are also viewed as the most important factor in identifying and assessing risk in the Islamic financial industry. Each board is made up of three or more Sharia scholars who are also conversant in finance or economics. They meet to make sure that the products and/or services offered by the firm are in compliance with the principles of Sharia. They can also take part in product research and development and issue a

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<sup>174</sup> P O'Malley (ed), *Governing Risk* (Ashgate, Aldershot 2005) xi-xxiii.

<sup>175</sup> Atbani (n 150) 90.

<sup>176</sup> L Von Mises, *The Theory of Money and Credit* (Liberty Fund, 1981) <<http://www.econlib.org/library/mises/msTContents.html>> accessed 22 October 2007. Sections II.12.17 and III.15.16.

fatwa certifying compliance.<sup>177</sup> The presence of SSBs is also important for sponsors of Islamic financial projects. In so doing they rely on these boards to monitor their ventures, thereby ensuring on behalf of all concerned—investors, depositors, and shareholders—that all transactions, policies and procedures are in line with Islamic law requirements.<sup>178</sup>

### **1.6.1 Membership of Sharia Supervisory Boards**

The members of the SSBs normally are Muslim scholars sourced from reputable institutions that have traditional learning courses where curricula are drawn from classical sources and where upon completion of a course the student is issued a permit (*ijazah*).<sup>179</sup> In addition to traditional studies, many of the scholars also undertake further studies in international finance, economics and legal studies pertaining to Western countries. Such studies improve their knowledge in various fields and make them more suitable to discharge their functions as members of SSBs. The function of SSB members is to ensure the ‘continued compliance of the index methodology and the constituents of index and they also act as the advocates for the minority shareholders and depositors.’<sup>180</sup>

While demand increases for SSBs, there are criteria that must be met to qualify for membership in SSBs. These criteria take into play the following factors: (1) that the candidate is in fact a reputable expert in Sharia laws, and has gone through the necessary schooling that would enable him to deal with matters pertaining to Islamic law, (2) he must also have worked in an advisory role; (3) he must show evidence of expertise in Islamic finance either in the form of papers

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<sup>177</sup> SYT DeLorenzo, 'Shari'ah Compliance Risk' (2007) 7 CJIL 2.

<sup>178</sup> R Siddiqui, 'Shari'ah Compliance, Performance and Conversion: The Case of the Dow Jones Islamic Market Index' (2007) 7 CJIL 1.

<sup>179</sup> Ibid 2.

<sup>180</sup> Ibid

published in this field or any other field relevant to the administration of Sharia rules, (4) he would have to show details of membership with SSBs of internationally renowned financial institutions, and (5) he must have the academic background that would enable him to deal with the social and economic contexts of Islamic financial considerations.<sup>181</sup>

### **1.6.2 Evolution of Sharia Supervisory Boards**

The revival of the marketing of Islamic financial products and services necessitated Islamic financial institutions to accept the assistance of experts on Sharia rules and norms for dealing with Sharia compliance risks. These institutions utilise such experts' knowledge of Sharia rules for transactions, that it is important to study their entire operations, including their policies and procedures, the structure of their products and services and the instruments covering them.

The scholars' opinions have received widespread responses from the banks' clients, and due to this, client acceptance of consultation with the SSBs has become a prominent feature of financial institutions. The formation of SSBs by all-member institutions was made mandatory by the promulgation of a standard to this effect by the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) in 1998.

The institutions dealing within a local region can appoint an SSB with local or regional membership only, but those institutions which intend to do business internationally usually face the problem that their SSB members may only be recognized in their own countries. To circumvent this shortcoming, those institutions engaged in global business ventures such as banks, asset managers, finance companies or index providers, have on-board SSBs whose members are scholars of international stature and with a broad background that covers a wide

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<sup>181</sup> DeLorenzo (n 177) 3.

range of cultures and languages.<sup>182</sup> Such internationally recognised SSBs have accreditation from the major schools of jurisprudence, as well as recognition by the various geographical areas where a Muslim community is found.

### **1.6.3 The Role of SSBs in Financial Service Products**

In order for consumers and investors to accept a financial product or service as Sharia compliant, it must first be approved by a religious authority.<sup>183</sup> Certain areas require that any financial product or service being offered to customers should receive the approval of an SSB and have a fatwa issued for it. The marketing of any financial product or service to the Islamic community cannot be undertaken without formal certification through a fatwa. Such certification ensures that a financial product or service certified by the SSB not only complies with state regulations, but has also undergone examination and verification by an Islamic law expert who is conversant with business transactions. It also signifies that it is in full compliance with the rules and standards prescribed by the SSB.

The role of the SSB extends from development of the product or service through to its final certification. The SSB's assistance starts in pre-certification by facilitating the structuring and development of products. After this, the SSB may issue the fatwa certifying compliance. An offering has to be Sharia compliant before a memorandum is issued; or, in the case of a product, before it is introduced into the market. By this stage, the SSB and management should have worked together to identify and lessen all risks that may compromise Sharia compliance.<sup>184</sup>

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<sup>182</sup> Ibid

<sup>183</sup> Ibid 2.

<sup>184</sup> Ibid

#### **1.6.4 Reasons for the Rejection of a Fatwa of SSB by Customers**

Not all fatwas issued by SSBs are accepted. There are situations where a fatwa is either rejected or may not appeal to the customers. Such reasons may include: (1) where the SSB decision is based on the interpretation of a minority school of jurisprudence, (2) where the disclosures in the fatwa do not meet the expectations of the board of investors, (3) when an SSB fatwa is vague either by failing to explain adequately its contents, or when the board is unfamiliar with what is being specified in the fatwa, thereby rejecting it to minimize risk, and (4) when consumers think that the fatwa has not properly addressed the compliance issues.<sup>185</sup>

### **1.7 Summary and Conclusion**

In the foregoing we have made a general survey of corporate governance, some definitions have been proposed and argued in the course of economic research, and its implementation considered within the context of Islamic law and the religious aspects of economics in relation to the Koran, the Sunna and the Hadith.

We have seen how Islam, which deals with all aspects of an individual's life, deals with its very important economic aspect. The sum total of human experience includes the behaviour of corporations and how they deal with shareholders' wealth and their own success. The growth of Islamic financial markets has made it almost mandatory to analyse the relationship between man and wealth.

In the last three to four decades, the number of Islamic financial institutions and the volume of their operations have grown to such an extent that there is a shortage of scholars who can be appointed as members of SSBs. Although financial institutions feel this shortage strongly, the

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<sup>185</sup> Ibid

people who are available have been able to enlarge the horizons of Islamic financial products and services to a large extent. There has been an increasing awareness and receptiveness by leaders of the industry and their clients of Sharia-enabled products and services which have been cleared and certified by the SSBs. The role played by Sharia in Islamic banking and finance in order to make it possible for successful products and services to be launched, a stakeholder approach to Islamic financial institutions and commercial enterprises would have to take a stakeholder approach. The stakeholders in this case include consumers, Sharia scholars, academics, Western institutions and the media in general.<sup>186</sup>

After this analytical and background study of the concepts of corporate governance in Islamic Sharia, we can say that these concepts are crystallized in two areas. The first area covers general concepts and rules brought about by Islamic Sharia based on values, morals and fear of the wrath of God, thereby avoiding those transactions prohibited by Sharia, including usurping the wealth of others. These concepts and rules were clarified initially by the Prophet Muhammad, and subsequently by the classical jurists through their respective schools.

The second area covers modern concepts developed by the modern ulama and jurists alongside developments in trade, finance and means of communication, whereby they were able to Islamicize several Western tools, thus rendering them Sharia compliant. The present reality embodied in the success of companies dealing in Islamic investment tools and entering world markets is proof of its success and the success of Islamic rules of corporate governance.

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<sup>186</sup> Siddiqui (n 178) 14.

## **2 Chapter Two: Corporate Governance: EU and UK Measures**

### **2.1 Introduction**

In this chapter we shall progressively focus on the analysis of the corporate governance of banking institutions, and through our analytical study to become familiar with the standards and rules of corporate governance in the United Kingdom. Our choice of the United Kingdom is not surprising; it embraces the largest financial market, in addition to its historical heritage in companies and commercial transactions. Consequently, a discussion of the rules of corporate governance in this country is inevitable for any researcher trying to conduct a study of the rules of corporate governance. We have also found it useful to consider the direction of the European Union concerning corporate governance, as well as its achievements in this matter, notably after the financial tremors caused by financial scandals in some European companies.

‘Corporate Governance refers to the structures and processes for the direction and control of companies.’<sup>187</sup> The establishment of relationships and their maintenance among controlling and minority shareholders, boards of directors and other external stakeholders are entrusted with the phenomenon of corporate governance.

Salacuse has noted that ‘Europe, except for the United Kingdom, does not seem to have separated the issues of corporate governance from corporate responsibility as sharply in public discussion as has the United States.’<sup>188</sup> European countries believe more in the participation of the corporation in community-related issues; their understanding of corporate governance is related more to complying with social responsibilities rather than from the angle of the investors

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<sup>187</sup> International Finance Corporation, 'Why Corporate Governance' (International Finance Corporation 2005) <<http://www.ifc.org/ifcext/corporategovernance.nsf/Content/WhyCG>> accessed 16 December 2007.

<sup>188</sup> JW Salacuse, 'Corporate Governance, Culture and Convergence: Corporations American Style or with a European Touch?' (2003) 14 EBLR (no 155) 472.

and institutions.<sup>189</sup> This is different from the UK or USA, where the objectives of corporate governance are targeted more on investor confidence.<sup>190</sup>

Globally, several legislative and administrative requirements in the form of new accounting standards, requirements as to detailed disclosures in financial statements, and strict enforcement of regulations on securities exchanges have been prescribed to ensure that governance of corporate entities is maintained at levels that are beneficial to themselves as well as to the people dealing with such bodies corporate. Corporate governance had been used to protect the interests of company stockholders in the past, although it had not been debated and discussed publicly. However, 'Corporate Governance' has assumed a new dimension in the post-Enron and post-globalization scenario as almost every major developed and developing nation ensures some sort promotion and protection thereof.<sup>191</sup>

Before discussing the measures taken by the UK and the EU, a brief survey of the recommendations of the Group of Eight (G8) and the Group of Twenty (G20) is relevant, as the member states felt the need for recommendations and initiatives in encouraging individual countries to enact measures that would improve the standards of corporate governance within their economic structures.

## **2.2 The G8 and G20 Initiatives**

Before the G8 became interested in corporate governance as a regulatory factor in promoting economic stability within its member countries, it limited itself by looking at such regulations in

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<sup>189</sup> Ibid

<sup>190</sup> Ibid 477.

<sup>191</sup> This is discussed in detail in AB Harris and AS Kramer, 'Corporate Governance: Pre-Enron, Post-Enron' in CL Culp and WA Niskanen (eds), *Corporate Aftershock: The Public Policy Lessons from the Collapse of Enron and Other Major Corporations* (J. Wiley, Hoboken, NJ 2003).

countries outside the group. The poor performance of economic practices in following the democratic change in Russia and the overall financial crisis in the world made the G7 and later the G8 become increasingly aware of poor corporate governance practices in countries outside the group, which would have a global negative impact on member nations.<sup>192</sup>

The increasing interest in corporate governance regulations centred on the way individual companies within the member countries behaved with respect to the various aspects of governance. Their Cologne (1999) and Okinawa (2000) summits ‘placed a new emphasis on transparency and accountability, on combating money laundering and tax evasion.’<sup>193</sup>

In 2002, the G8 took a major step forward, as a result of the September 11 terrorist attacks and the Enron and WorldCom scandals forced North American leaders to act. At the meeting in Halifax on 15 June 2002, the G7 finance ministers called on Russia to ‘strengthen the financial sector, improve corporate governance and the investment climate, and combat money laundering and terrorist financing.’<sup>194</sup>

However, it was not until the G8 summit at Evian in June 2003 that corporate governance issues occupied a prominent place. The recommendations at the Evian summit addressed specific issues pertaining to corporate governance. They highlighted the critical importance of sound and effective capital markets as prerequisites for ensuring the continuation of economic growth, keeping in clear perspective the financial declines of the late nineties and the outset of the 21st century. The G8 member nations emphasized the importance of ‘sound legal systems, effective

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<sup>192</sup> M Fratianni, P Savona and JJ Kirton (eds), *Corporate, Public and Global Governance: The G8 Contribution* (Ashgate Publishing Ltd, Aldershot 2007)

<sup>193</sup> Ibid

<sup>194</sup> --, 'Statement of G-7 Finance Ministers Halifax, June 15, 2002' (2002) <<http://treas.gov/press/releases/po3179.htm>> accessed 13 January 2010.

regulations and transparent corporate governance practices.’<sup>195</sup> The critical need for delivery of clear information from the perspective of the G8 member nations had two positive outcomes; one would be helping the shareholders to exercise control, while the other enabled investors to allocate funds to their most productive uses. Government bodies would support the achievement of these outcomes by ensuring that corporate transparency in providing information would help them in ‘monitoring markets and in identifying vulnerabilities.’<sup>196</sup> These mechanisms would breed and nurture trust and confidence, which are at the core of a healthy market economy.

The Evian summit discussed a wide spectrum of corporate governance issues, and came out with recommendations that it summarized in a declaration. In corporate governance, it called for the continuous effort to improve market integrity, which is necessary for proper functioning of the economy. In order to achieve this market integrity, it expressed its commitment to encourage ‘fair and effective competition.’<sup>197</sup> It further held that corporations are held accountable to their shareholders, which cannot be achieved without an advanced system of corporate governance. The declaration also called for transparency and accuracy of corporate financial reporting, supported by sound and recognizable accounting standards that can be applied on a continuous basis, to further enhance regulation of companies.

In addition to the initiatives and recommendations that the G8 countries proposed, the G20 group of finance ministers and central bank governors of 20 nations had their share in making proposals in the form of communiqués following their annual conferences. In these

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<sup>195</sup> --, 'Fostering Growth and Promoting a Responsible Market Economy - a G8 Declaration' (2003) <[http://www.g8.fr/evian/english/navigation/2003\\_g8\\_summit/summit\\_documents/fostering\\_growth\\_and\\_promoting\\_a\\_responsible\\_market\\_economy\\_-\\_a\\_g8\\_declaration.html](http://www.g8.fr/evian/english/navigation/2003_g8_summit/summit_documents/fostering_growth_and_promoting_a_responsible_market_economy_-_a_g8_declaration.html)> accessed 12 December 2009.

<sup>196</sup> Ibid

<sup>197</sup> Ibid

communiqués they reaffirmed their beliefs in good governance and transparency. Following the financial crises and corporate scandals in 2001 and 2002, they recognized the importance of ‘sound macro-economic policies, strong institutions and governance’ as critical elements in realizing the prospects and potential of their economies. Their emphasis on globalization is based on these ‘sound practices in the individual macro-economic spheres, including the need for sound national financial systems, effective supervision, and corporate governance in line with global best practice.’<sup>198</sup>

Among the points raised in their Berlin conference in November 2004, the G20 issued a communiqué in which it devoted a separate statement on transparency and information exchange. The approach still dealt in generalities, with ideals of enhancing sound economic growth and, as just mentioned, the need for transparency and information exchange. However, it did call for the implementation of these principles by utilizing legal mechanisms.<sup>199</sup> Within the scope of their global outlook G20 members still looked at individual member nations as the starting point where disclosure could be improved and governance and risk management could be strengthened. These issues dominated their declaration at their 2008 conference in Washington, DC. In a similar fashion to the G8 declaration at Evian mentioned above, the G20 stressed the necessity for regulators to ‘support market discipline’ and ‘avoid potentially adverse impacts on other countries.’<sup>200</sup> While their approach has been dominated by a global economic

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<sup>198</sup> G-20 Finance Ministers' and Central Bank Governors' Meeting, 'Delhi Communiqué' (2002) <[http://www.g20.org/Documents/2002\\_india.pdf](http://www.g20.org/Documents/2002_india.pdf)> accessed 10 January 2010.

<sup>199</sup> G-20, 'Communiqué: Meeting of Finance Ministers and Central Banks Governors, Berlin, 20-21 November 2004' (2004) <[http://www.g20.org/pub\\_communiques.aspx](http://www.g20.org/pub_communiques.aspx)> accessed 13 January 2010.

<sup>200</sup> G-20, 'Declaration: Summit on Financial Markets and the World Economy (Washington, DC, November 15, 2008)' (2008) <[http://www.g20.org/Documents/g20\\_summit\\_declaration.pdf](http://www.g20.org/Documents/g20_summit_declaration.pdf)> accessed 10 January 2010.

outlook, they were actually encouraging individual national regulators to take whatever action was necessary in improve market integrity in their respective countries.<sup>201</sup>

### **2.3 The European Commission Response**

As observed by Bernitz, ‘an important ambition of the European Commission is the creation of a level playing field and the abolition of different national obstacles to the establishment of a more integrated European capital market and company structure.’<sup>202</sup> However, the commission has a long way to go in achieving this ambition because of a large number of differences in the existing corporate governance models and in the corporate culture in different member nations. With this obstacle, and also hampered by large-scale corporate scandals in the US as well as in Europe, the EU has progressively increased its pressure on member nations to bring about radical changes in their corporate governance measures.<sup>203</sup>

While analyzing the adoption and follow up of corporate governance principles it is necessary to identify and appreciate the different models. These differ from each other in terms of voting rights; the ‘Anglo-American’ model is based on equal voting rights and dispersed ownership, while the ‘Continental-Nordic’ model has differentiated voting rights that encompass a more concentrated ownership. On the issue of advantages of both models Andre Nilsen<sup>204</sup> states that while considering takeovers in the European Union ‘varieties of capitalism approach can be used to distinguish between an Anglo-American and a Continental-Nordic model of corporate

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<sup>201</sup> Ibid

<sup>202</sup> U Bernitz, 'Special Issue Section on Corporate Governance in Europe in the Light of the Takeover Directive' (2004) 15 EBLR 1351.

<sup>203</sup> Ibid

<sup>204</sup> A Nilsen, 'Anglo-American V Continental-Nordic Models of Corporate Governance: The Political Economy of Takeovers in the European Union' (2004) 15 EBLR 1375.

governance, which provides a robust framework for analysing the political economy of takeover in the European Union.’

### **2.3.1 Evolution of Corporate Governance Principles in the EU – a Background**

Following the collapse of Enron in the US and corporate scandals in Europe such as Ahold in Holland and Parmalat in Italy, concern with financial reporting and other aspects of corporate governance became part of the EU policy’s agenda within what could be achieved by its Company Law and Financial Services Policies.<sup>205</sup>

From 1991 to 1997 different national codes for corporate governance were issued by EU member nations. These were followed by several other codes issued during the period 1998–2001.

Issuance of corporate governance codes was integrated by the OECD ‘Principles of Corporate Governance in 1999’, which contained a detailed framework for corporate governance issues.

In May 1999 the European Commission published its Financial Services Action Plan (FSAP) which put into place measures aimed at achieving efficient European capital markets that meet the needs of both investors and issuers. In its review of existing codes of corporate governance, the FSAP aimed at identifying any barriers that would deter the development of a single EU financial market, and put forward the idea of a unified European code of corporate governance to replace existing individual codes in the various members of the EU. This was presented to the Group of High Level Company Law Experts (Winter Group), which was formed in July 2001 to

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<sup>205</sup> EurActiv.com, 'Corporate Governance' <<http://www.euractiv.com/en/financial-services/corporate-governance/article-137147>> accessed 24 February 2010.

advise the Commission on a new framework of EU law which would include corporate governance.<sup>206</sup>

After the rejection of the Takeover Directive the Winter Group, followed the reasons for its founding, namely to make recommendations on the harmonization of legislation across the EU member nations and various other issues concerning corporate governance. On the basis of the reports submitted by the Winter Group the EU adopted an Action Plan in May 2003 to make improvements in corporate governance plans in the EU.

The ‘Corporate Governance Forum’ was established in October 2004 with 15 members representing the various stakeholders from across all EU nations, with the sole objective of promoting and coordinating the efforts of member states towards best practice corporate governance.<sup>207</sup>

Other important actions from the EU included the issuance of directives on: (1) harmonizing the contents of the prospectus, (2) market abuse, setting standards for the disclosure of price-sensitive information, and (3) company law directives proposing amendments with regard to disclosure requirements.

In September 2004, the commission, with a view to preventing corporate malpractices, outlined the following lines of defence and issued guidelines in this respect: (1) internal control mechanisms established through boards of directors, (2) independent audits, (3) supervisions and overseeing, and (4) enforcement by law.<sup>208</sup>

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<sup>206</sup> Ibid

<sup>207</sup> The contributions of the Corporate Governance Forum are discussed further in this thesis on pp. 92-83.

<sup>208</sup> Nilsen (n 168).

Corporate failures and scandals such as Enron and MCI WorldCom have highlighted the need to establish good governance systems as an important issue for all countries.<sup>209</sup> Nevertheless, these failures were not necessarily the instigators of corporate governance codes. Further, the collapses were not the only drivers that put pressure for further international convergence. During the last decade, a number of international agencies have taken an active role in promoting co-operation in crafting viable corporate convergence systems. For instance the Organisation for Economic Cooperation and Development (OECD) was the first international body to establish an inter-governmental task force in order to produce a set of globally acceptable standards of corporate governance. This brought together 29 member states of the OECD, the EU commission, the International Monetary Fund, The World Bank, The Bank for International Settlements, and the labour, business and investment community.<sup>210</sup> The OECD principles provide a framework to support countries in developing and establishing a corporate governance system in accordance with their own legal, regulatory and institutional environment. However, one major disadvantage of the OECD principles is their weak power of enforcement, which makes the code area a mere reference point for countries that wish to establish or reform their systems of governance.<sup>211</sup> As a result, most pieces of legislation in many countries are unclear. For instance, in the UK there are many invalid, unreliable and incorrect cost of capital elements that frustrate directors in their efforts to promote the success of companies. This is in spite of the existence of the UK Companies Act of 2006. This Act for the first time embedded in statute the corporate objective

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<sup>209</sup> M Davies and B Schlitzer, 'The Impracticality of an International "One Size Fits All" Corporate Governance Code of Best Practice' (2008) 23 *Man Aud J* 532-544.

<sup>210</sup> *Ibid* 533-534.

<sup>211</sup> *Ibid*

that it is the duty of company directors to promote the success of the company for the benefit of all its members.<sup>212</sup>

### **2.3.2 Progress in Corporate Governance Measures**

Based on a study of the changes in corporate governance measures between 2000 and 2004, in 300 of the largest publicly traded companies, Wo'jcik reports that while analysing corporate governance structure, the rights and duties of shareholders and takeover defences had changed only a little. Furthermore, the structure of the board of directors and its functioning with respect to disclosure had changed to a large extent in every country and industry analysed, and that 'continental companies have narrowed the gap in relation to the UK and Ireland, and there is evidence of convergence within individual countries and industries.' It has been observed that the European corporate governance platform still had not become solid with diversities all over Europe, while the differences between countries are less than the differences that exist between industries.<sup>213</sup>

### **2.3.3 New Proposals of European Commission in the Area of Corporate Governance**

The following are some of the proposals the EC had planned to enforce to further corporate governance in member nations:

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<sup>212</sup> S Paolo, 'The United Kingdom's Companies Act of 2006 and the Capital Asset Pricing Model: Attaining the Corporate Objective' (2010) 52 IJL Mgmt 253-264.

<sup>213</sup> D Wojcik, 'Convergence in Corporate Governance: Evidence from Europe and the Challenge for Economic Geography' (2006) 6 J Econ Geo 639. (Advance Access published on 9 May 2006).

### **2.3.3.1 Corporate Governance Statement**

Looking at the area of transparency the EC proposed to introduce the requirement of a corporate governance statement to be issued by the corporations with a declaration as to the extent the company complied with the corporate governance code. It must also offer sufficient explanation as to why it was not able to comply fully with the code. In addition to code compliance, the company's statement should also shed light on other factors, such as information on shareholders' rights, meetings, and the operation of the board of directors.<sup>214</sup>

#### **Liability of Board Members on the Financial and Key Non – Financial Information**

This stipulation requires the member nations to place a collective responsibility on the board of directors towards the company for the financial and key non-financial information which are part of the accounting statements. Though the EU considers sanctions and civil liability for non-compliance with the requirements of the accounting directive, there is no suggestion of a criminal sanction or punishment for wrongful information.<sup>215</sup>

### **2.3.3.2 Remuneration**

As long as sufficient information is provided to the shareholders of listed companies in member nations, the EC has allowed sufficient flexibility for the remuneration of directors of those companies registered in member nations territories, or outside those territories as long as the home office of these companies is registered in any of the member nations. However, this flexibility goes along with the implementation of three measures which have to be taken by the

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<sup>214</sup> EURLEX, 'Directive 2004/25/Ec of the European Parliament and of the Council of 21 April 2004 on Takeover Bids' (2004) <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004L0025:EN:HTML>> accessed 15 December 2007.

<sup>215</sup> , 'Meeting in Brussels' (2005) JURI Rep 5. <<http://www.europarl.europa.eu/comparl/juri/newsletter/20050421.pdf>> accessed 16 December 2007. 'The Commission proposes to amend the Accounting Directive and to insert a new section. Arts50b, 50c and 60a of the Accounting Directive and Arts 36(a) and 48 of the Consolidated Account Directive' 5/14.

companies: (1) company policy on remuneration should be disclosed in a statement covering projected remuneration in subsequent fiscal years, (2) this disclosure should include details of remuneration of individual directors, and (3) companies must allow shareholders to participate in decision making concerning director remuneration, to be substantiated by way of agenda items in shareholder general meetings.<sup>216</sup>

### **2.3.3.3 Other Transparency Measures**

In the matter of management reports, guidelines have been issued for the publication of annual reports within four months, half-yearly reports within two months after six months and an interim statement within the first and second six month period if the company is not obliged to make any quarterly report. 'The Directive on transparency requirements will revise and replace provisions of the Directive 2001/34/EC on the admission of the securities to official stock exchange listing.'<sup>217</sup> At the same time, according to the new directive, shareholders should disclose acquisition or disposal of shares with voting rights if their proportion of it is around thresholds ranging between 5 and 75 percent.<sup>218</sup>

### **2.3.3.4 Composition of the Board of Directors**

Another important recommendation is that the balancing of the board of directors with appropriate numbers of executive/managing and non-executive/supervisory directors should be fixed in a way that no individual or small group of individuals can gain dominance in the decision-making process. Similarly, suggestions have been made on the role of the chairman and

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<sup>216</sup> M Pannier and J Rickford, 'Corporate Governance Disclosures in Europe' (2005) 16 EBLR 985-986.

<sup>217</sup> Ministerie van Financien, 'Provisional Version: Press Release' (Ministerie van Financien 2004) <<http://www.minfin.nl/BFB04-1116b.doc>> accessed 16 December 2007.

<sup>218</sup> Pannier and Rickford (no 175) 987. The actual percentages range between 5% and 30% in 5 point intervals, followed by two levels--30% and 50%.

CEO and disclosure if the CEO becomes the chairman. The guidelines also contain specifications about the qualifications of non-executive directors.<sup>219</sup>

### **2.3.3.5 Shareholders' Rights**

The directives issued by the EC also recommend that shareholders are furnished with maximum information and should be treated equally. In addition, shareholders should have unrestricted voting rights, should receive full and proper information regarding the conduct of the business, and a system should be put in place for them to vote in absentia.<sup>220</sup>

## **2.4 The EU Corporate Governance Forum**

In a press release issued in October 2004 the EC set up a Forum of fifteen experts as senior advisers to discuss best practices in member states, aimed at a convergence of corporate governance codes of the member nations, in addition to offering advice to the EC.<sup>221</sup>

The major function of the Forum is to promote and coordinate convergence of the national corporate governance codes which are dissimilar in each of the member nations. The guidance should extend not only to designing the national corporate governance code but also to streamlining the existing procedures of the member nations to make them more effective.

Guidance from the Forum would also enable member nations to monitor and enforce compliance and disclosure. The Forum would also concentrate on the provision of significant added value in facilitating the discussion and dialogues among the representatives of the Forum, which are

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<sup>219</sup> BAE Systems, 'The Board' (BAE Systems) <<http://production.investis.com/investors/corpgov/introduction/>> accessed 16 December 2007.

<sup>220</sup> Pannier and Rickford (n 175) 986.

<sup>221</sup> Press Releases, 'Corporate Governance: Commission Creates European Forum to Promote Convergence in Europe' (Europa 2004) <<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/04/1241&format=HTML&aged=0&language=en&guiLanguage=en>> accessed 16 December 2007.

selected from all over Europe. The Forum will extend such guidance to all the interested nations and identify the best practices of corporate governance and disseminate them among member and non-member nations.

In its meeting held in June 2006, the European Corporate Governance Forum considered, among other things, the following matters in connection with corporate governance: (1) application of the comply-or-explain principle in Europe with respect to monitoring application of the principle in member states for further consideration, (2) the role of employees as stakeholders in corporate governance, (3) disclosure of investors' identities, and (4) a 'Commission proposal for a directive on the exercise of voting rights by shareholders of companies having their registered office in a member state and whose shares are admitted to trading on a regulated market and amending directive 2004/109/ec', as reported by the Minutes of the Meeting of 1 June 2006 of the European Commission.<sup>222</sup> In a statement issued on risk management and internal control, the Forum specified new regulatory measures governing these two issues in corporate governance.<sup>223</sup>

## **2.5 Corporate Governance in the EU and the Effect of Corporate Scandals**

When the stock market's bubble burst in 2000, it impacted on the EU countries more than it did the US. However, as has been noted, 'in Europe, this sudden market decline was not associated with the same pervasive accounting and financial irregularity that shook the US economy and

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<sup>222</sup> European Commission, 'European Corporate Governance Forum: Minutes of the Meeting of 20 January 2006' (European Commission 2006) 3 <[http://ec.europa.eu/internal\\_market/company/docs/ecgforum/minutes-20-01-06\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/ecgforum/minutes-20-01-06_en.pdf)> accessed 18 December 2007.

<sup>223</sup> --, 'Statement of the European Corporate Governance Forum on Risk Management and Internal Control' (EUROPA 2006) 1 <[http://ec.europa.eu/internal\\_market/company/docs/ecgforum/statement\\_internal\\_control\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/ecgforum/statement_internal_control_en.pdf)> accessed 16 December 2007.

produced the Sarbanes–Oxley Act in 2002.<sup>224</sup> In Europe, alterations to financial statements are rare as compared to those in the US. The nature of financial scandals in Europe, such as the Parmalat scandal, is different from what happened in the US, where the frauds are perpetrated in the form of earnings statements as in the case of Enron or WorldCom. However, those European firms which had been cross-listed in the USA seem to have suffered from such accounting frauds. While the corporate scandal in Europe in the case of Parmalat, and Enron in the US, have happened due to the failure of the gatekeepers, they both differ in characteristics demanding a separate set of corporate governance principles. In the Parmalat scandal, the Tanzi family should not be solely blamed for the scandal. An equal measure of blame falls on the system of corporate governance in the company which resulted from ‘regulatory gaming’ and the deliberate oversight on the part of those entrusted with upholding the integrity of the market.<sup>225</sup>

The US needed the more stringent Sarbanes – Oxley Act. But in Europe the remedy was found in the various directives prescribed by the EU, which included the use of audit committees. This has been widely accepted in the governance code of European countries. This is so even with companies having a two-tier governance structure. But in those companies, there is a slight variation in the codes and principles that are recommended.<sup>226</sup>

It has also been shown that issues relating to the implementation and enforcement of the new corporate governance codes or guidelines were receiving more attention and several approaches had been introduced to facilitate implementation of these codes. Some of the approaches went

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<sup>224</sup> JC Coffee Jr., 'A Theory of Corporate Scandals: Why the USA and Europe Differ' (2005) 21 *Oxf Rev Econ Policy* 199.

<sup>225</sup> J O'Brien (ed), *Governing the Corporation: Regulation and Corporate Governance in an Age of Scandal and Global Markets* (Ebook Mall) 11.

<sup>226</sup> P Collier and M Zaman, 'Convergence in European Corporate Governance: The Audit Committee Concept' (2005) 13 *CGAIR* 753.

strictly according to the provisions for enforcing the exact implementation of the codes by drawing up comprehensive plans for implementation. Others followed the approach of monitoring market developments and adjusting the intensity of the enforcement of the corporate governance codes accordingly.<sup>227</sup>

### **2.5.1 Corporate Scandal in the EU – the Parmalat Affair – Views on Corporate Governance**

There had been wide publicity on the ‘Parmalat Affair’ the details of which were spread by almost all kinds of media including the financial press, various internet sites representing consumer and investor interests and also legal websites for the general information of the public to make them aware of the weaknesses which existed in corporate governance systems. The events associated with the affair had presented a phenomenon to be studied by all concerned for the promotion of measures that will effectively prevent reoccurrence of such happenings. Analysis of events connected with the scandal surrounding the securities of the ‘Parmalat group’ identified three categories of non-professional investors. These categories were based on the situation the people were in at the time when the incident happened. The first group includes those who had acquired bonds or securities in the Parmalat group much earlier than information on the financial issues being faced by the group became common knowledge. In the second group are those who wanted to buy and speculate on the securities of the group even after they had knowledge of the financial problems faced by the group. A third group acquired the securities involuntarily through the acts of banks or investment companies of which these people were the clients. It is interesting to note that each of these groups of people was protected in varying degrees depending on the extent to which they could gather information about the

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<sup>227</sup> Ewymeersch, 'The Enforcement of Corporate Governance Codes' (2006) 6 JCLS 113.

situation in which the stocks were found and also the intentions with which the shares were acquired by them.

The securities were being offered to these different kinds of investors during the entire period during which the poor financial status of the group was being circulated in the market. Certain financial brokers continued to place the securities even after news broke about the bad financial state of affairs of the group. These purchases were made by the brokers and investment firms on behalf of their clients both with and without their knowledge and orders, simply to earn the attractive brokerage the shares were offering.

Worse, some sold their clients securities from their own assets in order to escape from the stock's loss of value by 'discharging it' onto other people's assets. Distinctions also need to be made between brokers, according to their level of responsibility.<sup>228</sup>

This situation is totally based on the relationship between the investor and the investment firms acting on their behalf. It may, however, be noted that there are relationships that find their place both above and below those mentioned. There is a 'maze' of finance companies so identified and reported by the renowned Italian financial dailies. In fact one such newspaper even published an organization chart of the group of companies as it existed at the time when it collapsed financially.

It is worth mentioning the role of Italian and foreign financing banks which were aware of the financial problems being faced by the group. There were investigations to find out exactly the extent to which these firms had knowledge of the instability of the company. Other groups of people who can also be held accountable for the state of affairs of the group were the auditors of

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<sup>228</sup> G Alpa, 'The Legal Maze of the Parmalat Affair' in JJ Norton and J Rickford (eds), *Corporate Governance Post – Enron: Comparative and International Perspectives* (British Institute of International and Comparative Law, London 2006) 94

the group whose actions are also under investigation. The following are some of the possible observations:

1. The group's directors, auditors and the investment bankers were those responsible for the criminal developments
2. The parties who were to recover damages were the investors and or their associations
3. The events associated with the group had led to the restructuring of the company that was in crisis. Usually the affairs of such companies are entrusted to a referee
4. Most of the group's operational companies had been declared bankrupt and a list of creditors had been admitted
5. The fate of the employees of the group and their social obligations
6. The value of stock of the restructured company
7. The extent of the litigation likely to be faced by other group companies existing throughout the world
8. The civil liability of the Italian and other foreign investment banks from whom the Parmalat group obtained their finances, and
9. The possibility of placing any liability on 'Consob', the Italian supervisory body responsible for controlling the group's accounts and statements.<sup>229</sup>

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<sup>229</sup> Ibid 94-95.

All the above issues have contributed much to the knowledge and analysis of events for future guidance in the matter of good corporate governance so that such undesirable financial scandals would not take place. It may be observed that in view of the number of people involved in the whole affair it is difficult to fix individual responsibilities for the resultant financial debacle. This has necessitated serious debate on the initiation of strict corporate governance measures that will be able to protect the interests of not only the investors but also of other stakeholders connected with the company.

‘The financial maze constructed by a company that was originally family-run, traded in the dairy industry, esteemed for its excellent products, then overwhelmed by risky financial transactions, has thus been joined by the legal maze.’<sup>230</sup> The number of complex issues opened by the case provides a real workshop for various legal professionals as there were various remedies that would be available for the complex problems raised by the scandal.

## **2.6 Corporate Governance and Harmonization of Legislation in the EU Context**

‘The beginning of European company law legislation in the 1970s can be described as a movement towards an ‘EU Companies Act’. ‘In particular, the proposal for a Fifth Company Law Directive and the initial proposal for a Statute for a European Company (SE) included detailed rules for the internal structure of companies.’<sup>231</sup> Company Law harmonization across the EU nations was to formulate a total framework of company law aimed at removing barriers to the free movement of companies across the member nations. The harmonization objective includes eradicating the differences in the individual national laws by harmonization to achieve

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<sup>230</sup> Ibid 95.

<sup>231</sup> Pannier and Rickford (n 216) 955-976.

consistency in the various provisions affecting cross-border transactions. Harmonization of the legislation also had the objective of protecting the interests and the property of the creditors of foreign companies as if they were domestic creditors. However, the EU's harmonization approach suffered a setback with a number of issues that obstructed the flow of efforts in this direction. Such issues included enlargement of the EU with the entry of more nations, including the UK and Ireland, who brought more variations of company law regulations and other legal frameworks that has hampered progress. Similarly, the varied concepts of employee participation in the management of the company adopted in the different countries also blocked the initiatives of the EC to harmonize company law across member nations. Other factors which further hampered progress were the draft Fifth Directive and the proposed EC Directive on cross-border company mergers. Therefore, it may be stated that harmonization of the regulation of the internal functioning of an organization, which can be regarded as the core area of corporate governance, is yet to be achieved at the EU level.

## **2.7 Corporate Governance and Disclosure Requirements in the EU**

Progress has been made by the EU in harmonizing company law legislation of different member nations by taking initiatives such as the Financial Service Action Plan implemented in 1999, and the progress made by the enactment of the Statute for a European Company. However, a political deadlock occurred in the process with the hold up of the Takeover Directive in 2001 by the European Parliament. This can be considered a major blow to the Lisbon Agenda and had the effect of significantly delaying the harmonization progress. In order to obviate the difficulty, the European Commission appointed a group of company law experts under the chairmanship of Jaap Winter known as the 'Winter Group'. The main functions of the Winter Group were to address the issues that blocked the Takeover Directive and also to provide advice on

modernizing company law legislation in the EU.<sup>232</sup> The Group submitted its reports in January and November 2002. Based on these reports the EC developed its Action Plan on harmonization of the Company Law and the framework for corporate governance.

### **2.7.1 Principles of European Court of Justice in Corporate Disclosure Requirements**

The European Court of Justice (ECJ) was insisting that corporate disclosure rules were followed even before the initiatives of the Winter Group and the EC. This is evident from the decision of ECJ in the case of *Cassis de Dijon*.<sup>233</sup> The concepts of corporate disclosure were further developed by the decisions of the ECJ, even in the area of company law. Such concepts relate to the ‘freedom of establishment’. The question of protecting the interests of corporate creditors and shareholders by substantive disclosure requirements against the disclosure rules, represented by the freedom of establishment, was also the subject of several Court decisions.

The court in *Centros* held that the Companies Board of the Danish Department of Trade could not refuse to register a branch of a Danish citizen’s private limited company (Ltd) registered in the UK just because this type of company was chosen to avoid the more restrictive and substantial Danish capital requirements for companies registered in Denmark.<sup>234</sup>

‘Similarly, the Court in *Inspire Art* held that more restrictive Dutch rules (law on formally foreign companies) were incompatible with EU law.’<sup>235</sup> It appears that the EU has advanced further in harmonizing the external relationship of the company than in its efforts to harmonize the internal relationships. It may also be noted that even greater disclosure of information is

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<sup>232</sup> --, 'High Level Group of Company Law Experts, Issues Related to Takeover Bids (10 January 2002)' (Europa 2002) <[http://europa.eu.int/comm/internal\\_market/company/docs/takeoverbids/2002-01-hlgreport\\_en.pdf](http://europa.eu.int/comm/internal_market/company/docs/takeoverbids/2002-01-hlgreport_en.pdf)> accessed 18 December 2007.

<sup>233</sup> Case C-120/78 *Cassis De Dijon* ECR (ECJ). 649.

<sup>234</sup> Case C-212/97 *Centros Ltd V Erhvervs- Og Selskabstyrelsen* (ECR).

<sup>235</sup> Case C-167/01 *Kamer Van De Koophandel En Fabrieken Voor Amsterdam V Inspire Art Ltd* (ECR).

prescribed in the capital market directives covering the issues of transparency, issue of the prospectus and listing requirements.

### **2.7.2 Corporate Governance and Modernizing the Structure of Boards**

The EU has made extensive recommendations regarding the role of non-executive or supervisory directors on the board which are more or less similar to the directives of the EU in respect of directors' remuneration. But unlike the latter, the roles and responsibilities of non-executive directors provide for a 'comply or explain' approach from the companies in member nations, while the disclosure requirements in respect of the directors' remuneration are mandatory. The EU has provided considerable freedom for member nations to form their own codes or legislation, if they think that a legislative measure would be effective in satisfying the requirements in respect of non-executive directors on the board. The EC has approached the issue of the structure of the boards with the 'transparency' aspect as the overriding principle rather than a regulation of substantive details.

### **2.7.3 Board Balance and Board Committees**

One of the major recommendations made by the Winter Group and the Action Plan of the European Commission was the requirement of a board balance that can ensure effective corporate governance through independent overseeing of the corporate commercial and financial operations. On the composition of boards with non-executive directors, 'an appropriate balance of executive/managing and non-executive/supervisory directors such that no individual or small group of individuals can dominate decision making'<sup>236</sup> was suggested. Another area into which the recommendation regarding the board balance extends is the appointment and role of the chairman of the board. In this connection, in order to increase the objectivity of the chairman

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<sup>236</sup> Pannier and Rickford (n 216) 987.

when overseeing the corporate decision-making process, it is highly recommended that the CEO should abstain from also becoming chairman of the board. If it becomes necessary to combine the two positions, there must be suitable disclosure of such information along with safeguards by the company for an effective overseeing by the chairman so appointed. It is also recommended that boards should have a sufficient number of independent non-executive or supervisory members.

The recommendations in this direction also suggest that there should be suitable provision by the companies for the creation of audit committees within the board. The provisions should also cover the nomination of members to the boards and the appropriate remuneration of the members nominated. It must, however, be noted that there is no intention of establishing a separate body of members outside the board and also that the decision-making power should remain with the supervisory board. The recommendations provide flexible provisions to cover smaller companies. They also prescribe minimum standards for the creation and composition of the committees as well as their methods of operation. The role and responsibilities of the committees are also established by the recommendations. There are recommendations that the non-executive or supervisory directors have a dominant position on the board. Similarly, it is necessary that the nomination committee should have a majority of independent non-executive directors. But in the case of remuneration and audit committees, the requirements are that such committees should be exclusively constituted by non-executive directors and it is also mandatory that a majority of them are independent.

#### **2.7.4 Corporate Governance and Audit Committees in the EU Context**

Audit committees in the EU context are governed by the new Audit Directive which has prescribed some additional and different requirements for forming such committees. These

committees are defined as ‘public interest’ committees. The draft Audit Directives were underwritten by the Financial Services Action Plan 1999 and the salient features were discussed with the Securities and Exchange Commission of the United States for an effective implementation in the EU context. The public interest entities are defined by the Audit Directive to include those entities having a significant exposure in the market by virtue of their business, size or the number of employees. Thus the expression includes all major listed EU corporate entities, banks and other investment and financial undertakings and insurance companies. However, the Audit Directive fell short of strengthening audit committees by accepting only one independent member as an accountant or auditor to be present on the committee, which was made up largely with a vast majority of non-executive and supervisory or only supervisory directors.<sup>237</sup>

Another deviation that the Audit Directive made from the recommendations is that the audit committee is given the additional role of nominating the external accounting firm to be appointed as external auditors. Hence it follows that the appointment of the external auditor in the general meeting should follow the nomination of the audit committee.

## **2.8 UK Responses to Application of Corporate Governance Principles**

Corporate governance encompasses the exercise of administrative powers over corporate entities. While during the nineteenth century the foundation for modern corporations was laid, the twentieth century witnessed the development of several management theories. The twenty first century concentrates on the governance issues as the focus is on ensuring the legitimacy and the

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<sup>237</sup> Ibid 989.

effectiveness of the exercise of external pressure and power over corporate bodies all over the world.<sup>238</sup>

The evolution of corporate governance in the UK can be traced back to the early 20<sup>th</sup> century which saw a significant development when public companies started listing their shares on the stock exchanges. This led to a wider dispersion of shareholders and weakened further the link between shareholders and management. As the UK joined the EEC in 1973, it had to face existing corporate governance models that were native to the continent, as in the case of the fifth draft issued by the EEC in 1972, which proposed a two-tier board as practiced in Germany and Holland. However the idea of a two tier board was not accepted by the UK. The country was in favour of the unitary board approach comprised of both executive and non-executive directors who were made responsible for the day to day running of the business. The UK's response to the two-tier system was the formation of a committee chaired by Lord Bullock. This committee recommended the continuation of the unitary board with a worker representative board, although this was not well received in Britain's corporate quarters.<sup>239</sup>

Pannier points out that 'The EU Commission Action Plan *Modernising Company Law and Enhancing Corporate Governance of 2003* has already prompted a number of adjustments to the company law of the UK and other EU Member States.'<sup>240</sup>

As quoted by Mallin 'the paper by Bernard Taylor provides an interesting insight into the events at Shell which led to it having to write off large amounts of reserves after these had been

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<sup>238</sup> R Tricker, 'Corporate Governance: A Subject Whose Time Has Come In' in R Tricker (ed) *Cg* (Ashcroft Publishing, Aldershot 2000)The title in this reference is the text of the Editor's introduction to the book.

<sup>239</sup> Ibid

<sup>240</sup> M Pannier, 'New European Company Law and Corporate Governance - the UK and the New Member States' (2005) EBLR 1366.

overbooked, and which shook the confidence of the stock market' is an example that illustrates the need for corporate governance reforms in UK.<sup>241</sup>

It was observed by Taylor that the climate for corporate governance drastically changed after the corporate scandals and reform measures had been undertaken to prevent their recurrence and protect investor interests.<sup>242</sup>

Various studies have been conducted to assess the impact of corporate governance measures on the disclosure of corporate news in the corporate setup in the UK and other countries. As per Lynsey et al., 'the introduction of the Cadbury, Greenbury and Hampel reports was accompanied by a significant increase in the number of news announcements'.<sup>243</sup>

### **2.8.1 Various Committee Reports and the Development of Corporate Governance in the UK Context**

Corporate governance issues in the UK went through a range of committees which issued reports regarding the governance of public companies in the 1990s. One example is the Cadbury Committee, which was established in 1991 by the Financial Reporting Council, the London Stock Exchange and other related entities. Among the Cadbury Committee's recommendations was that a public company must comply with a 'code of best corporate practice' if it was to remain listed on the Exchange.<sup>244</sup>

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<sup>241</sup> C Mallin, 'Review of International Corporate Governance Conference Held at Birmingham Business School, July 2005' (2006) 14 CGAIR 146.

<sup>242</sup> B Taylor, 'Review of the 8th International Conference on Corporate Governance and Board Leadership, Henley Management College, October 2005' (2006) 14 CGAIR 519.

<sup>243</sup> S Lynsey, E Jones and C Marston, 'Corporate Governance Codes and the Supply of Corporate Information in the UK' (2006) 14 CGAIR 497.

<sup>244</sup> Alpa (n 228) 1.

The Cadbury Committee report was followed by the Greenbury Committee in 1995 and its recommendations, except those relating to share options, long-term incentive schemes and pension entitlements which were included in the listing requirements, making it a compulsory listing precondition.

The Hampel Committee formed in 1998 supplemented the recommendations made by the Cadbury and the Greenbury committees by contributing improvements over their recommendations.

The London Stock Exchange, based on the Hampel report, brought out a general code of good practice entitled 'The Combined Code' which was made compulsory for all companies proposing to become listed after 31 December 1998. Despite the fact that it is a code, non-compliance may entail a listed company in a fine or in some cases refusal to list.

In 1999 the Turnbull Report prescribed three measures; the evaluation of risks facing a company in the responsibilities of the board of directors, putting into place effective safeguard mechanisms and internal control systems to prevent or reduce risk, and internal controls to include a transparent annual assessment of risks.

The aftermath of the Enron scandal necessitated publication of the Higgs Report and a 'Revised Combined Code' with the main emphasis on collective responsibility of the board of directors. The recommendations of the Higgs Report did not approve the French and German models of board structure but preferred the existing UK unitary structure. The Higgs Report advocated a

greater involvement of non-executive directors, basing its recommendation on the Revised Combined Code.<sup>245</sup>

## **2.8.2 Corporate Governance in the UK Financial and Banking Sectors**

The need for stronger corporate governance measures for banking companies was increasingly felt by experts in the banking industry after the US savings and loan crisis of the 1980s and the Asian Financial crisis that produced a major economic shock in the 1990s. An analysis of the available literature reveals that most corporate governance measures concentrated on the non-financial sector. However, the UK financial services regulatory measures have provided for effective corporate governance practices in banking and financial services firms ensuring a proper balancing of the stakeholders' interests.

The corporate governance norms for banks differ fundamentally from those of the non-financial sector, as banks undertake special kinds of risks in their operations. Eatwell and Taylor emphasize that 'an effective control of the systemic risks of the banks is at the root of a safe and sound banking system.'<sup>246</sup> Since the banks usually shift the social cost of their risk-taking to consumers, they normally tend to under-price their financial risks. This would expose the banks to systemic risks. Banks may incur social costs on their risk-taking as they quite often resort to imprudent lending and also maintain inadequate deposit insurance resulting in a 'run' on the bank. This kind of fragility in banking operations and their vulnerability to exposure to different systemic risks calls for adequate corporate governance measures to be in place to ensure customer confidence.

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<sup>245</sup> Ibid

<sup>246</sup> J Eatwell and L Taylor, *Global Finance at Risk: The Case for International Regulation* (Polity Press, Cambridge 2000) The [Economist](#) defines 'systemic risk' as 'the risk of damage being done to the health of the financial system as a whole. A constant concern of bank regulators is that the collapse of a single bank could bring down the entire financial system.'

Applying the principles of corporate governance in the UK context, it should be noted that traditionally the UK Company Law made directors more responsible for the company's interests than protecting the interests of the individual shareholders. This implies that directors are responsible for the shareholders, collectively in the form of a company, rather than to the individual shareholders. In the case of banks, UK courts have invariably fixed the duties and responsibilities of the directors and other officers through decisions in various cases. One important judgment detailing the duties of directors with regard to the functioning of a bank was delivered in the *Marquis of Bute's Case*.<sup>247</sup> 'The case stands for the proposition that a 'reasonable person' test would not be applied to acts or omissions of a director or senior manager who had failed to keep himself informed of the bank or company's activities.'<sup>248</sup> The stand taken by the court was very lenient in respect of standards for directors' liabilities. However, court decisions in subsequent cases like *Dovey v Corvey* took a different direction towards stricter governance and liability standards for directors.<sup>249</sup>

As regards UK company directors' fiduciary duties, it has been well established that they should act in the best interests of the company, implying that the directors have an individual duty of good faith to the company.<sup>250</sup> Elaborate provisions of the Companies Act 1985 deal with directors' fiduciary duties; the remedy for breach of fiduciary duty because of wrongs committed by the bank manager has been prescribed as restitution of the property or compensation for the value as the case may be. Because of these express provisions, the scope of redress for aggrieved

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<sup>247</sup> *Re Cardiff Savings Bank V the Marquis of Bute* (CH). 100.

<sup>248</sup> A Kern, 'Corporate Governance and Banks' in JJ Norton and J Rickford (eds), *Corporate Governance Post – Enron: Comparative and International Perspectives* (British Institute of International and Comparative Law, London 2006) 261.

<sup>249</sup> *Dovey V Corvey* 477 (AC).

<sup>250</sup> The Companies Act 1985, Part IX, s. 282-319.

shareholders against breach of duties by directors and officers of the company was found to be very limited under English law. This has necessitated the framing of a regulation allowing both shareholders and regulators to hold managers and board members directly responsible for any breaches, irrespective of their skills or training. This ‘liability regime’ is clearly stated in the UK Financial Services and Markets Act 2000 and the regulations set by the Financial Services Authority.<sup>251</sup>

### **2.8.3 Corporate Governance under the UK Financial Services and Markets Act 2000**

The objects for which the Financial Services and Markets Act 2000 (FSMA) were enacted were: (1) create public confidence in the financial system,<sup>252</sup> (2) promote total awareness about the operations of the financial and banking system,<sup>253</sup> (3) guarantee consumer protection,<sup>254</sup> and (4) reduce financial-related crimes.<sup>255</sup>

In order to achieve these broader objectives the FSMA established the Financial Services Authority (FSA) as the regulatory body with an overall responsibility for supervision of the operations of the banking industry and to regulate the functioning of the investment services and the insurance industry.<sup>256</sup> FSA acquired legislative authority to effectively achieve these statutory objectives. The functions of FSA include policy formulation and setting up standards with respect to the administration of regulations for banks and other financial institutions,

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<sup>251</sup> Kern (n 248) 263.

<sup>252</sup> Financial Services and Markets Act 2000 s1, s2(a)-(c). The FSMA 2000 was amended by the Financial Services Act 2010.

<sup>253</sup> Ibid s4 (1), (2) (a)-(b), (3).

<sup>254</sup> Ibid s5 (1), (2) (a)-(d), 3(a)-(b).

<sup>255</sup> Ibid s6.

<sup>256</sup> Ibid s138-142.

authorization of the formation of new companies, approval and initiation of procedures regarding the registration of top level managers and key executive bank personnel, undertaking investigations, enforcement of different regulatory measures and disciplinary measures, nurturing and maintaining cordial relationships with customers and overall supervision of the banking and financial sector.<sup>257</sup> The FSA has also been given the authority to enter into negotiations with the regulators from different regions, countries and governments with respect to a number of issues concerning, among others, the following: (1) information exchange relating to banks and other entities in the financial service industry, (2) coordination of activities to ensure the implementation of the standards prescribed by the EU and other international organizations regarding the functions of the banks and other, and (3) the ‘cross border enforcement and surveillance of transnational financial institutions’.

#### **2.8.4 Financial Services Authority and Corporate Governance**

The FSMA has ensured that the provisions promulgated by it ensure high standards of conduct by senior level executives and officers of all regulated financial institutions. The main theme of the Act in respect of enforcement of corporate governance principles regarding financial institutions is that accountability is greatly enhanced by requiring a higher degree of transparency in all matters of reporting. This would automatically make available sufficient information to government authorities, owners of banking companies, creditors and other stakeholders for an assessment of the working of the banks. In order to strengthen the accountability of the managers and other senior officers of the bank, the FSA has adopted legislative measures that provide for the civil liability of senior managers and directors of

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<sup>257</sup> Ibid s19-s20.

financial institutions in respect of the wrongs committed by their firms, irrespective of whether they had knowledge of such wrongdoing or not.

‘The FSA has incorporated the eleven high-level principles of business that were part of previous UK financial services legislation.’<sup>258</sup> These principles apply invariably to all organizations as well as to directors and other senior executives in the UK financial services industry. The principles of ‘integrity, skill, care and diligence; management and control; financial prudence; market conduct; conflicts of interests; and relations with regulators’ have been incorporated in the standards being established by the FSA.

Thus the UK Financial Services Authority has moved towards regulating banks and other financial institutions by devising prudential and effective supervisory and regulatory standards that ensure an effective corporate governance framework. By adopting these standards FSA is able to address the principal-agent issues through continuous and improved monitoring, refined disclosure and accounting principles, an efficient and better corporate governance policy framework and controlling the activities of the institutions through market discipline.

FSA also requires banks and other financial institutions to establish adequate internal control measures working within the broad framework of the corporate governance principles that will protect the interests of all internal and external stakeholders’ interests from the different kinds of risks the banks and other institutions undertake in their functioning. In contrast to the governance policies being adopted by the US in respect of banking interests where the protection of the safety and soundness of the banking organizations take predominance, UK legislation and policies strive to balance the interests of the stakeholders and also to bring about an all round

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<sup>258</sup> --, 'The FSA Publishes Response Paper on Principles for Business' (Financial Services Authority) <<http://www.fsa.gov.uk/pubs/press/1999/099.html>> accessed 20 July 2007.

protection for a safe and sound banking system to ensure balanced economic growth and development.

### **2.8.5 Recent Developments in Corporate Governance in the UK**

There have been a number of factors that are responsible for increased corporate governance measures in the UK. For instance a number of financial collapses as in the case of Polly Peck, BCCI etc., had led to an increased concern over several corporate governance issues in the UK.<sup>259</sup> Similarly, increased exposure of institutional investors, such as pension funds and insurance companies, in the shareholdings of publicly listed companies, in addition to the increased concern of institutional investors consequent on exposure of their shareholding have also created more awareness of corporate governance practices. The increased technological advances in the area of information and communication have improved the understanding and awareness by institutional investors of corporate governance issues. In addition, more expectations by companies of obtaining external funding had given rise to an increasingly important role for corporate governance to instil confidence in the minds of prospective investors. The need to create greater confidence in the stock market so as to improve the investment climate has also enhanced the importance of corporate governance in the UK.<sup>260</sup>

According to Mallin the development of corporate governance has taken a triangularization involving institutional investors and their official representative organizations, recommendations of the Cadbury Committee and the London Stock Exchange as the regulatory body monitoring

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<sup>259</sup> Full discussions of Polly Peck can be found in D Barchard, *Asil Nadir and the Rise and Fall of Polly Peck* (V. Gollancz, London 1992); B Nevzat and G Fraser, *The Turquoise Conspiracy: Asil Nadir, the Collapse of Polly Peck and the Persecution of a Family* (Noble House, London 1999) For a discussion of the BCCI scandle, see P Truell and L Gurwin, *False Profits: The inside Story of BCCI, the World's Most Corrupt Financial Empire* (Houghton Mifflin, Boston, MA 1992)

<sup>260</sup> C Mallin, A Mullineux and C Wihlberg, 'The Financial Sector and Corporate Governance: The UK Case' (2005) 13 CG 533.

the corporate governance. One update of this triangularization is the inclusion of the Combined Code in addition to the Cadbury Committee recommendations.<sup>261</sup>

### **2.8.6 Role of Institutional Investors in the UK**

The Cadbury Committee had identified the increased role of institutional investors in corporate governance in the UK.<sup>262</sup>

In the UK institutional investors have become an important contributor of share capital over the last three decades and there has been a continued increase in their ownership role. This has led to the development of a fiduciary responsibility on institutional investors. Originally this responsibility extended to protection of the interests of the ultimate owner of the shares. However, over a period, this concern of institutional investors had extended to the internal governance of the company and the company's relationship with other external and internal stakeholder groups of the company including society in general.<sup>263</sup>

### **2.8.7 New Combined Code for the UK: The Combined Code on Corporate Governance (Revised June 2008)**

The 2008 version of the combined code on corporate governance outlines revised instructions from the 2006 issue. It includes corporate guidelines for large and small UK companies facilitating them in their behaviour regarding important management decisions. The content of the report focuses on the interests of companies and shareholders by providing essential provisions to guide operational matters. The new version offers a more comprehensive overview for interpreting the codes of governance.

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<sup>261</sup> CA Mallin, *The Role of Institutional Investors in Corporate Governance* (Institute of Chartered Accountants in England & Wales, London 1994)

<sup>262</sup> Mallin, Mullineux and Wihlborg, 'The Financial Sector and Corporate Governance: The UK Case'

<sup>263</sup> Ibid

It specifically highlights the fact that the codes are not mandatory and management has the freedom to modify corporate rules provided that such rules offer sustenance to the cause of good governance.<sup>264</sup> Furthermore, the 2008 version stands out from previous versions by illustrating an in-depth analysis of disclosures and transparency rules. For ease of interpretation, it also contains a separate section outlining the areas where combined codes and disclosures or transparency rules overlap. Overall, the pattern of the 2008 corporate governance code is similar to preceding reports with the exception of a more exhaustive discussion on managerial matters accompanied by simple explanations of complex codes.

### **2.8.8 The Combined Code on Corporate Governance June 2006**

The Financial Reporting Council of UK, in its 2006 edition of the combined code on corporate governance, provides an overview of important financial reporting practices that companies and its shareholders should seek to emulate. A comprehensive section summarizes the duties of companies as it relates to the corresponding reporting procedures for financial reporting. The main section contains the definition, roles and corresponding reporting structure on matters pertaining to directors, remuneration, audit and relations with shareholders. Each section is further elaborated by a main principle, supporting principles and code provisions that contain multiple subdivisions. A minor portion of the report is specifically devoted to addressing the codes governing institutional shareholders. In addition, there are three schedules at the end which

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<sup>264</sup> The Financial Reporting Council Limited, 'The Combined Code on Corporate Governance' (2008) <[http://www.frc.org.uk/documents/pagemanager/frc/Combined\\_Code\\_June\\_2008/Combined%20Code%20Web%20Optimized%20June%202008\(2\).pdf](http://www.frc.org.uk/documents/pagemanager/frc/Combined_Code_June_2008/Combined%20Code%20Web%20Optimized%20June%202008(2).pdf)> accessed 23 June 2009.

provide additional assistance on issues such as performance- based rumination, liabilities of non-executive directors and disclosure of corporate governance arrangements.<sup>265</sup>

### **2.8.9 Good Practice from the Higgs Report June 2006**

The Higgs Report followed. Derek Higgs on the recommendation of Secretary of State, Patricia Hewitt and Chancellor Gordon Brown, produced the first copy in January 2003. It established responsibility in defining the roles of non-executive directors and other prominent board members, including the chief executive. The Higgs Report strives to cover essential aspects of the responsibilities of the chairman of the board and that of the non-executive directors of a company.

Besides defining the roles of high level office bearers it provides detailed guidance on how the remuneration committee should decide the compensation packages while offering its suggestions on the rules to follow when appointing those directors.<sup>266</sup> The Higgs report is also noted for its lucid explanation of the issues surrounding the pre- and post-induction of the non-executive directors. It will not be an oversimplification to suggest that the Higgs Report sets the gold standards which every UK organization should seek to follow when appointing its board members.

### **2.8.10 Internal Control: Revised Guidance for Directors on the Combined Code**

Also known as Turnbull Guidance, the Guidance on Internal Control is considered a great success in meeting the overall objectives of developing an internal control system for

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<sup>265</sup> The Financial Reporting Council Limited, 'The Combined Code on Corporate Governance' (2006) 29 <<http://www.frc.org.uk/documents/pagemanager/frc/Combined%20code%202006%20OCTOBER.pdf>> accessed 23 June 2009.

<sup>266</sup> The Financial Reporting Council Limited, 'Good Practice Suggestions from the Higgs Report' (2006) <[http://www.ecgi.org/codes/documents/frc\\_gp\\_2006.pdf](http://www.ecgi.org/codes/documents/frc_gp_2006.pdf)> accessed 23 June 2009.

corporations. The Guidance outlines the most important rules that every director should follow in order to attain better results by tackling new risks, changing circumstances and new market expectations. Since 1999, such has been the effectiveness and influence of the published guidance that various company executives have reported significant improvement in internal control processes even without details on exactly how to implement such controls.<sup>267</sup> The report is divided into five sections, including the importance and objectives of the internal control process. Special emphasis is laid on the responsibilities of the directors for maintaining and then reviewing the internal control process. The entire report is numerically categorized to provide a simple interface for directors to follow. It also contains a useful appendix which provides definite instructions to board members for discussing priorities of internal control with their management and elaborates on factors like risk assessment, controlled activities, informational flow and self monitoring.

### **2.8.11 The Combined Code on Corporate Governance 2003**

The 2003 Code on Corporate Governance replaced the previous code issued by the Hampel Committee in 1998. In fact, all recent codes on corporate governance are formatted and take their guidance from these codes enacted in 2003. It was the first code that required all corporations to adopt main and supporting principal guidelines on their financial reports. In addition to other rules, it supported the idea of ‘comply or explain’ rules, which insisted that companies should clearly state the purpose of their non-compliance with codes, if any, to the shareholders. The 92 page comprehensive report included suggestions of good practices on internal control and audit committees by Turnbull and Smith respectively. It also contained a detailed discussion on the

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<sup>267</sup> The Financial Reporting Council Limited, 'The Combined Code on Corporate Governance' (2003) <[http://www.ecgi.org/codes/documents/combined\\_code\\_final.pdf](http://www.ecgi.org/codes/documents/combined_code_final.pdf)> accessed 23 June 2009.

Higgs Report and is considered by many as a guide to all the future combined codes on corporate governance.

### **2.8.12 Audit Committees - Combined Code Guidance (the Smith Report) January 2003**

The Smith Report on audit committees provides guidelines to board members for understanding the objectives of audit committees and establish an unbiased relationship with the team and director of the audit committee. It also highlights the importance of the fact that the audit committee is an integral part of the business and is liable to board members, but should act as an independent body within the company.

Guidance is provided to all those working with the audit team to provide a better understanding of the most important rules. The functions of the audit committee are expressed in terms of supervision, assessment and review.<sup>268</sup> Such guidance sequence ensures that the roles of the audit committee, management and board members are clearly defined. The hallmark of the guidance is the essential requirements that are printed in bold. Each member of the audit team has to comply with such requirements to ensure a conflict-free environment between the company and the external auditors. To provide a global perspective, the Smith Report goes a step further by offering an international perspective and comparison of audit rules around the world.

### **2.8.13 The Higgs Report: Review of the Role and Effectiveness of Non-executive Directors January 2003**

In 2003, Derek Higgs proposed a new set of roles for non-executives directors of companies. The report included a sequence of published reports which seek to revitalize the contemporary corporate governance policies in the UK. It followed such well-known reports as Cadbury,

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<sup>268</sup> The Financial Reporting Council Limited, 'Audit Committees: Combined Code Guidance' (London 2003) <[http://www.ecgi.org/codes/documents/ac\\_report.pdf](http://www.ecgi.org/codes/documents/ac_report.pdf)> accesses 31 May 2009.

Greenbury, Hampel and Turnbull but the main objective of the Higgs report remained the rehabilitation of corporate governance rules in light of major financial setbacks in the UK that had led to a bear market.<sup>269</sup> The rules covered more than one hundred pages and included seventeen chapters and several annexes.

It offered a new outlook on the roles of non-executive directors including a proposal to establish a position of senior independent director. It was also the first to propose that non-executives members of the board should meet at least once a year in the absence of other board members. Moreover, it provided several acute and powerful guidelines incorporating effective management practices such as writing the number of board meetings and the attendance of individual members.

#### **2.8.14 The Combined Code: Principles of Good Governance and Code of Best Practice May 2000**

This report set the standard for the principles of good governance in UK corporations. The London Stock Exchange quickly reverted to follow the rules established in this combined code and requested that all companies should also comply with the regulations formulated in the new report. The committee in charge of preparing the combined code promoted the fact that this report was in part a summary of the earlier Cadbury and Greenbury recommendations.<sup>270</sup> The only differences were the new set of codes that were specifically created to amend few rules prescribed by Cadbury and Greenbury. The final version of the combined code suggested that

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<sup>269</sup> D Higgs, 'Review of the Role and Effectiveness of Non-Executive Directors' (Department of Trade and Industry 2003) <<http://www.ecgi.org/codes/documents/higgsreport.pdf>> accessed 23 June 2009.

<sup>270</sup> The Committee on Corporate Governance, 'The Combined Code: Principles of Good Governance and Code of Best Practice' (Committee on Corporate Governance 2000) <[http://www.ecgi.org/codes/documents/combined\\_code.pdf](http://www.ecgi.org/codes/documents/combined_code.pdf)> accessed 23 June 2009.

every company should offer two separate statements; the first should explain relevant compliance with the codes while the second should describe reasons for non-compliance.

### **2.8.15 Internal Control: Guidance for Directors on the Combined Code (Turnbull Report) September 1999**

The Turnbull Report recommended an effective system of internal control that was much sought by the London Stock Exchange. In a letter to companies, the then head of listing at LSE, Paul Geradine exalted the publication of the Turnbull Report and asked listed companies to abide by the new rules by systematically relinquishing the older Rutterman guidance. The objective of the report was to educate the directors of listed companies on a system of internal control which would not only protect the company's assets but also safeguard the interest of shareholders.<sup>271</sup>

Contributors to the report advised companies to perform a regular internal audit of their organization. They also suggested that companies which are lacking an internal audit process can follow the codes to create one. Overall, the report provides a summary of the objectives, requirements and responsibilities of directors and offers guidance on risk management, financial and operational controls.

### **2.8.16 Hampel Report (Final) January 1998**

In order to review the works of Cadbury and Greenbury, the Committee on Corporate Governance issued its findings on what it believed were the major principles underlying the establishment of a corporation. The report explained the rules of conduct of a corporation by emphasizing, in particular, the role of directors and shareholders.

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<sup>271</sup> The Institute of Chartered Accountants in England & Wales, 'Internal Control: Guidance for Directors on the Combined Code' (The Institute of Chartered Accountants in England & Wales 1999) <<http://www.ecgi.org/codes/documents/turnbul.pdf>> accessed 23 June 2009.

The Hampel Report was prepared after extensive research that constituted multiple group discussions, letters, interviews and evaluation of the previous literature on the topic.<sup>272</sup> Almost all the major UK institutions including the Confederation of British Industry, Institute of Directors, London Stock Exchange, the Consultative Body of Accountancy Bodies and the National Association of Pension Funds took an active role in providing important data that helped accomplish the final version. In short, the Hampel Report covered aspects of corporate governance that were altogether missing from Cadbury and Greenbury recommendations.

### **2.8.17 Greenbury Report (Study Group on Directors Remuneration) 15 July 1995**

The sole purpose of the Greenbury Report was to answer the growing shareholder and public concern over the remuneration of directors. Sir Richard Greenbury, chairman of Marks & Spencer presided over a study group that included several of UK's top industries to provide landmark recommendations on the issue. The report clearly states that the final set of codes can equally be applied to the remuneration packages of all senior executives of a company.<sup>273</sup> It is noticeable that the report was prepared under the committee's own perception that remuneration at the time was on a par with that of Europe and much below the standards of American companies. It also assumed that the overall remuneration package of directors was under constant scrutiny by the shareholders.

Nevertheless the report's main objective was to eliminate any mistakes and misjudgements and elaborate in simple codes the main provisions to a better remuneration package. The Greenbury Report visualized the idea to form a separate group to audit the directors pay incentive. The

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<sup>272</sup> Committee on Corporate Governance, 'Final Report' (1998) <<http://www.ecgi.org/codes/documents/hampel.pdf>> accessed June 23 2009.

<sup>273</sup> --, 'Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury' (1995) <<http://www.ecgi.org/codes/documents/greenbury.pdf>> accessed 23 June 2009.

formation of a separate group would also help facilitate the implementations of the rules. The entire report consisted of a discussion on best practices, main action points and included the new remuneration policy and service contracts. A list of disclosure requirements accompanied by illustrative disclosure formats was provided to help understand the reporting criteria.

### **2.8.18 Cadbury Report (The Financial Aspects of Corporate Governance) 1 December 1992**

The Cadbury Report is widely regarded as the first and one of the most comprehensive findings on the financial and operational matters concerning British companies. Under the leadership of Adrian Cadbury, the committee provided a detailed set of rules for the best practices in corporate governance. The main theme of the Cadbury findings remained focused on the control and reporting functions of the board and subsequent role of internal auditors. It was also the first report to establish the existing reporting criterion for all UK organizations to indicate the level of compliance with the established codes.

In fact, the Cadbury report is deemed a successor to all modern UK reports on organizational practices and conduct. The extensive report summarized the important codes relating to the board, matters of internal control, auditors and shareholders.<sup>274</sup> The UK government agreed that in two years time, another committee would review the results of Cadbury findings and its effectiveness. It was indeed a precursor to all the important documents to be released in the future.

The new combined code issued in 2003 has been introduced to be applied to all listed UK companies. This report had most of the provisions contained in the Higgs Report. One of the

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<sup>274</sup> --, 'Cadbury Report: The Financial Aspects of Corporate Governance' (1992)  
<<http://www.ecgi.org/codes/documents/cadbury.pdf>> accessed 23 June 2009.

main criticisms levelled against Higgs' recommendations was that the report contained too many provisions which made the report more to do with procedural compliance than helping companies 'comply or explain'. To this extent the report was found to be weak. This anomaly was removed in the new Combined Code wherein the 'comply or explain' principles were given renewed strength. This has given institutional shareholders the opportunity to discuss with the company any non-compliance about which the institution is dissatisfied. The institutional investor thus is given an opportunity to obtain further explanations. 'In practice, this should result in a more flexible approach being adopted, but will also result in companies having to make greater disclosure in their annual report and accounts. They will now have to explain how they have applied the main principles and the new supporting principles.'<sup>275</sup> Although the institutions could express their dissatisfaction directly to the companies their choice is often constrained by the size of their holdings and the policy of the institutions in maintaining a balanced portfolio of investments.<sup>276</sup>

The new Combined Code includes the roles and responsibilities of non-executive directors. The additional responsibilities placed on the non-executive directors include 'challenging and developing strategy, monitoring of performance, risk assessment, responsibility for the level of executive director remuneration, appointment of executive directors and succession planning.'<sup>277</sup>

An increased expectation of the standard of care that needs to be exercised by non-executive directors in relation to financial controls has also been emphasized in the Combined Code. These additional responsibilities have enabled non-executive directors to spend more time in

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<sup>275</sup> C Mayo, 'United Kingdom: UK Corporate Governance' (2003)  
<<http://www.iflr.com/?Page=17&ISS=16381&SID=515151>> accessed 23 June 2008.

<sup>276</sup> Mallin, Mullineux and Wihlborg, 'The Financial Sector and Corporate Governance: The UK Case' 535.

<sup>277</sup> Mayo (n 235).

discharging their functions so that they can be found to be more effective. Non-executive directors should not only review the committee meetings but also attend to the induction, professional development and understanding of the requirements of the company for making the business a success.<sup>278</sup>

The Combined Code has also increased the roles and responsibilities of the nomination committee to a substantial extent including ensuring that a more transparent and rigorous process of appointing the committee members is implemented.

The government that came into power after the introduction of the new Combined Code accepted its principles as a positive step forward in ensuring better corporate governance. The UK Department of Treasury commissioned a review of institutional investors in the UK (Myners Report). The objective of this review was to improve the quality of investment decision making and also to ensure that the management of corporate entities is accountable to the individual shareholders. The review was also conducted to find out the ways of streamlining the proxy voting and the processes of communication. One of the key issues was ensuring that voting and reporting processes are revamped specifically in relation to overcoming custodian and fund manager-related impediments to effective proxy voting activism.<sup>279</sup>

### **2.8.19 Remarks on Corporate Governance in the UK**

Internationally recognized accounting and auditing standards have helped the UK to implement a high level of transparency and increased disclosure in corporate and financial sectors. Based on the recommendation of the Cadbury Report there have been a number of subsequent

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<sup>278</sup> Ibid

<sup>279</sup> Australian Council of Super Investors Inc., 'Best Practice: Corporate Governance Newsletter' (2001) 4 <[http://www.acsi.org.au/documents/Newsletter\\_1.pdf](http://www.acsi.org.au/documents/Newsletter_1.pdf)> accessed 23 June 2008.

developments in the corporate governance area, such as the reports by Greenbury, Hampel, Turnbull, Myners, Higgs and Smith. The revised Combined Code, which came into effect in 2003, has extended the robustness of this traditional reporting covering the increased requirements for ensuring good corporate governance. This enabled institutional investors to become active in expanding their horizon of investments in the equity of publicly traded companies in the UK.

## **2.9 Banking Corporate Governance in the Aftermath of the Recent Financial Crisis**

The 2007-2010 financial crises can be described as the worst crisis the world has faced since the Great Depression. Economic crisis which began in the United States spread to Europe, specifically the United Kingdom. Consumer wealth plummeted and a number of financial institutions were claimed. The economic crisis was triggered by a subprime mortgage crisis in the United States. Since the 1980s, the U.S. has repealed many regulations in the financial sector.<sup>280</sup> The Clinton and Bush administrations encouraged Americans to spend to stimulate economic growth. This included encouraging Americans to borrow to invest in real estate because the Federal Reserve kept the interest rate low.<sup>281</sup>

As a result of the decreased cost of real estate, demand coupled with minimal regulations had led to subprime lending. Interest rates began to rise and eventually consumers defaulted on their loans and lending institutions repossessed homes.<sup>282</sup> Minimal regulation of the financial market

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<sup>280</sup> R Kuttner, 'The Bubble Economy' (2007) *The American Prospect* <[http://www.prospect.org/cs/articles?article=the\\_bubble\\_economy](http://www.prospect.org/cs/articles?article=the_bubble_economy)> accessed 26 February 2011.

<sup>281</sup> P Blustein, *The Chastening: Inside the Crisis That Rocked the Global Financial System and Humbled the Imf* (Revised and Updated edn PublicAffairs, New York 2008)

<sup>282</sup> J Miller and B Jackson, 'Who Caused the Economic Crisis?' (FactCheck.org 2008) <[http://www.factcheck.org/elections-2008/who\\_caused\\_the\\_economic\\_crisis.html](http://www.factcheck.org/elections-2008/who_caused_the_economic_crisis.html)> accessed 26 February 2011.

was one factor in the economic crises.<sup>283</sup> Reducing regulation gave rise of to the shadow banking system, which used bait and switch methods to sell loans with hidden interest rates.<sup>284</sup>

The most important factor in the financial crisis is corporate governance. Both the U.S. and the U.K. overlooked corporate governance. This allowed financial institutions to underestimate their lending risk. Even when crisis in the mortgage sector became imminent, financial institutions continued to invest in the sector.<sup>285</sup>

### **2.9.1 Bank Crisis in the UK**

Before 2001 when the bank crisis started in the U.K. and U.S., U.K. banks had no previous exposure to wholesale lending markets. This was a new experience to U.K. banks and a euphemism for collective international banks.<sup>286</sup> The U.K. financial crisis was an overspill of the U.S. In September of 2007, Northern Rock was granted emergency financial support from the Bank of England as a last resort.<sup>287</sup> Northern Rock was among the new lenders that relied on the markets instead of the deposits to fund lending.<sup>288</sup> The Bank of England set its base rate at 5.75%.<sup>289</sup> In 2007, depositors withdrew more than £1 billion from Northern Rock; the biggest run in the history of banking industry in U.K.<sup>290</sup> Northern Rock dipped into increasing trouble

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<sup>283</sup> Ibid

<sup>284</sup> M Thoma, 'What Caused the Financial Crisis?' (Economist's View 2008)  
<<http://economistsview.typepad.com/economistsview/2008/10/what-caused-the.html>> accessed 26 February 2011.

<sup>285</sup> Ibid

<sup>286</sup> CNN.com, 'Timeline: Banking Crisis' (CNN.com 2008)  
<<http://edition.cnn.com/2008/BUSINESS/09/30/us.bailout.timeline/index.html>> accessed 26 February 2011.

<sup>287</sup> Ibid

<sup>288</sup> Ibid

<sup>289</sup> Ibid

<sup>290</sup> MF Guillen, 'The Global Economic & Financial Crisis: A Timeline' (University of Pennsylvania)  
<<http://lauder.wharton.upenn.edu/pdf/Chronology%20Economic%20%20Financial%20Crisis.pdf>> accessed 26 February 2011.

with each withdrawal until the U.K. government intervened in 2008. U.K. banks had borrowed more than 600 billion from 'wholesale lending markets'.<sup>291</sup> In 2007, there were nine banks in the FTSE100 all shares index with a total market capitalization of £369 billion.<sup>292</sup> By 2009, the total capitalization of FTSE100 banking sector had shrunk to £138.1 billion.<sup>293</sup> The drop in FTSE 100 banks total capitalization resulted from the effect of the credit crisis, during which financial systems collapsed. Institutions including Alliance and Leicester, Bradford & Bingley, HBOS, and Northern Rock could not exist as stand-alone banks.<sup>294</sup>

In 2008, FTSE fell by more than 7% in one week and this was only a beginning.<sup>295</sup> More job losses came in 2009 and the British Sterling pound fell to its 23 year low.<sup>296</sup> As the rate of unemployment in U.K. hit 2 million, government intervention was inevitable. The U.K. debt hit £1.46 trillion and the number of U.K. firms that were going to liquidation increased by 24%.<sup>297</sup>

The sub-prime mortgage crisis that started in the U.S. caught up with the U.K. financial sector. Debt obligation vehicles were sold to the U.K.'s international investors in. Interbank lending became difficult leading and liquidity shortage resulted. This exposed underlying structural weaknesses in the banking system, like over-reliance on wholesale funding. The remuneration

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<sup>291</sup> JE Bethel, A Ferrell and G Hu, *Legal and Economic Issues in Litigation Arising from the 2007-2008 Credit Crisis* (Harvard Law School, Cambridge, MA 2008)

<sup>292</sup> House of Commons Treasury Committee, 'Banking Crisis: Dealing with the Failure of the UK Banks' (HC416 House of Commons, London 2009)

<sup>293</sup> Ibid

<sup>294</sup> A Brummer, *The Crunch : How Greed and Incompetence Sparked the Credit Crisis* (Updated edn Random House Business Books, London 2008)

<sup>295</sup> House of Commons Treasury Committee(

<sup>296</sup> Abelmesh, 'UK Financial Crisis 2007/2008: Where to Next?' (ablemesh.co.uk) <<http://www.ablemesh.co.uk/thoughtsukfinancialcrisis.html>> accessed 26 February 2011.

<sup>297</sup> Ibid

structure in most banks offered large bonuses to company executives to encourage risk-taking.<sup>298</sup>

In the backdrop of these challenges, Prime Minister Gordon Brown commissioned Sir David Walker to come up with a report to corporate governance reform.

## **2.9.2 UK Response: Sir David Walker Reports and Recommendations**

The United Kingdom was also adversely affected by the 2008 crisis and they also implemented a bank rescue.<sup>299</sup> One effect of the financial crisis was widespread capital deprivation.<sup>300</sup> In 2008, the U.K. allocated £500 to stabilize the economy.<sup>301</sup> This decision came 48 hours after FTSE100 recorded a single-day largest fall since 1987.<sup>302</sup> Under the rescue, £200 billion was given to Bank of England's Special Liquidity Scheme.<sup>303</sup> The government also increased banks' capitalization to £25 billion.<sup>304</sup> However, £400 billion was provided as 'fresh money' since the government implemented a short loans program of £100 billion.<sup>305</sup>

Alistair Darling informed the House of Commons that the rescue would restore confidence in the banking system.<sup>306</sup> The U.K. rescue invested £50 Billion through bank shares and addressed the

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<sup>298</sup> Practical Law Company, 'Financial Crisis: Q&a (UK)' (2009) <<http://corporate.practicallaw.com/9-383-6743>> accessed 26 February 2011.

<sup>299</sup> G Wong, 'U.K. Unveils Second Bank Rescue Plan' (CNNMoney.com 2009) <[http://money.cnn.com/2009/01/19/news/international/britain\\_bank\\_bailout/index.htm?postversion=2009011908](http://money.cnn.com/2009/01/19/news/international/britain_bank_bailout/index.htm?postversion=2009011908)> accessed 26 February 2011.

<sup>300</sup> R Chote, 'Financial Crisis: Someone Will Have to Dig Us out of All This Debt' *The Telegraph* (London 8 October 2008) <<http://www.telegraph.co.uk/finance/comment/3161595/Financial-Crisis-Someone-will-have-to-dig-us-out-of-all-this-debt.html>> accessed 26 February 2011.

<sup>301</sup> Ibid

<sup>302</sup> British Broadcasting Corporation, 'Stocks Slide Despite Reassurances' (BBC News 2008) <<http://news.bbc.co.uk/2/hi/business/7655288.stm>> accessed 26 February 2011.

<sup>303</sup> Ibid

<sup>304</sup> HM Treasury, 'Statement by the Chancellor on Financial Stability' (HM Treasury 2008) <[http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/statement\\_chx\\_081008.htm](http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/statement_chx_081008.htm)> accessed 26 February 2011.

<sup>305</sup> British Broadcasting Corporation, 'Rescue Plan for UK Banks Unveiled' (BBC News 2008) 26 February 2011.

<sup>306</sup> HM Treasury

key issue of solvency while expanding Bank of England's Special Liquidity Scheme.<sup>307</sup> In 2009, corporate governance rang in the mind of Britons with announcement of Goldman Sachs results.<sup>308</sup> Prime Minister, Sir David Walker, was appointed to improve corporate governance.<sup>309</sup> He maintains that corporate governance is to protect the rights of shareholders with a strategy checks and balances. Sir David's report recommended that a BOFI board provide business awareness sessions and NED personalize its development approach. NEDs on BOFI is expected to be commit 30 to 36 days in major bank board.<sup>310</sup> FSA's interview process for NEDs should involve assessments by senior advisors.

Sir David continued that members of unitary board of BOFI should challenge proposals and strategies proposed by the executive. The business must be given priority over personal commitment.<sup>311</sup> The board should be made aware of material changes in share register and make contact shareholders. Fund managers authorized by FSA must indicate their commitment to Stewardship Principles on their Website.<sup>312</sup>

Sir David's report gave recommendations on governance of risk. Recommendation 23 highlights BOFI must separate board risk from the audit committee.<sup>313</sup> The audit committee should be

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<sup>307</sup> Ibid

<sup>308</sup> K Allen, 'Campaigners Blast Walker Report on Banks' *The Guardian* (Manchester 26 November 2009) <<http://www.guardian.co.uk/business/2009/nov/26/walker-report-attacked-by-campaigners>> accessed 27 February 2011.

<sup>309</sup> L Armistead, 'Sir David Walker's 39 Steps' *The Telegraph* (London 7 July 2009) <<http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/5844477/Sir-David-Walkers-39-steps.html>> accessed 27 February 2011.

<sup>310</sup> W David, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities' (HM Treasury 2009) <[http://www.audit-committee-institute.be/dbfetch/52616e646f6d4956f9ed6cb8ae5277dbec35c233bab54a5b/walker\\_review\\_consultation\\_160709.pdf](http://www.audit-committee-institute.be/dbfetch/52616e646f6d4956f9ed6cb8ae5277dbec35c233bab54a5b/walker_review_consultation_160709.pdf)> accessed

<sup>311</sup> Ibid

<sup>312</sup> Ibid

<sup>313</sup> Ibid

given oversight responsibility. BOFI will be served by a CRO who shall participate in oversight.<sup>314</sup> Under recommendation 26, it is provided that good practice should be observed in strategic transactions by the risk committee.<sup>315</sup> The board will oversee appraisal of any proposition and draw external advice before a decision is reached.

Executive remuneration and bonuses were a major issue throughout the crisis and the seminal reason for Sir David's commissioned report.<sup>316</sup> Sir David recommended the remit of the remuneration committee be extended to all aspects of remuneration policy. Specifically David argued that if non-binding resolutions on remuneration committee report that attracts less than 75% of cast votes, the chairman has to stand for re-election regardless of terms of appointment.<sup>317</sup>

According to Vince Cable, Liberal Democrat Treasury Spokesman, Sir David's report should have named the biggest earners.<sup>318</sup> The report was criticized for targeting remuneration of over 1 million pounds. Brenda Barber, TUC generation secretary, argued that the report would give important financial establishment reforms.<sup>319</sup>

### **2.9.3 The Case of BCCI**

It would serve the purpose of our thesis to consider the case of the Bank of Credit and Commerce International (BCCI) at some length, as it is part of the world financial crisis that had a direct impact on corporate governance in the UK. A major international bank, BCCI was founded in

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<sup>314</sup> Ibid

<sup>315</sup> Ibid

<sup>316</sup> Ibid

<sup>317</sup> Ibid

<sup>318</sup> Allen (n 308).

<sup>319</sup> Ibid

1972 by the eminent Pakistani banker and financier, Agha Hasan Abedi. The registration of the bank was done in Luxemburg and its head offices were located at Karachi and London. After a decade of phenomenal record of growth, BCCI had operations in 78 countries and had over 400 branches worldwide. Its total assets exceeded \$20 billion. It became the 7th largest private bank in the world. In spite of its remarkable credentials in banking sector, the bank was misused by the ISI along with the CIA for clandestine operations aimed to achieve political objectives. Such downtrodden policies and approaches signalled the death bell for the bank.<sup>320</sup>

The growth and development of the BCCI was remarkable in the history of modern banking. It created a benchmark for others in different fields of the banking sector. The banks funds were contributed mainly by investors in Abu Dhabi. The bank of America also was a major share holder with a 25% share. In 1977, the bank of America increased its shareholding to 45%. Unexpected growth achieved by the bank raised many eyebrows in the industry. Investigations were conducted by banking regulators and reports of results in between October and November 1977, indicated that the operations of the bank were not in conformity with the regular banking operations and practices.<sup>321</sup>

Soon after the report, the bank of America started to sell the shares it had on BCCI. By 1977, the bank was almost established in many countries except America. The management was eager to develop its business in the US as it thought it would be a key towards international success. With this objective, it attempted a hostile takeover of financial general Bank shares in Washington DC. But this bid was unsuccessful because the bank did not disclose details about the operations

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<sup>320</sup> Wikipedia, 'Bank of Credit and Commerce International' (Wikipedia: The Free Encyclopedia 2010) <[http://en.wikipedia.org/wiki/Bank\\_of\\_Credit\\_and\\_Commerce\\_International](http://en.wikipedia.org/wiki/Bank_of_Credit_and_Commerce_International)> accessed 27 February 2011.

<sup>321</sup> D Edwards, 'The Bank of Credit and Commerce International Scandal: A Warning for Bank Regulators' (1992-1993) 24 Law & Pol.Int.Bus. 1267-1283.

they planned. But in 1982, it succeeded in gaining control of the Financial General through loaning funds to a group of Middle Eastern investors. The federal agency suspected about the involvement of the bank but was assured by the former secretary of defence, Clark Clifford that the deal had nothing to do with BCCI. After this the bank acquired the National bank of Georgia and the independence bank of Encino. In 1988, the bank was indicted by a federal grand jury for laundering illegal drug money. It was fined 14 million against this offence in 1990.

Since its inception, BCCI was viewed by many as the bank of criminals, drug lords and anti socials. Many believed that its operation was controlled by the black squad, a gang of criminals engaged in bribery, kidnapping and murder. Many countries appointed regulators to check the operations of the bank including the Bank of England who appointed Price water Coopers who discovered that massive frauds were taking place in the bank that will make sure its downfall. The fraud had affected around 800000 depositors of the bank. The regulators seized the assets of the bank worth more than \$20 billion. Although the actual losses of the investors are unknown, it is estimated to be around \$15 billion. The failure of BCCI was one of the largest in those times.<sup>322</sup>

Since its inception, all the policies of the bank were against the normal corporate governance rule followed by its counterparts. The bank was insolvent from the 1970's but its top managers succeeded in manipulating the accounts and concealing losses. It kept deposits off the books; hid investments made in the US and showed false profits. Loans were given to gulf group of shipping companies, which were larger than its capital base. It was involved in money laundering services favouring the drug traffickers, intelligence agencies, arms dealers, tax evaders, political offender's, and dictators around the globe. The bank systematically made questionable or illegal

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<sup>322</sup> Ibid

payments to world leaders, government officials and political figures to obtain deposits and to open new branches. Many of the frauds and offences committed by the bank were hidden smartly through the influence of Lobbyists having high reputation and power in countries including US and UK.<sup>323</sup>

Through the mid 1980's all the treasury operations of the bank suffered huge losses. The senior managers siphoned off deposits in order to cover these losses. When the depositors withdrew their money, then the other deposits were diverted to cover the losses. Making fictitious loans, not recording the deposits and dealing in own shares to manufacture profits were practiced by managers, shareholders and board members.

In a coordinated action, on July 1991, regulators in eight nations ordered the closure of all the offices of the bank within their jurisdictions. The bank had largest concentration of deposits in the UK at the time of closure. All the local regulators operated under their own national laws because there were no international laws to close a bank till date.<sup>324</sup>

The failure of the bank prompted many governments in Europe to think about increased banking regulations as well as role of supervisors<sup>325</sup> 6.

The BCCI was owned by a number of groups since its incorporation. ICIC owned nearly 70% till 1989, but after that its share holding was reduced to 11% due to obvious reasons. The Abu Dhabi group owned 40%. But most of the shares were held by the banks nominees themselves. The Middle Eastern elites used nominees to hold their stock as they did not want to disclose their

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<sup>323</sup> N Passas, 'The Genesis of the BCCI Scandal' (1996) 23 JL & Soc 57-72.

<sup>324</sup> D Alford, 'Supervisory Colleges: The Global Financial Crisis and Improving International Supervisory Coordination' (2010) 24 Emory Int'l L.Rev. 57-80.

<sup>325</sup> PJ Arnold and P Sikka, 'Globalization and the State-Profession Relationship: The Case the Bank of Credit and Commerce International' (2001) 26 Accounting Org Soc 475-499.

interest to the public. Since its image was maligned in the public, the bank could not enter the American market quickly as anticipated. However it used its undue influence and immoral methods not suited to good corporate governance to achieve this objective by using the services of a reputed law firm managed by former secretary of state Clark Clifford. Using the influence of this firm, the bank made a backward entry by purchasing the shares of First American bank, moreover to cover up the entire operation from the federal agencies; Clark Clifford was made chairman of First American<sup>326</sup>

The growth and development of the BCCI was phenomenal, however it dug its own grave through poor and unethical style of corporate governance. The functions and operations of the BCCI is a clear thesis for future case studies relating to poor governance.<sup>327</sup>

Many scholars are with the point that the growth and failure of the BCCI is a result of globalization where rules and auditing related to transnational banking failed to hold its place.<sup>328</sup> Problems in international banking after globalization and their remedies can be studied and implemented after going through the effects of situations created by the BCCI.

## **2.10 Conclusion**

Historically, corporate scandals have led to the formulation of various pieces of legislation that merely respond to visible financial concern and outrage of the public and which leave a number of large business issues unaddressed. One example of such legislation is the narrow focus of the US Sarbanes-Oxley Act. The market model and legislative model that collectively focus on compliance and accountability are increasingly being seen as detrimental to the efficiency and

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<sup>326</sup> Wikipedia, 'Bank of Credit and Commerce International' (n 320).

<sup>327</sup> Arnold and Sikka (n 325).

<sup>328</sup> Ibid

performance of public companies. This has been one of the drivers for the rising preference for private equity as an extension of, and reaction to, governance developments of the past decade.

Clark et al, reviewing the Ahold crisis of corporate governance and its implications for global standards, observe that the Ahold case in the EU can be considered as an instance where major institutional investors have taken the initiative to intervene directly with the firm intention to bring about reforms in the firm's corporate governance to ensure a better stock market performance. The authors concede that

It seems that domestic and EU regulatory agencies came last to the Ahold crisis; while legal proceedings were instituted to assess the liability of Ahold's auditors and the like, the swiftest response to the crisis came from those with the biggest ownership stakes in the firm.<sup>329</sup>

These types of action by institutional investors can be regarded as an effective market model of corporate governance based on the assumption that institutional investors are the absolute owners of the enterprises.

In conclusion, the EU and UK reaction to matters and rules of corporate governance left each member country the freedom of choice to adopt what is suitable concerning corporate governance rules, and took action through what is known as the Financial Services Action Plan and the EU Corporate Governance Forum. In doing so, mechanisms were developed for joint work among members of the European Union to develop corporate governance standards such as disclosure and transparency for the member states. However, the United Kingdom chose the voluntary option and was content with the reports of corporate governance codes. In this chapter

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<sup>329</sup> GL Clark, D Woźcicki and R Bauer, 'Geographically Dispersed Ownership and Inter-Market Stock Price Arbitrage—Ahold's Crisis of Corporate Governance and Its Implications for Global Standards' (2006) 6 J Econ Geo 318. (Advance Access published on 25 November 2005).

we also discussed that the nature of British law gives assurances to shareholders that made it unnecessary to impose additional obligatory standards for corporate governance rules.

## 3 Chapter Three: Corporate Governance in the United States

### 3.1 Introduction

This chapter reviews the standards and rules of corporate governance in the United States, a country that has one of the largest financial markets in the world, in addition to the largest corporations in terms of stock market value. Undoubtedly the events of 2002, exemplified in the financial scandals of the largest US corporations, resonated in shock and serious repercussions in the US economy in particular, and the global economy in general. Through this study we will see how the United States dealt with these scandals through legislation of the Sarbanes-Oxley Act.

To help understand corporate governance in the US, it is necessary to keep in mind that company regulation is subject to two types of distinct corporate laws; federal and state. Federal laws (such as the Sarbanes-Oxley Act) are enacted by the US Congress and affect companies throughout US territories. State laws, however, are enacted in individual states, with their own corporate law statutes and their own sets of laws created by branches of their judiciary.<sup>330</sup> State statutes determine the rules of incorporation, financial and legal capital rules, the basic makeup of the board of directors and shareholder rights and powers. The courts and judges in each state have the responsibility of interpreting statutory laws.<sup>331</sup>

As a result of the differences in state laws and regulations, the states are in competition with one another, vying to attract companies to incorporate in their individual states. Furthermore, as a company is not required by law to establish its headquarters in the state of its incorporation,

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<sup>330</sup> AR Pinto, 'The United States' in AR Pinto and G Visentini (eds), *The Legal Basis of Corporate Governance in Publicly Held Corporations: A Comparative Approach* (Kluwer, The Hague 1998) 254.

<sup>331</sup> Ibid

companies in general tend to incorporate in those states which offer those laws and statutes which are most favourable to them in terms of legal efficiency, competent judges and professional agents who provide the necessary services for the efficient running of corporations.<sup>332</sup>

While companies have to abide by state laws of incorporation and governance, they are also subject to laws enacted by the federal government, which control publicly-held firms throughout the US. Federal securities laws go back to 1933, when the Securities Act was issued by Congress to regulate the offering of securities to the public. In 1934 Congress passed the Securities and Exchange Act to regulate both the offering and trading of securities. These acts defined the role played by the federal government in monitoring and regulating corporate behaviour. This was exemplified by the creation of the Securities and Exchange Commission (SEC), a US government agency with nationwide jurisdiction to enforce as well as to interpret federal securities laws. Its powers also extend to disciplining those who committed acts against its laws.<sup>333</sup>

There are two approaches to the corporate governance framework. The first is a market driven model that comprises self-regulation that operates independently of state intervention. This model operates on public pressure such as compulsion by institutions such as stock exchanges and institutional investors who prescribe certain norms and conditions of good governance,

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<sup>332</sup> The literature regarding the debate on regulatory competition and forum shopping includes such works as P Angelini and N Cetorelli, 'The Effects of Regulatory Reform on Competition in the Banking Industry' (2003) 35 JMCB; Y Liu, DS Putler and CB Weinberg, 'Is Having More Channels Really Better? A Model of Competition among Commercial Television Broadcasters' (2004) 23 Market Sci; CM Radaelli, 'The Puzzle of Regulatory Competition' (2004) 24 J Pub Pol

<sup>333</sup> Almajid (n 19) 61-62.

where corporate entities have no choice except to follow them.<sup>334</sup> The second model evolves from the intervention of the state and is characterized by legislative requirements, especially with respect to disclosures, by way of prescription rather than being based on suggestion or principles. The latest legislative developments in countries such as the UK, North America and Australasia which have corporate governance frameworks based on compliance are examples of the second model. Of these two, in the US a significant contribution has been market-driven shareholder activism as a reaction to the management abuses and corporate scandals that shook the US economy to a great extent.<sup>335</sup>

### **3.2 Corporate Governance Legislation in the United States**

The enactment of the Sarbanes – Oxley Act in 2002, corporate governance measures in the United States were in the developing stage and only self-regulated measures had evolved as major initiatives. The California Public Employees Retirement System and the ‘Guidelines on the Significant Corporate Governance Issues’ published by General Motors are some of the self regulatory corporate governance initiatives. In contrast to the strategies being adopted by the UK and the European Union, the United States is in favour of enforceable legislation for regulating corporate governance measures. The legislation provides enforcement provisions with strong sanctions, also of a criminal law nature. Different tort remedies and class actions add to the deterrent. As a result, corporate governance standards in the US include the prescription of fines

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<sup>334</sup> The first model is usually developed a complex relationship in between state intervention and acts of private market players. For instance 'self regulation' often develops to pre-empt state intervention. Rule making or standard setting may have participation from organs of the state. The enforcement may be supported by legislation or regulators. In the European corporate governance field, self regulation has in pre-empted European Union legislation. The difference between self-regulation and government regulation see P Grajzl and P Murrell, 'Allocating Law-Making Powers: Self-Regulation vs. Government Regulation' (2005) SSRN eLib <<http://ssrn.com/paper=870888>> accessed 17 December 2010.

<sup>335</sup> J Armour and BR Cheffins, 'The Rise and Fall (?) of Shareholder Activism by Hedge Funds' (2009) <<http://ssrn.com/paper=1489336>> accessed 17 December 2010.

and imprisonment as sentences for non-compliance with the various standards advised. These sentences function as sanctions against erring companies and their directors.

The corporate scandals of Enron, Tyco and WorldCom resulted in the promulgation of the Sarbanes – Oxley Act in 2002 as the sole legislation concerning corporate governance issues.<sup>336</sup>

The legislation made significant changes to corporate governance reporting requirements. These changes are applicable to all companies required to file periodic reports to the Securities Exchange Commission (SEC). The unique and interesting feature of the Sarbanes – Oxley Act can be seen from the fact that this Act has created a corporate governance code that is enforceable through the operation of legislation. The other important feature of this Act is its extraterritorial impact. The provisions of this Act are applicable to all companies listed on the New York stock exchange and the NASDAQ, irrespective of their country of origin and registration. Companies of non-US origin have their shares listed on US stock exchanges through the issue of instruments known as American Depository Receipts (ADRs).

The Act set out minimum standards which incorporate corporate governance principles which until that time had no compelling or binding force on the entities. Until enactment, these were merely guiding principles and not enforceable legislation:

The main requirements of the Act are:

1. the requirement that the majority of independent directors be on the board of directors;
2. standards for determining director independence;

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<sup>336</sup> The financial reporting scandals of Enron are discussed in H Rockness and J Rockness, 'Legislated Ethics: From Enron to Sarbanes-Oxley, the Impact on Corporate America' (2005) 57 J Bus Ethics For a discussion of Tyco's false reporting of corporate earnings see MA Desai, 'The Degradation of Reported Corporate Profits' (2005) 19 J Econ Pers A discussion of WorldCom's scandal can be found in H Roland, 'Enron, Worldcom, and the Consequences: Business Criminal Law between Doctrinal Requirements and the Hopes of Crime Policy' (2004) 8 Buff Crim L Rev

3. independent audit, compensation, nomination and governance committees with specific responsibilities;
4. the responsibility of audit committees for annual independent auditing of the corporation, disclosure and to ensure compliance with legal and regulatory obligations;
5. holding of regular meetings of non-management directors;
6. regular board committee self-evaluations;
7. development and publication by companies of specific governance guidelines and codes of conduct for their operations.<sup>337</sup>

### **3.3 US Perspective on Corporate Governance Measures**

The major failure of corporate governance measures has been identified as one of the main causes of the large-scale corporate scandals in the United States. The provisions included in the Sarbanes – Oxley Act, which are applicable to corporations that are subject to the Securities Exchange Act 1934, have been suitably amended to ensure higher standards of corporate governance among various corporations. The significant provisions have been designed to address enhanced and effective internal control measures and higher transparency levels in the disclosure of financial and other information which are at the root of good corporate governance. ‘Sarbanes–Oxley and state corporate statutes provide the framework for management, board and audit committee responsibilities.’<sup>338</sup> Able assistance to the Sarbanes – Oxley Act to achieve its object of ensuring good corporate governance measures is being provided by other federal and state laws including ‘anti-trust laws, securities laws and environmental laws’. Apart from imposing specific compliance requirements this legislation also provides ‘guidance and direction’ to corporations in the matter of maintaining good governance principles. It also takes into consideration the role played by the listing requirements of the New York Stock Exchange

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<sup>337</sup> R Smerdon, *A Practical Guide to Corporate Governance* (2nd edn Sweet & Maxwell, London 2004) 198.

<sup>338</sup> R Thompson, 'Preemption and Federalism in Corporate Governance: Protecting Shareholders' Rights to Vote, Sell and Sue' (1999) 62 LCP 215.

(NYSE), the National Association of Securities Dealers Quotation System (NASDAQ), as well as generally accepted accounting principles of the accounting professions.<sup>339</sup>

One of the agencies able to exert effective pressure on corporations in respect of their corporate governance measures is the Securities and Exchange Commission (SEC). The functions of the SEC include the ultimate protection of investors' interests by overseeing various issues concerning dealings in securities for raising capital and also ensuring compliance with the listing requirements for effective regulation of the stock markets in the US. Because of the stringent penal sanctions provided, the corporations whose shares are listed in the stock exchanges and are publicly traded are following both formal and informal pronouncements by the SEC effectively.<sup>340</sup>

### **3.3.1 Development of Corporate Governance in the United States**

It is important to review significant developments in corporate governance activities to gain an insight into the efforts of the United States to promote governance measures, especially after the incidence of major corporate scandals like Enron and WorldCom. The developments attained by the country with respect to federal and state laws, and in particular the securities laws, have been greatly influenced by the culture of the country. It is also important to examine these cultural values which have contributed to the development of various enactments in the country.

Immediately after the Civil War, the worst event in the economic history of the United States, several monopolistic and discriminatory trade practices started to corrupt the functioning of

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<sup>339</sup> D Busbee, 'Public Regulation and Private Business Conduct: A US Perspective on Good Corporate Governance' in JJ Norton and J Rickford (eds), *Corporate Governance Post-Enron: Comparative and International Perspectives* (British Institute of International and Comparative Law, London 2006) 236.

<sup>340</sup> SE Bonner, Z-V Palmrose and SM Young, 'Fraud Type and Auditor Litigation: An Analysis of Sec Accounting and Auditing Enforcement Releases' (1998) 73 AR 503-532.

business enterprises, through the formation of business trust pools and other types of arrangements which were collusive in nature.<sup>341</sup> These corrupt business entities resorted to price fixing and other unethical business practices which led to the promulgation of the Sherman Act in 1890 to proscribe the undesirable monopolistic and restrictive trade practices in the country.<sup>342</sup> Although there was no emphasis on strictly enforcing the provisions of the Sherman Act, the Clayton Act (1914) and the Robinson – Patman Act (1936) followed to strengthen the provisions of the Sherman Act.<sup>343</sup>

The 1920s witnessed a spate of speculative and fraudulent activities in the securities market which necessitated the passing of ‘The Securities Act’ in 1933 and the ‘The Securities and Exchange Act’ in 1934. Corporate dealings in securities were greatly regulated by a number of amendments made to this legislation as well by the ‘rules, regulations, investigations and enforcement actions’ initiated by the Securities Exchange commission in later years.<sup>344</sup>

Before the 1960s the corporate history of the United States witnessed an evasive attitude by boards of directors in respect of their responsibility to ensure good corporate governance, but during the 1970s the attitudes and behaviour of the boards changed quickly due to increased ‘legislative actions, court decisions and investigations by the SEC’. The cases of *Escott v Barchris Construction Corporation*,<sup>345</sup> *Penn Cent Transport Co*<sup>346</sup> and the Watergate scandal

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<sup>341</sup> P Temin, 'The Post-Bellum Recovery of the South and the Cost of the Civil War' (1976) 36 J Econ Hist

<sup>342</sup> GJ Stigler, 'The Origin of the Sherman Act' (1985) 14 JLS

<sup>343</sup> For a discussion of the Clayton Act and how it was considered a response to the ineffectiveness of the Sherman act, see CD Ramírez and C Eigen-Zucchi, 'Understanding the Clayton Act of 1914: An Analysis of the Interest Group Hypothesis' (2001) 106 Pub Choice 157-181. The role of the Robinson-Patman Act in honing the effectiveness of the Sherman Act is dicussed in MA Adelman, 'The Consistency of the Robinson-Patman Act' (1953) 6 Stan L Rev 3-22.

<sup>344</sup> TK McCraw, 'With Consent of the Governed: Sec's Formative Years' (1982) 1 J Pol Anal Mgmt 346-370.

<sup>345</sup> (1968)

evidencing illegal corporate payments were important events that forced the US administration to enact the Foreign Corrupt Practices Act (FCPA) in 1977, which amended the Securities and Exchange Act by requiring detailed bookkeeping methods, thereby reflecting transactions and dispositions of assets, in addition to internal control.<sup>347</sup>

Corporate governance measures took on a new dimension with the formation of a task force in 1979 which in 1980 prepared a 'Staff Report on Corporate Accountability,' incorporating changes in the securities laws as advised by the SEC. Further developments in the corporate governance spectrum were added by various court judgments after the Taskforce report. The 'Blue Ribbon Report,' jointly sponsored by the NYSE and NASDAQ on the recommendation of the SEC, placed emphasis on the formation and enhancement of the responsibilities of audit committees. The report aimed at improving the performance of audit committees by providing recommendations and guidelines for best practices that were later adopted by the SEC, NYSE and NASDAQ.

Over the period, the roles and responsibilities of the board of directors have been subject to many judicial decisions and reviews. Most of the decisions and debates centring round the audit committees are of recent origin, especially after the Enron corporate scandal. In fact, the Sarbanes – Oxley Act requires the entire board to be the audit committee, although this requirement suffers from a shortcoming, in that, where the chief executive officer (CEO) of the company is also a member of the board, he cannot function as a member of the audit committee, as he is not independent. Thus corporate governance in the US has gone through a series of developments through federal and state laws and regulations, as well as best practices and other

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<sup>346</sup> *Penn Cent Transp Co V New York* (439 US).

<sup>347</sup> *Busbee* (n 339) 238.

non-governmental means. It has been the case where such measures have resulted from questionable corporate behaviour and failures.<sup>348</sup>

### **3.4 US Corporate Scandals**

‘The Enron Corporation collapsed in an accounting scandal involving large-scale financial statement misrepresentations and undisclosed self-interested transactions by the senior financial officer.’<sup>349</sup> Just one year before the debacle, Enron was in seventh position in the US in terms of market capitalization. The firm had a very high reputation in energy trading and distribution, and was highly regarded as one of the top performers with foresighted innovative qualities. Enron’s failure happened at a time when the US economy was in an economic shock caused by the 9/11 terrorist attack and Enron attracted much media attention. In the months after the Enron demise, questionable accounting and executive practices involved additional publicly held companies. WorldCom had to file the largest bankruptcy reorganization in US history. These scandals forced Congress to take action eventually and adopt the regulatory regime imposed by SOX.<sup>350</sup>

#### **3.4.1 Events Leading to the Bankruptcy of Enron**

When the company was at its peak, it was reporting a turnover of \$80 billion and profits of about \$1 billion. The company was recognized as the most innovative company for six consecutive years by *Fortune*. After a series of changes in the top executive positions, amid rumours about financial trouble in the company, Enron announced charges against profits and a reduction in shareholder’s equity due to related transactions with LJM-2, partially owned by Enron’s CFO.

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<sup>348</sup> Ibid 243.

<sup>349</sup> R Romano, 'Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?' (2005) 21 *Oxf Rev Econ Policy* 213.

<sup>350</sup> Ibid 214.

The role of 'LJM partnerships is to provide Enron with a partner for asset sales and purchases as well as an instrument to hedge risk.'<sup>351</sup>

Less than a month from this time Enron announced about the accounting errors relating to transactions with another partnership of the CFO. Also there were restructuring of some accounting transactions as short term solutions to basically cover the transactions which were flawed and baseless. These transactions enabled the company executives to earn millions of dollars by a careful manoeuvring of the accounting records and keeping the share prices of the company at artificially higher prices. Such statements lead to formal investigation by Securities Exchange Commission in to Enron partnerships. As a result of such investigations serious dubious accounting transactions were brought to light which finally led to the filing of one of the largest bankruptcies of the country.<sup>352</sup>

The transactions of Enron gave new insight into the corporate governance lapses in the case of the management of Enron. As Peter Munzig points out, the first one being the dual role Michael Kopper played as manager and investor of the partnership while an employee of Enron. (Kopper was the managing director of Enron's global finance unit and reported directly to the CFO). This conflict of interest explicitly violated Enron's own Code of Ethics and Business Affairs. The second governance issue is in connection with the Compensation Committee's lack of review of Kopper's compensation resulting from the transactions, while the third governance issue deals with the lack of auditing oversight from the Audit and Compliance Committee concerning the decision not to consolidate the entity.<sup>353</sup>

These kinds of corporate practices result in a financial loss not only to the company concerned, but also affect innumerable investors who have invested their money in the stocks and securities of the limited companies. Since investments in securities are made with trust in the board of directors and other executives of the companies, they have an onus to protect the interest of shareholders of the company whether they are major or minor; individuals or institutions. In the

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<sup>351</sup> PG Munzig, 'Enron and the Economics of Corporate Governance' (Honours thesis Stanford University 2003) 20.

<sup>352</sup> Ibid 21.

<sup>353</sup> Ibid 23.

case of Enron, investors' confidence was taken for a ride by top management of the company that has witnessed the demise of a giant business enterprise. Along with the company, thousands of investors who had invested millions of dollars lost their savings. It was a similar situation for other stakeholders of the company, such as its innocent employees and the creditors who supplied products and services to Enron on the basis, as it turned out, of the ill-earned reputation of the company in the market by book adjustments and dubious entries. Moreover, the executives of the company amassed a large volume of money which otherwise would not have been earned by them. This money and wealth was earned by confidence tricks. The irony of the situation is that the statutory auditors, who were supposed to be the watch dogs to protect the interests of all the internal and external stakeholders, never brought these frauds and other misdeeds to the public to caution them against the peril of losing their investment.<sup>354</sup>

Nikos Passas strongly contends that harmful corporate practices are criminal in nature be they financial or otherwise; lawful or illegal and such practices result in the degrading of the environments in the third world and other tangible consequences detrimental to the public interest. They may result in the loss of numerous lives and wanton destruction of large number of properties belonging to both the public and private sector. The author opines that they can also be claimed as 'legal crimes'.<sup>355</sup>

### **3.4.2 Corporate Scandals – Difference in US and European Contexts**

One of the serious consequences of poor corporate governance is corporate scandal in the form of accounting and financial frauds. Analysing the incidence of corporate scandals globally, two issues emerge that need to be addressed to find out the reasons for such happenings. One is that

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<sup>354</sup> N Passas, 'Lawful but Awful: Legal Corporate Crimes' (2005) 34 J SocEcon 786.

<sup>355</sup> Ibid 784.

the nature of corporate scandals differs from economy to economy. The other issue is that although economies are subject to the same economic conditions, scandals may occur in one but not in another economy. A possible explanation for this phenomenon may lie in the structure of the ownership of the corporate entities involved. It is also possible to explain from past experience that a spate of corporate scandals follows a stock market bubble; serious measures in the form of new regulations would also follow as a natural consequence. This experience can be related to the corporate scandals that happened in Europe and the United States at the start of the millennium immediately after the burst of the stock market bubbles during the early 2000s. While such incidents resulted in the provision of regulatory measures such as the Sarbanes – Oxley Act in the United States due to large-scale accounting and financial irregularities, in Europe the aftermath was not so severely felt.<sup>356</sup> This can be seen from the fact that financial restatements in Europe were rarely found whereas at least 10 percent of the listed companies in the US resorted to such restatements in the period from 1997 to 2002.<sup>357</sup>

‘While Europe also had financial scandals over this same period (with the Parmalat scandal being the most notorious), most were characteristically different from the US style of earnings manipulation scandal (of which Enron and WorldCom were the iconic examples).’<sup>358</sup> It can be argued that the differences in the structure of the shareholding of the corporate entities may be considered as one of the reasons for various kinds of corporate scandal having differences in their nature and the identity of the people responsible for such frauds, and also for the varying number of such incidents. It may be noted that the whole corporate world can be grouped into two broad corporate governance systems; a dispersed ownership system represented by a strong

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<sup>356</sup> Coffee Jr. (n 224) 198.

<sup>357</sup> Ibid 198-199.

<sup>358</sup> Ibid 199.

security market with high transparency and controlled by a disciplinary mechanism which provides for stringent disclosure standards, and a concentrated ownership system having a weaker securities market and lesser transparency and disclosure measures. In the dispersed ownership systems corporate executives tend to be the perpetrators of frauds while in the concentrated ownership systems the controlling shareholders take the lead in indulging in accounting and other frauds.<sup>359</sup> The operating methods of the two groups are also different in that corporate management adopts earnings management as the manipulating device; the controlling shareholders take the route of exploiting the private benefits of control. It also happened that the auditors, analysts and credit rating agencies (generally termed as ‘gatekeepers’) failed both in Europe and the US but in different ways. As a result of the debacles many reforms have been suggested in the form of new regulations. But it must be appreciated that a remedy in the form of Sarbanes – Oxley Act as in the United States may not be suitable in Europe.<sup>360</sup>

From a European perspective, concentrated and dispersed ownership systems in continental Europe on the one hand and in the Anglo-American corporate scene on the other, has shown that the highest concentration of ownership under the European system has been found in Germany and Italy, while the US and UK have shown a dispersed ownership, with France somewhere in the middle.<sup>361</sup>

It has also been noted that a major distinction between the European and US perspectives results from each operating under a totally different legal system.<sup>362</sup> Shareholder rights under US

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<sup>359</sup> Ibid

<sup>360</sup> Ibid

<sup>361</sup> L Enriques and P Volpin, 'Corporate Governance Reforms in Continental Europe' (2007) 21 J Econ Pers 118.

<sup>362</sup> G Owen, T Kirchmaier and J Grant, *Corporate Governance in the US and Europe: Where Are We Now?* (Palgrave Macmillan, Houndsmill 2006) 3.

common law are a lot stronger than their counterparts under civil law, mostly prevalent in the EU. Under the common law system, shareholder rights are not as easily avoided as in the civil law system. Therefore, minority shareholders are better protected under the former system than under the latter. In Europe; most firms are owned by dominant shareholders in whose hands rests legal control of the firm. Such shareholders (usually including the founder, members of the family and other such individuals) control the board, with invariably limited or no representation of minority shareholders.<sup>363</sup>

Another difference between the US and Europe can be found in their corporate law systems. In the US corporate law provides for only a single board system, 'with no mandatory labour representation.'<sup>364</sup> US corporate law gives full power to a single board of directors, without any further rules as to board composition. The main difference of the two systems is that under the US system, executive management is delegated by the board, and can thus be changed at any time; 'whereas the powers of, for example, the German Management Board are vested by law and cannot be reduced even by a shareholders' resolution on amendments to the Articles.'<sup>365</sup>

Although the scope of this thesis does not allow for a full discussion of the differences of corporate governance regimes between the US and UK, it is worth mentioning here that the main general difference is that whilst in the US corporate governance systems are determined predominantly by legislative reforms in the form of Sarbanes-Oxley Act<sup>366</sup> and other detailed regulatory provisions which the Act required through the Securities and Exchange Commission

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<sup>363</sup> Ibid

<sup>364</sup> R Bohinc, 'Choosing between the U.S. Single Board or the European Two-Tier Board: A Brief Comparative Corporate Governance Analysis' (2000) <<http://ssrn.com/abstract=221969>> accessed 21 October 2008.

<sup>365</sup> Ibid

<sup>366</sup> See below p 153 and following.

(SEC) New York Stock Exchange (NYSE) and NASDAQ. The ‘comply or explain’ approach followed by the UK in respect of corporate governance varies significantly from the regulatory approach taken by the Sarbanes-Oxley Act.<sup>367</sup> Although SOX-related regulations follow the ‘comply or explain’ approach (for example, in relation to whether a company has a "code of ethics" or its audit committee has a "financial expert"), in most of other occasions the US regulations tend to rely on the penal provisions of the SOX like fines and imprisonments for any violation of the provisions of the Act.<sup>368</sup>

### **3.5 Sarbanes-Oxley Act**

The Sarbanes – Oxley Act (shortly known as the SOX Act) named after two US senators, has brought the most significant financial legislation in the history of US financial markets 70 odd years after the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934. The Act was an initiative to restore shareholder confidence in the total system of trading in public securities after the US economy was flooded by a series of corporate scandals that led to the loss of billions of dollars of the investing public’s money. It applies to all Securities and Exchange Commission (SEC) registered organizations, irrespective of where their trading activities are geographically based. SOX is different from the UK's Combined Code, and from codes of corporate governance adopted elsewhere in the OECD, in that compliance is mandatory, rather than ‘comply or explain’. This aspect, combined with significant potential sanctions for individual directors, is driving SOX compliance requirements through the supply chain.

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<sup>367</sup> See above pp 89, 92, 101, 106, 117-118.

<sup>368</sup> A Dowdney, 'Corporate Governance in the U.K. And U.S. Comparison' <<http://www.metrocorpocounsel.com/current.php?artType=view&artMonth=December&artYear=2005&EntryNo=3957>> accessed 8 July 2008.

With the passing of the Sarbanes-Oxley Act, there was an increase in corporate responsibility with reference to financial reporting. Notably, the legislation has caused a ripple effect and its impacts can be realised in financial reporting in other countries. A study carried out by in South East Asia indicated that in general, there was a changing trend of increased transparency in financial reporting.<sup>369</sup> Nevertheless, this trend cannot necessarily be directly attributed to the effects of the Sarbanes-Oxley Act, but it appears to be related to a wider, more transcendent worldwide reform movement toward increased corporate responsibility and financial reporting, to which the Sarbanes-Oxley Act seems to have served as a catalyst.

### **3.5.1 Purposes of the Sarbanes-Oxley Act**

The purposes for which the legislation was enacted are to:

- Restores public trust in the public securities market
- Improve corporate governance and promote ethical business practices
- Enhance transparency of financial statements and disclosures
- Ensure that company executives are aware of material information emanating from a well-controlled environment
- Hold management accountable for material information that is filed with the SEC and released to investors.<sup>370</sup>

Another important impact of the passing of this Act had been described by Karan and Sharifi in that the Act will have a profound effect on the probable merger and acquisition deals, as after passing of the Act, both the acquirer and the target should understand the implications of the cost and effect of the Act and any firm that has even a slightly shady accounting background will be

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<sup>369</sup> P Herz and P McGurr, 'Sarbanes-Oxley: How Far Does It Reach? An Exploratory Study in South East Asia' (2006) 14 Asian Review of Accounting 83-100.

<sup>370</sup> JK Cheung, 'Challenges in Improving Corporate Governance' (AIG 2006) <<http://www.asialawandpractice.com/download/APIInhousesummit06/Governance.pdf>> accessed 18 July 2007.

neglected by the acquirers. This may act as a deterrent for the number of such merger and acquisition deals that are likely to be taken up.<sup>371</sup>

### 3.5.2 Salient Features of the Act

It has been clearly stated that the Sarbanes-Oxley Act 'is designed to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws.'<sup>372</sup> Its importance as a piece of legislation has been widely recognized as an important tool in governing and assessing the effectiveness of financial disclosure and the practice of public accounting. Only the US securities laws of the early 1930s precede it in its significance. It has put into place rigorous requirements, which have benefited professionals in both accounting and law to oversee the financial affairs of public companies.<sup>373</sup> It is yet another manifestation of legislation designed to protect the investor in a dispersed shareholder market such as the US.

While the Act lays down detailed requirements for the governance of organizations, the three highest profile and most critical sections – which were implemented in phases - are 302, 404 and 409.

#### 3.5.2.1 Sections 302, 404, 409<sup>374</sup>

	302	404	409
Required:	Quarterly certification of	Management	Monitor

<sup>371</sup> V Karan and M Sharifi, 'Will Sox Kill the Deal?' (2006) 17 J Corp Accounting & Fin 37.

<sup>372</sup> Ibid

<sup>373</sup> Price Waterhouse Coopers, 'Sarbanes-Oxley: The Act and Strategies for Compliance' (2007) <<http://www.pwc.com/Extweb/NewCoAtWork.nsf/docid/D0D7F79003C6D64485256CF30074D66C>> accessed 20 December 2007.

<sup>374</sup> , 'US Corporate Governance: Sarbanes Oxley' (IT Governance) <[http://www.itgovernance.co.uk/corpgov\\_us.aspx](http://www.itgovernance.co.uk/corpgov_us.aspx)> accessed 28 January 2009.

	financial reports  Disclosure of all known control deficiencies  Disclose acts of fraud	annually certify internal controls  Independent accountant must attest report  Quarterly change reviews	operational risks  Material event reporting  'Real-time' implications – 4 business days for report to be filed
Responsible	• CEO • CFO	• Management • Independent auditor	• Management • Independent auditor

### 3.5.2.2 Section 3: Commission Rules and Enforcement.

A violation of Rules of the Public Company Accounting Oversight Board ("Board") is treated as a violation of the '34 Act, giving rise to the same penalties that may be imposed for violations of that Act.

### 3.5.2.3 Section 101: Establishment; Board Membership.

The Board will have five financially-literate members, appointed for five-year terms. Two of the members must be or have been certified public accountants, and the remaining three must not be and cannot have been CPAs. The Chair may be held by one of the CPA members, provided that he or she has not been engaged as a practicing CPA for five years.

The Board's members will serve on a full-time basis.

No member may, concurrent with service on the Board, "share in any of the profits of, or receive payments from, a public accounting firm," other than "fixed continuing payments," such as retirement payments.

Members of the Board are appointed by the Commission, "after consultation with" the Chairman of the Federal Reserve Board and the Secretary of the Treasury.

Members may be removed by the Commission "for good cause."

#### **3.5.2.4 Section 101: Establishment; Duties of the Board.**

#### **3.5.2.5 Section 103: Auditing, Quality Control, and Independence Standards and Rules.**

The Board shall:

1. register public accounting firms;
2. establish, or adopt, by rule, "auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers;"
3. conduct inspections of accounting firms;
4. conduct investigations and disciplinary proceedings, and impose appropriate sanctions;
5. perform such other duties or functions as necessary or appropriate;
6. enforce compliance with the Act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto; and,
7. set the budget and manage the operations of the Board and the staff of the Board.

*Auditing standards.* The Board would be required to "cooperate on an on-going basis" with designated professional groups of accountants and any advisory groups convened in connection with standard-setting, and although the Board can "to the extent that it determines appropriate" adopt standards proposed by those groups, the Board will have authority to amend, modify, repeal, and reject any standards suggested by the groups. The Board must report on its standard-setting activity to the Commission on an annual basis.

The Board must require registered public accounting firms to "prepare, and maintain for a period of not less than 7 years, audit work papers, and other information related to any audit report, in sufficient detail to support the conclusions reached in such report."

The Board must require a second partner review and approval of audit reports registered accounting firms must adopt quality control standards.

The Board must adopt an audit standard to implement the internal control review required by section 404(b). This standard must require the auditor evaluate whether the internal control structure and procedures include records that accurately and fairly reflect the transactions of the issuer, provide reasonable assurance that the transactions are recorded in a manner that will permit the preparation of financial statements in accordance with GAAP, and a description of any material weaknesses in the internal controls.

**3.5.2.6 Section 102(a): Mandatory Registration**

**3.5.2.7 Section 102(f): Registration and Annual Fees.**

**3.5.2.8 Section 109(d): Funding; Annual Accounting Support Fee For The Board.**

In order to audit a public company, a public accounting firm must register with the Board. The Board shall collect "a registration fee" and "an annual fee" from each registered public accounting firm, in amounts that are "sufficient" to recover the costs of processing and reviewing applications and annual reports.

The Board shall also establish by rule a reasonable "annual accounting support fee" as may be necessary or appropriate to maintain the Board. This fee will be assessed on issuers only.

**3.5.2.9 Section 104: Inspections of Registered Public Accounting Firms**

Annual quality reviews (inspections) must be conducted for firms that audit more than 100 issues, all others must be conducted every three years. The SEC and/or the Board may order a special inspection of any firm at any time.

**3.5.2.10 Section 105(b) (5): Investigation and Disciplinary Proceedings; Investigations; Use of Documents.**

**3.5.2.11 Section 105(c) (2): Investigations and Disciplinary Proceedings; Disciplinary Procedures; Public Hearings.**

**3.5.2.12 Section 105(c) (4): Investigations and Disciplinary Proceedings; Sanctions.**

**3.5.2.13 Section 105(d): Investigations and Disciplinary Proceedings; Reporting of Sanctions.**

All documents and information prepared or received by the Board shall be "confidential and privileged as an evidentiary matter (and shall not be subject to civil discovery other legal process) in any proceeding in any Federal or State court or administrative agency, . . . unless and until presented in connection with a public proceeding or [otherwise] released" in connection with a disciplinary action. However, all such documents and information can be made available to the SEC, the U.S. Attorney General, and other federal and appropriate state agencies.

Disciplinary hearings will be closed unless the Board orders that they be public, for good cause, and with the consent of the parties.

Sanctions can be imposed by the Board of a firm if it fails to reasonably supervise any associated person with regard to auditing or quality control standards, or otherwise.

No sanctions report will be made available to the public unless and until stays pending appeal have been lifted.

**3.5.2.14 Section 106: Foreign Public Accounting Firms.**

The bill would subject foreign accounting firms who audit a US company to registrations with the Board. This would include foreign firms that perform some audit work, such as in a foreign subsidiary of a US company that is relied on by the primary auditor.

**3.5.2.15 Section 107(a): Commission Oversight of the Board; General Oversight Responsibility.**

**3.5.2.16 Section 107(b): Rules of the Board.**

**3.5.2.17 Section 107(d): Censure of the Board and Other Sanctions.**

The SEC shall have "oversight and enforcement authority over the Board." The SEC can, by rule or order, give the Board additional responsibilities. The SEC may require the Board to keep certain records, and it has the power to inspect the Board itself, in the same manner as it can with regard to SROs such as the NASD.

The Board, in its rulemaking process, is to be treated "as if the Board were a 'registered securities association'"--that is, a self-regulatory organization. The Board is required to file proposed rules and proposed rule changes with the SEC. The SEC may approve, reject or amend such rules.

The Board must notify the SEC of pending investigations involving potential violations of the securities laws, and coordinate its investigation with the SEC Division of Enforcement as necessary to protect an ongoing SEC investigation.

The SEC may, by order, "censure or impose limitations upon the activities, functions, and operations of the Board" if it finds that the Board has violated the Act or the securities laws, or if the Board has failed to ensure the compliance of accounting firms with applicable rules without reasonable justification.

**3.5.2.18 Section 107(c): Commission Review of Disciplinary Action Taken By the Board.**

The Board must notify the SEC when it imposes "any final sanction" on any accounting firm or associated person. The Board's findings and sanctions are subject to review by the SEC.

The SEC may enhance, modify, cancel, reduce, or require remission of such sanction.

### **3.5.2.19 Section 108: Accounting Standards.**

The SEC is authorized to "recognize, as 'generally accepted'... any accounting principles" that are established by a standard-setting body that meets the bill's criteria, which include requirements that the body:

- (1) be a private entity;
- (2) be governed by a board of trustees (or equivalent body), the majority of who are not or have not been associated persons with a public accounting firm for the past two years;
- (3) be funded in a manner similar to the Board;
- (4) have adopted procedures to ensure prompt consideration of changes to accounting principles by a majority vote;
- (5) consider, when adopting standards, the need to keep them current and the extent to which international convergence of standards is necessary or appropriate.

### **3.5.2.20 Section 201: Services Outside the Scope of Practice of Auditors; Prohibited Activities.**

It shall be "unlawful" for a registered public accounting firm to provide any non-audit service to an issuer contemporaneously with the audit, including: (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert services unrelated to the audit; (9) any other service that the Board determines, by regulation, is impermissible. The Board may, on a

case-by-case basis, exempt from these prohibitions any person, issuer, public accounting firm, or transaction, subject to review by the Commission.

It will not be unlawful to provide other non-audit services if they are pre-approved by the audit committee in the following manner. The bill allows an accounting firm to "engage in any non-audit service, including tax services," that is not listed above, only if the activity is pre-approved by the audit committee of the issuer. The audit committee will disclose to investors in periodic reports its decision to pre-approve non-audit services.

Statutory insurance company regulatory audits are treated as an audit service, and thus do not require pre-approval.

The pre-approval requirement is waived with respect to the provision of non-audit services for an issuer if the aggregate amount of all such non-audit services provided to the issuer constitutes less than 5 % of the total amount of revenues paid by the issuer to its auditor (calculated on the basis of revenues paid by the issuer during the fiscal year when the non-audit services are performed), such services were not recognized by the issuer at the time of the engagement to be non-audit services; and such services are promptly brought to the attention of the audit committee and approved before completion of the audit.

The authority to pre-approve services can be delegated to one or more members of the audit committee, but any decision by the delegate must be presented to the full audit committee.

#### **3.5.2.21 Section 203: Audit Partner Rotation.**

The lead audit or coordinating partner and the reviewing partner must rotate off the audit every five years.

#### **3.5.2.22 Section 204: Auditor Reports to Audit Committees.**

The accounting firm must report to the audit committee all "critical accounting policies and practices to be used...all alternative treatments of financial information within [GAAP] that have been discussed with management...ramifications of the use of such alternative disclosures and treatments, and the treatment preferred" by the firm.

#### **3.5.2.23 Section 206: Conflicts of Interest.**

The CEO, Controller, CFO, Chief Accounting Officer or person in an equivalent position cannot have been employed by the company's audit firm during the one-year period preceding the audit.

#### **3.5.2.24 Section 207: Study of Mandatory Rotation of Registered Public Accountants.**

The GAO will do a study on the potential effects of requiring the mandatory rotation of audit firms.

#### **3.5.2.25 Section 209: Consideration by Appropriate State Regulatory Authorities.**

State regulators are directed to make an independent determination as to whether the Boards standards shall be applied to small and mid-size non-registered accounting firms.

#### **3.5.2.26 Section 301: Public Company Audit Committees.**

Each member of the audit committee shall be a member of the board of directors of the issuer, and shall otherwise be independent.

"Independent" is defined as not receiving, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer, and as not being an affiliated person of the issuer, or any subsidiary thereof.

The SEC may make exemptions for certain individuals on a case-by-case basis.

The audit committee of an issuer shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer.

The audit committee shall establish procedures for the "receipt, retention, and treatment of complaints" received by the issuer regarding accounting, internal controls, and auditing.

Each audit committee shall have the authority to engage independent counsel or other advisors, as it determines necessary to carry out its duties.

Each issuer shall provide appropriate funding to the audit committee.

#### **3.5.2.27 Section 302: Corporate Responsibility for Financial Reports.**

The CEO and CFO of each issuer shall prepare a statement to accompany the audit report to certify the "appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer." A violation of this section must be knowing and intentional to give rise to liability.

#### **3.5.2.28 Section 303: Improper Influence on Conduct of Audits**

It shall be unlawful for any officer or director of an issuer to take any action to fraudulently influence, coerce, manipulate, or mislead any auditor engaged in the performance of an audit for the purpose of rendering the financial statements materially misleading.

**3.5.2.29 Section 304: Forfeiture of Certain Bonuses and Profits.**

**3.5.2.30 Section 305: Officer and Director Bars and Penalties; Equitable Relief.**

If an issuer is required to prepare a restatement due to "material noncompliance" with financial reporting requirements, the chief executive officer and the chief financial officer shall "reimburse the issuer for any bonus or other incentive-based or equity-based compensation received" during the twelve months following the issuance or filing of the non-compliant document and "any profits realized from the sale of securities of the issuer" during that period.

In any action brought by the SEC for violation of the securities laws, federal courts are authorized to "grant any equitable relief that may be appropriate or necessary for the benefit of investors."

**3.5.2.31 Section 305: Officer and Director Bars and Penalties.**

The SEC may issue an order to prohibit, conditionally or unconditionally, permanently or temporarily, any person who has violated section 10(b) of the 1934 Act from acting as an officer or director of an issuer if the SEC has found that such person's conduct "demonstrates unfitness" to serve as an officer or director of any such issuer.

**3.5.2.32 Section 306: Insider Trades During Pension Fund Black-Out Periods Prohibited.**

Prohibits the purchase or sale of stock by officers and directors and other insiders during blackout periods. Any profits resulting from sales in violation of this section "shall inure to and be recoverable by the issuer." If the issuer fails to bring suit or prosecute diligently, a suit to recover such profit may be instituted by "the owner of any security of the issuer."

### **3.5.2.33 Section 401(a): Disclosures in Periodic Reports; Disclosures Required.**

Each financial report that is required to be prepared in accordance with GAAP shall "reflect all material correcting adjustments . . . that have been identified by a registered accounting firm . . . ."

"Each annual and quarterly financial report . . . shall disclose all material off-balance sheet transactions" and "other relationships" with "unconsolidated entities" that may have a material current or future effect on the financial condition of the issuer.

The SEC shall issue rules providing that pro forma financial information must be presented so as not to "contain an untrue statement" or omit to state a material fact necessary in order to make the pro forma financial information not misleading.

### **3.5.2.34 Section 401 (c): Study and Report on Special Purpose Entities.**

SEC shall study off-balance sheet disclosures to determine a) extent of off-balance sheet transactions (including assets, liabilities, leases, losses and the use of special purpose entities); and b) whether generally accepted accounting rules result in financial statements of issuers reflecting the economics of such off-balance sheet transactions to investors in a transparent fashion and make a report containing recommendations to Congress.

### **3.5.2.35 Section 402(a): Prohibition on Personal Loans to Executives.**

Generally, it will be unlawful for an issuer to extend credit to any director or executive officer. Consumer credit companies may make home improvement and consumer credit loans and issue credit cards to its directors and executive officers if it is done in the ordinary course of business on the same terms and conditions made to the general public.

### **3.5.2.36 Section 403: Disclosures of Transactions Involving Management and Principal Stockholders.**

Directors, officers, and 10% owners must report designated transactions by the end of the second business day following the day on which the transaction was executed.

### **3.5.2.37 Section 404: Management Assessment of Internal Controls.**

Requires each annual report of an issuer to contain an "internal control report", which shall:

1. state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
2. contain an assessment, as of the end of the issuer's fiscal year, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

Each issuer's auditor shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this section shall be in accordance with standards for attestation engagements issued or adopted by the Board. An attestation engagement shall not be the subject of a separate engagement.

The language in the report of the Committee which accompanies the bill to explain the legislative intent states, "--- the Committee does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees."

Directs the SEC to require each issuer to disclose whether it has adopted a code of ethics for its senior financial officers and the contents of that code.

Directs the SEC to revise its regulations concerning prompt disclosure on Form 8-K to require immediate disclosure "of any change in, or waiver of," an issuer's code of ethics.

#### **3.5.2.38 Section 407: Disclosure of Audit Committee Financial Expert.**

The SEC shall issue rules to require issuers to disclose whether at least one member of its audit committee is a "financial expert."

#### **3.5.2.39 Section 409: Real Time Disclosure.**

Issuers must disclose information on material changes in the financial condition or operations of the issuer on a rapid and current basis.

#### **3.5.2.40 Section 501: Treatment of Securities Analysts by Registered Securities Associations.**

National Securities Exchanges and registered securities associations must adopt conflict of interest rules for research analysts who recommend equities in research reports.

#### **3.5.2.41 Section 601: SEC Resources and Authority.**

SEC appropriations for 2003 are increased to \$776,000,000. \$98 million of the funds shall be used to hire an additional 200 employees to provide enhanced oversight of auditors and audit services required by the Federal securities laws.

#### **3.5.2.42 Section 602(a): Appearance and Practice before the Commission.**

The SEC may censure any person, or temporarily bar or deny any person the right to appear or practice before the SEC if the person does not possess the requisite qualifications to represent others, lacks character or integrity, or has wilfully violated Federal securities laws.

#### **3.5.2.43 Section 602(c): Study and Report.**

The SEC is to conduct a study of "securities professionals" (public accountants, public accounting firms, investment bankers, investment advisors, brokers, dealers, attorneys) who have been found to have aided and abetted a violation of Federal securities laws.

#### **3.5.2.44 Section 602(d): Rules of Professional Responsibility for Attorneys.**

The SEC shall establish rules setting minimum standards for professional conduct for attorneys practicing before it.

#### **3.5.2.45 Section 701: GAO Study and Report Regarding Consolidation of Public Accounting Firms.**

The GAO shall conduct a study regarding the consolidation of public accounting firms since 1989, including the present and future impact of the consolidation, and the solutions to any problems discovered.

#### **3.5.2.46 Title VIII: Corporate and Criminal Fraud Accountability Act of 2002.**

It is a felony to "knowingly" destroy or create documents to "impede, obstruct or influence" any existing or contemplated federal investigation.

Auditors are required to maintain "all audit or review work papers" for five years.

The statute of limitations on securities fraud claims is extended to the earlier of five years from the fraud, or two years after the fraud was discovered, from three years and one year, respectively.

Employees of issuers and accounting firms are extended "whistleblower protection" that would prohibit the employer from taking certain actions against employees who lawfully disclose private employer information to, among others, parties in a judicial proceeding involving a fraud claim. Whistle blowers are also granted a remedy of special damages and attorney's fees.

A new crime for securities fraud will have penalties of fines and up to 10 years imprisonment.

### **3.5.2.47 Title IX: White Collar Crime Penalty Enhancements**

Maximum penalty for mail and wire fraud increased from 5 to 10 years.

Creates a crime for tampering with a record or otherwise impeding any official proceeding.

SEC given authority to seek court freeze of extraordinary payments to directors, officers, partners, controlling persons, agents of employees.

US Sentencing Commission to review sentencing guidelines for securities and accounting fraud.

SEC may prohibit anyone convicted of securities fraud from being an officer or director of any publicly traded company.

Financial Statements filed with the SEC must be certified by the CEO and CFO. The certification must state that the financial statements and disclosures fully comply with provisions of the Securities Exchange Act and that they fairly present, in all material respects, the operations and financial condition of the issuer. Maximum penalties for wilful and knowing violations of this section are a fine of not more than \$5,000,000 and/or imprisonment of up to 20 years.

### **3.5.2.48 Section 1001: Sense of Congress Regarding Corporate Tax Returns**

It is the sense of Congress that the Federal income tax return of a corporation should be signed by the chief executive officer of such corporation.

### **3.5.2.49 Section 1102: Tampering With a Record or Otherwise Impeding an Official Proceeding**

Makes it a crime for any person to corruptly alter, destroy, mutilate, or conceal any document with the intent to impair the object's integrity or availability for use in an official proceeding or

to otherwise obstruct, influence or impede any official proceeding is liable for up to 20 years in prison and a fine.

### **3.5.2.50 Section 1103: Temporary Freeze Authority**

The SEC is authorized to freeze the payment of an extraordinary payment to any director, officer, partner, controlling person, agent, or employee of a company during an investigation of possible violations of securities laws.

### **3.5.2.51 Section 1105: SEC Authority to Prohibit Persons from Serving as Officers or Directors**

The SEC may prohibit a person from serving as an officer or director of a public company if the person has committed securities fraud.

## **3.5.3 After-effects of the Act**

As some of the literature has indicated, the SOX has led to changes in corporate behaviour and practices.<sup>375</sup> Only three years after the passage of the Sarbanes-Oxley Act, there was a significant increase in the time corporate directors spent on their board duties and the increased time that executives spent on reporting matters.<sup>376</sup> It can be construed that this increase in activity was the direct result of a new evaluation of the possible consequences for misrepresentation of financial and related statements. Such awareness of the dire consequences has caused CEOs and CFOs to

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<sup>375</sup> RP Bartlett III, 'Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going-Private Decisions' (2009) 76 U Chi L Rev; HE Canary and MM Jennings, 'Principles and Influence in Codes of Ethics: A Centering Resonance Analysis Comparing Pre- and Post-Sarbanes-Oxley Codes of Ethics' (2008) 80 J Bus Ethics; JC Coates IV, 'The Goals and Promise of the Sarbanes-Oxley Act' (2007) 21 J Econ Pers; A Valenti, 'The Sarbanes-Oxley Act of 2002: Has It Brought About Changes in the Boards of Large U. S. Corporations?' (2008) 81 J Bus Ethics; SC Vera-Muñoz, 'Corporate Governance Reforms: Redefined Expectations of Audit Committee Responsibilities and Effectiveness' (2005) 62 J Bus Ethics

<sup>376</sup> RF Radin and WB Stevenson, 'Comparing Mutual Fund Governance and Corporate Governance' (2006) 14 CGAIR 368.

realize the need for accuracy in the presentation of financial statements and also the importance of transparency in their dealings and their disclosures.<sup>377</sup>

Furthermore, CFOs became more focused on making their organizations aware of the Sarbanes-Oxley Act requirements through appropriate education, presentations and communications and are working to align various organizational processes with these requirements. Moreover, public companies are taking steps to ensure their directors are aligning their practices with the guidelines set forth by the Act and listing requirements.<sup>378</sup>

Hemphill, on the basis of the study from Coopers that measures the opinion of directors and CEOs of the top 2000 publicly traded companies, reports that ‘reflecting the increasing board demands on a director’s time, “professional directors” who sit on six or more boards are fading away. In 2003, only 33% of CEOs and 16% of outside directors were limited to additional board seats, compared with 43% and 29%, respectively, in the 2004 survey.’<sup>379</sup>

In another instance, Richard W. Leblanc has observed that the experience of the directors is critical to the effectiveness with which the board can function, ‘however, evidence that board independence has neutral to negative effects on board effectiveness is not’.<sup>380</sup>

Stephen Wagner and Lee Dittmar in ‘The Unexpected Benefits of Sarbanes-Oxley Best Practice’ observe

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<sup>377</sup> Ibid

<sup>378</sup> Protiviti Inc, 'Insights on to-Day's Sarbanes-Oxley and Corporate Governance Challenge' (2003) <<http://www.boardmember.com/network/ProtivitiSurveyReport.pdf>> accessed 14 August 2007.

<sup>379</sup> TA Hemphill, 'The Sarbanes–Oxley Act of 2002: Reviewing the Corporate Governance Scorecard' (2005) 20 J Corp Cit

<sup>380</sup> RW Leblanc, 'What's Wrong with Corporate Governance: A Note' (2004) 12 CGAIR 436.

Perhaps SOX's most burdensome element was Section 404, which says that it is management's responsibility to maintain a sound internal-control structure for financial reporting and to assess its own effectiveness, and that it is the auditors' responsibility to attest to the soundness of management's assessment and report on the state of the overall financial control system.<sup>381</sup>

On these views, Peter Van der Heyden responds by saying that although as a result of SOX there resulted a highly efficient accounting procedure, 'less duplication of data entry and checking, clearer definitions of the content of reports, more standardization of functions across different divisions or geographic locations, and so on', the function of accounting is not just to show the numbers but to help senior management in taking meaningful decisions.<sup>382</sup>

In another study undertaken by Rajeeva Sinha it was found that there was an interplay between external and internal governance mechanisms that were adopted in monitoring top management, with differences in the effects of the external (regulatory) governance mechanisms on the effectiveness of internal corporate governance mechanisms.<sup>383</sup>

Thus it can be said that corporate governance measures should be capable of effecting improvements in the environment both internal and external to the firms.

### **3.5.4 Effects of Passing of the Sarbanes – Oxley Act on Executive Compensation**

Stock options were at one time the favourite and popular method of compensating senior and middle level corporate executives for achieving desired stock-price gains in the short term.

However, what happened at Enron had made many of the companies and their senior leaders to rethink executive compensation in the form of stock options; as such options were the gateway for corporate fraud. While there had been a tremendous increase in compensation, 313 percent from 1990 to 2003, corporate profits increased only 128 percent with an explanation increment

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<sup>381</sup> S Wagner and L Dittmar, 'The Unexpected Benefits of Sarbanes-Oxley' (2006) 84 Har Bus Rev 133.

<sup>382</sup> P Van Der Hayden, 'Letters to the Editor: The Unexpected Benefits of Sarbanes-Oxley' Har Bus Rev

<sup>383</sup> R Sinha, 'Regulation: The Market for Corporate Control and Corporate Governance' (2006) 16 Glob Fin J 265.

of 41 percent. In spite of the increase in the quantum of compensation payable, the companies and their boards of directors are looking at different methods of executive compensation so that they can attract and retain the best available talent.<sup>384</sup>

Introduction of the Sarbanes – Oxley Act has made most of the major listed companies discard stock options as a form of executive compensation, except for top-level leaders. But such a shift in compensation methods has not been favoured by many top-tier executives as they consider stock options give them a sense of ownership, while the other options were viewed only as entitlements. In their work on the subject, John Palter et al. have shown that this ‘fundamental tenet of ownership is leveraged to bolster and to motivate individuals to improve corporate performance. Unfortunately, the extremes of this same drive can sometimes result in executives ignoring corporate warning signs or putting their own interests above the greater good of the company.’<sup>385</sup> Due to the adverse effects such forms of compensation generate, the Sarbanes-Oxley and the Stock Exchange regulations have placed some restrictions on executive compensation offered by corporate entities. These restrictions are clearly listed by Palter et al:

1. Personal loans, or extensions of credit, to directors and officers are prohibited.
2. Incentive-based compensation must be returned or clawed back by the company if received by a C-level employee as a result of a financial report resulting from misconduct.
3. Adequate internal controls must be in place and certified as adequate.
4. Independent accountants must value option compensation.
5. Option expenses must be reported.<sup>386</sup>

### **3.5.5 Alternative Forms of Executive Compensation**

Companies have devised various new methods of executive compensation. One such method is a traditional ‘deferred stock options’ where the executive contributes a certain percentage of

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<sup>384</sup> JJ Palter and JR Leverette, 'Filling the Stock Option Void' (2006) 38 Com & Ben Rev 50.

<sup>385</sup> Ibid 51.

<sup>386</sup> Ibid

monthly earnings for a preset period of time and at the end of the period the executive is entitled to purchase the option or in some cases one and a half options of the stocks of the company.

Another option that is increasingly being considered for compensating corporate executives is to make them participate in long-term bonus plans where contributions are made into a pool which vests over time. Based on the defined tenure of the pool substantial cash payouts are considered for the different executives. The only shortcoming of this executive compensation method is that investments in shares may result in more lucrative returns to the executives than the pool money invested in any other form.<sup>387</sup>

### **3.6 Public Company Accounting Oversight Board**

The Sarbanes-Oxley Act created the Public Company Oversight Board (PCAOB), which was entrusted with the responsibility of regulating the auditing of public companies in the US. The Board has made it mandatory for auditors to register with the Board. The Board creates procedures for quality assurance and independent ethical standards with which the auditors are required strictly to adhere.

The Act also contains rules that govern the provision of audit and non-audit services by the auditors to the companies on behalf of which the company is acting in the capacity of auditors. The Act also provides disclosure requirements in respect of the fees and charges received by auditors for audit and other services. Thus it may be stated that the independence of auditors, being the scrutinizers, is being subjected to wide scrutiny, in the aftermath of the corporate scandals in the US.<sup>388</sup>

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<sup>387</sup> Ibid 51-52.

<sup>388</sup> RS Boster, 'The Public Company Accounting Oversight Board: De' Ja' Vu Seidman's Quasi Government' (2007) Fall Pub Budg & Fin 132.

### 3.6.1 Corporate Governance and the Structure of the Board of Directors

Fama and Jensen observe that the board of directors of any company can be regarded as the ‘heart of the corporate governance’ as they have been delegated and are expected to exercise controlling authority on the top management in their decision-making functions. The board of directors has also been vested with the power of monitoring the integrity of the financial statements of the companies concerned. There are usually different ways of structuring the board of directors depending on the requirements of the organization.<sup>389</sup> There are two schools of thought about the purpose and nature of the structure of the board of directors. According to one view, the boards are formed to increase managerial control over companies and hence the boards should be structured to have more participation from management than outsiders as independent directors. In this case, the boards will have more insight into the operations of the firm. The other viewpoint is that the boards are formed basically to reduce agency costs and this school believes that the boards should be structured to have more outside independent directors so that management may have to get more ratification from the boards for their actions and decisions. In this way the difference between the interests of management and the shareholders is bound to be narrowed. ‘The conflict between the two viewpoints lies in the level of control over management exercised by shareholders. Some firms are structured to emphasize the board of director’s ability to monitor and control management while other firms are not.’<sup>390</sup>

These are opposing views in the sphere of corporate governance and many companies have structured their boards of directors in such a way that they exercise managerial control as well as monitoring over the activities on the management.

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<sup>389</sup> EF Fama and MC Jensen, 'Separation of Ownership and Control' (1983) 26 JLE 301-325.

<sup>390</sup> ST Petra, 'The Effects of Corporate Governance on the Informativeness of Earnings' (2007) 8 Econ Of Gov 130.

### 3.6.2 Corporate Governance and the Duties of Directors in the US Context

The fiduciary duties of directors in the sphere of corporate governance can be identified from the perspective of two focal points; one as imposed by the requirements of the corporate governance framework with respect to the discharge of their functions, and the other as an ongoing duty towards the shareholders and the company. The interrelationship of this function as expected by corporate governance implementation and the general duties of directors is not very complex in nature, in the sense that the duties expected of directors in the form of members in various committees towards the corporate governance framework is quite distinct from the regular duties of directors in the day to day functioning of the firm. Thus corporate governance places special responsibilities on the directors who function as members of the audit committee to act as the connecting link between the company and the integrity of the external auditors in the discharge of their gate-keeping functions. In the discharge of such functions as members of the audit committee, directors should act above board in the public interest beyond their duties towards the company's present shareholders. Prioritizing the discharge of these two responsibilities effectively in the company's as well as the public interest is the role of the director.

The second factor that needs consideration in the matter of the duties of the directors under corporate governance is the duty of loyalty to the corporation. 'That is, a director's duty of fidelity to the interests of the corporation imposes more than an obligation to refrain from participating in board decisions in which the director has an undisclosed and material financial or other economic interest.'<sup>391</sup> The general objective of the corporate governance reforms is to 'enrich the content of the loyalty' of directors towards fulfilling their duties towards the company

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<sup>391</sup> DA Demott, 'Texture of Loyalty' in JJ Norton and J Rickford (eds), *Corporate Governance Post-Enron: Comparative and International Perspectives* (British Institute of International and Comparative Law, London 2006) 24.

as well as the public. In fact, legitimizing the extent to which the directors of US corporations are moved away from the influence of the shareholders depends largely on enriching the content of this duty of loyalty on the part of the directors.

Lately there has been an increased scepticism as to whether most of the directors of US corporations have the capacity and the will power to discharge their duties in a manner that enables them to form their own judgments in decisions, independent of other managerial influence. The answer to this question is viewed pessimistically as corporate governance measures recommend increasing the participation of more independent outside directors in comparison to those who belong in the corporate echelons. This needs to be proved over time. In this context it is also to be seen to what degree the directors are independent of shareholders in the majority of US public corporations.

The striking feature<sup>392</sup> of the Delaware corporation statute, in making the removal of directors by the majority of shareholders impossible without cause where the directors' terms are staggered, implies the difficulty in establishing the governance standards in respect of the duties of directors in respect of US corporations. However in the UK context the situation is different, with section 303 of the UK Companies Act 1985 providing a simple majority of shareholders the right to remove any or all of the directors. The power under section 303 is enhanced by the introduction of section 368 whereby 10 percent of the shareholders may call for a shareholders' meeting to consider, among other things, changes in the Board. Thus the position of the board of directors in

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<sup>392</sup> According to the website of State of Delaware: "The Delaware General Corporation Law is the most advanced and flexible business formation statute in the nation. The Delaware Court of Chancery is a unique 210 year old business court that has written most of the modern U.S. corporation case law. Delaware's State Government is business-friendly and accessible." <<http://corp.delaware.gov/faqs.shtml#numcorps>>

the UK context is more vulnerable than that of their US counterparts as there are more opportunities for intervention by the shareholders.

### **3.6.3 Corporate Governance and Audit Committees in the US Context**

The content of directors' duties and the effective internal control mechanism for a successful implementation of the corporate governance principles and framework is assisted by the 'Audit Committees' through which the directors discharge their functions. Moreover, governance reforms created an important link between audit committees and external auditors, thereby bringing into the internal governance of the corporation a mechanism that bolsters the principle of looking after the interests of the company in the integrity of its functions, which are served by the external auditors.<sup>393</sup> In fact this linking function justifies the independent quality requirement of the directors as distinct from the qualities required for the discharge of their regular duties to the present shareholders.

SOX has specific requirements for the formation of audit committees by the firms subject to the Act. 'Section 301(2) provides that an audit committee shall have direct responsibility for the appointment, compensation, and retention of any accounting firm employed "for the purpose of preparing or issuing an audit report or related work". The accounting firm appointed by the company shall have the reporting responsibility to the audit committee. The function of the audit committee includes overseeing the audit function of the accounting firm and also resolving the issues that result in a disagreement between the management of the company and the accounting firm with regard to the reporting of the financial and non-financial issues. Exhaustive provisions have been made in SOX to provide the necessary authority to the audit committee to take the required steps so that the duties expected of it can be discharged effectively. In effect, the

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<sup>393</sup> Demott (n 391) 30-31.

discharge of the functions of the audit committee will have its impact on the orientation of the directors who become members of the audit committee. While their position remains the same as directors of the company in so far as the discharge of their fiduciary duties are concerned, the inclusion of the directors in the audit committee places them in an anchor position to monitor the relationship between the management of the company and the external accounting firm appointed to conduct the audit of the company. In that situation the commitment of the directors is to make their position systemic and public-oriented.<sup>394</sup>

### **3.6.4 Role of Accounting in Corporate Governance**

The roles played by corporate accountants are varied and are of vital importance. The most prominent of these roles is in preparing and attesting the corporate financial statements which serves the purpose of presenting the factual financial position of the company to the investors and general public. The following are the principal statements that a company prepares and on which the investing public rely for making their investment decisions: (1) balance sheet – showing the value of assets and liabilities of the company as on any particular date as well as the net worth of the company as at the end of any fiscal period, (2) statement of income – exhibiting the amount of revenues received by the company for the fiscal year; and (3) statement of cash flows – the amount of cash flowing from and to the business entity on account of the operations carried out by the firm, its various investments and other financial transactions.<sup>395</sup> These financial statements are accompanied by detailed notes with explanations, details relevant to the

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<sup>394</sup> LJ Abbott and others, 'Corporate Governance, Audit Quality and the Sarbanes-Oxley Act: Evidence from Internal Audit Outsourcing' (2005) SSRN eLib See also SC Thompson, 'The Missing Link in Sarbanes-Oxley: Enactment of the 'Change of Control Board' Concept, or Extension of the Audit Committee Provisions to Mergers and Acquisitions' (2007) SSRN eLib

<sup>395</sup> S Siegel, 'Global Accounting Dimensions of Corporate Governance' in JJ Norton and J Rickford (eds), *Corporate Governance Post-Enron: Comparative and International Perspectives* (British Institute of International and Comparative Law, London 2006) 49.

statement items, and an independent audit report attesting to their fair and accurate presentation of the financial position of the operation.<sup>396</sup>

The roles of accountants in the light of the abovementioned statements with respect to the corporate governance framework may be considered as extending to two different functions. The first one is internal and can assume the description of a ‘stewardship function,’ which has the purpose of evaluating the functioning and the performance of the management internally. Such evaluation is done on behalf of the managers themselves and also on behalf of outsiders dealing with the company. The following corporate governance functions would fall under this category:

Measurement of executive performance and compensation

Effective evaluation of the performance of the products of the company

Measurement of the performance of the various operating divisions of the company (such measurement to include the income, expenditure and the resultant profitability)

Deciding on the business policies which have a bearing on the financial status of the company (these financial issues may relate to the borrowings by the company, pricing policies and the investment decisions)

Assisting the company in fixing the dividend policies of the company

Enabling the company to take decisions on acquisitions and disposition of undertakings<sup>397</sup>

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<sup>396</sup> Ibid 50.

<sup>397</sup> Ibid

Although the list is not exhaustive, all internal evaluation decisions are based on some kind of accounting information and any lack in the accounting system will lead to lack of accounting information which in turn will lead to an internal failure in corporate governance. Good corporate accounting is always at the root of good corporate governance.<sup>398</sup>

The external role of accounting is often referred to as the ‘investor and creditor function’ and is concerned with providing detailed and relevant information to the external stakeholders such as creditors. Such information is also required by the investors who wish to buy the shares of any particular company. The investors and creditors base their decisions on information provided by the accountants for the kind of financial exposure they would like to take in investing or lending to the company. The American accounting profession often emphasizes this corporate accounting role.<sup>399</sup>

The function of financial reporting is thus to ensure that sufficient information is being provided to prospective investors and creditors and other people who are have a need to assess the position of the company with respect to its capabilities of honouring its financial commitments in the matter of payment of dividends, payment of interest, payment of the ‘proceeds from the sale, and the redemption or maturity of securities or loans. Thus, financial reporting should provide information to help investors, creditors and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise.’<sup>400</sup>

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<sup>398</sup> Ibid

<sup>399</sup> Ibid

<sup>400</sup> Financial Accounting Standards Board, 'Statement of Financial Accounting Concepts No 1: Objectives of Financial Reporting by Business Enterprises' (1978) para 37.

From the corporate governance point of view it is necessary to understand the functions of these financial statements in their proper perspective. The balance sheet presents historical information on the value of assets and liabilities of the firm and also the ownership interests of the enterprise. Although most of the items are presented at their original cost some items need to be shown at their market or current value. The income statement presents for the year then ended the economic performance of the company in accordance with the established accounting principles. The cash flow statement presents for the year then ended the receipts and payments of the company.

It is also necessary to make a clear demarcation between the stewardship function and the investor and creditor function of accounting. While some of the aspects of the internal stewardship function look by their nature into the historical information, the investor and creditor function necessarily looks into the future. While the people in the firm who are entrusted with the job of decision making can rely on the historical accounting information as the basis of their decisions, they must ensure that such information is reliable and relevant. On the other hand, those who have to take a decision with respect to future investments, including creditors or investors, can make use of the historical information as the starting point for arriving at the expected future status by a simple extrapolation of such historical figures. It is also quite possible that different people access and use the accounting data for different purposes and also some of them may generate additional information like 'ratios, projections, valuations and estimates' out of the presented data. The Enron and other related scandals have prompted those who make decisions based on accounting to demand assurances in various reliable forms that the accounting information is reliable.<sup>401</sup> Therefore it is reasonable to assume that the lessons

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<sup>401</sup> Siegel (n 276) 51.

provided by corporate scandals like Enron should increase awareness among those dealing with the financial statements to rely on the accounting statements only when they have thoroughly gone through such statements personally and are satisfied with the ‘amounts, contents, currency and other relevancy of information’ contained therein.

The reliability of the financial statements is usually assured by the auditors of the firm. The audits are carried out by independent accountants and the audits are carried out in accordance with established auditing standards. The assurances being provided by the audit include assurances that the statements have been prepared in accordance with generally accepted accounting principles, are free from material misrepresentation, and present a true and fair view of the financial position of the company and of the results of the operations of the company upon which the report is made. Usually such assurances are included by way of statements in the audit report. It follows from the above that failure to comply with standards makes those financial statements misleading because proper governing accounting principles have not been applied. The audit failures in the accounting disasters of Enron and other notorious scandals where proper accounting procedures were not followed, leading to misstatements and inaccurate reports, all of which did not reflect the true state of affairs of the financial position or results of operations of the corporations involved.<sup>402</sup>

### **3.7 Corporate Governance and Transparency**

In almost all countries corporations, because of the nature of the form of organization and the attached limited liability, are duty bound to make all information pertaining to their working available to the general public. ‘As economies and markets become increasingly complex, the

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<sup>402</sup> J Van Niel, 'Enron--the Primer' in NB Rapoport and BG Dharan (eds), *Enron: Corporate Fiascos and Their Implications* (Foundation Press, 2004) 16.

amount and type of information required to be disclosed has increased in complexity too. In contemporary times, the disclosure of more specific financial information became an important instrument in world markets.<sup>403</sup> The compilation and presentation of financial data is of paramount importance for prospective investors who want to buy shares in different companies as well as to the creditors and even banking and other financial institutions. In addition, transparent corporate information reporting often prevents fraudulent activities. Large corporations, by virtue of their economic position, acquired greater social power and as a consequence 'accountability' of the companies to the public has followed suit. This corporate power attains legitimacy only by addressing the accountability issue with great care and sincerity. Macmillan compares accountability of corporations with democratic elections, observing that 'accountability in this context is to act as a device for legitimizing corporate power in much the same way as democratic elections and the principles of administrative law make government accountable for its power and therefore legitimize that power.'<sup>404</sup> Considering the economic and social power multinational and transnational corporations can exercise across different economies and societies, it is vitally important to ensure that proper and stringent international disclosure requirements evolve so that such great private powers are legitimized.

### **3.8 Impact of Corporate Governance Reforms on Company Performance in the US**

Present day rapid business and industrial developments, changing economic conditions, highly volatile capital markets and increased shareholders' demand for enhanced corporate governance to protect their interests, high expectations of transparency in the wake of large business failures,

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<sup>403</sup> S Bottomley, 'Taking Corporations Seriously: Some Considerations for Corporate Regulation' (1990) 19 FL Rev 203, 206.

<sup>404</sup> F Macmillan, 'Corporate Disclosure in the Era of Globalization' in B Rider, Y Tajima and F Macmillan (eds), *Commercial Law in a Global Context* (London 1998) 22.

improved risks associated with enhanced global market place, evolution of e-commerce, and the use of advanced information and communication technologies—all have propelled the role of the board of directors in ensuring good corporate governance. These new and emerging demands have necessitated the boards to be more knowledgeable, committed and proactive to the changing corporate scenario.<sup>405</sup>

The important reform brought about in the corporate governance norms in the United States was the enactment of the Sarbanes-Oxley Act in 2002 with a view to restoring shattered public confidence in the governance of publicly listed companies. The Act provided for the establishment of a Public Accounting Oversight Board, enacted new provisions concerning the external audit of public corporations and specified various new requirements for the constitution of the boards of corporations. The changes instituted by the Act in connection with the boards include the provision that the members of the Audit Committee must all be independent directors. There was a prohibition on loans to any director or executive from the company. Personal certification by the CEO and the CFO to the effect that the audit of their corporation was conducted accurately and completely, with systems and processes in place for the detection of any financial irregularities was another requirement placed by the Act.<sup>406</sup>

Apart from the new provisions of the Sarbanes-Oxley Act, both NYSE and NASDAQ implemented new corporate governance rules to monitor the performance of the listed companies (See page 147). It may be noted that the common theme among all these reforms is the agency theory perspective which are applied to improve the role of the board of directors by enhancing

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<sup>405</sup> Price Waterhouse Coopers, 'US Corporate Governance' <<http://www.pwc.com/extweb/service.nsf/docid/7059E6427040F87D85256B11006412CA>> accessed 8 July 2008.

<sup>406</sup> D Finegold, GS Benson and D Hecht, 'Corporate Boards and Company Performance: Review of Research in Light of Recent Reforms' (2007) 15 CG 866.

the element of independence of directors.<sup>407</sup> Thus the emphasis of the reforms points more towards the monitoring responsibility of the board which coincides with the agency-theory focus of the various literatures enunciated on the board functions. However, the studies by Zahra and Pearce in 1989<sup>408</sup> and Johnson et al. in 1996<sup>409</sup> have found the boards playing multiple roles in the functioning of the corporation apart from monitoring.

The core of good corporate governance code can be found in the recommendation on the role and functions of the board of directors. In accordance with the corporate governance principles based on dominant agency theory, the board of directors is expected to play an active and independent role in controlling and monitoring the behaviour of the top management, as has been shown in the works of Alchian and Demsetz,<sup>410</sup> Jensen and Meckling,<sup>411</sup> and Fama and Jensen.<sup>412</sup> Scholars and corporate governance practitioners recommend that: (1) there should be an increased number of non-executive and independent directors, (2) the roles of chairman and the CEO should be split, (3) the corporations should create various committees like nomination, remuneration and audit committees comprising of non-executive directors, and (4) an evaluation procedure should be developed for assessing the performance of the board of directors. Among those who have

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<sup>407</sup> The agency theory of corporate governance is defined as the relationship between the principals, i.e. the shareholders, and the agents, i.e. the company executives and managers. This theory was first introduced in 1972 by Alchian and Demsetz. See AA Alchian and H Demsetz, 'Production, Information Costs, and Economic Organizations' (1972) 62 *Amer Econ Rev* 777-795. It was further developed by Jensen and Meckling in 1976. See Jensen and Meckling 308.

<sup>408</sup> S Zahra and J Pearce, 'Boards of Directors and Corporate Financial Performance: A Review and Integrative Model' (1989) 15 *J Mgmt* 291-334.

<sup>409</sup> J Johnson, C Daily and A Ellstrand, 'Board of Directors: A Review and Research Agenda' (1996) 22 *J Mgmt* 409-438.

<sup>410</sup> Alchian and Demsetz 777-795.

<sup>411</sup> Jensen and Meckling 305-360.

<sup>412</sup> Fama and Jensen (n 389).

dealt with these issues are Lorsch and MacIver,<sup>413</sup> Demb and Neubauer,<sup>414</sup> Charan,<sup>415</sup> Conger, Lawler III and Finegold, 2001.<sup>416</sup> The implementation of these practices was considered as essential to avoid the governance problems and also to enhance the performance of the board of directors as well as the corporations.

Another common impact of these reforms on board performance as found from a review of the literature is that the corporate governance reforms with respect to the norms concerning the constitution and functioning of the boards had no positive effect on the corporate financial performance. Although it cannot be stated that these reforms are ineffective, it appears that the new practices have not derived adequate support from corporate governance principles.

### **3.8.1 Corporate Governance and Merger Activity in the US**

Before the 1980s corporate governance in the US remained fairly inactive in the sense that there was no effective use of corporate governance mechanisms by the corporations or their managers. After 1980 there was a period during which the corporate world of the US witnessed a spate of takeover and restructuring activity. The restructuring activities were characterized by both leverage buyouts and hostile takeovers. US corporations purchased more than \$ 500 billion in shares, for which they had to borrow additional funds to finance their takeover activities. This led to large-scale leveraged buyouts. The period also witnessed a higher level of leveraged buyouts with debts of corporations exceeding even 80 percent of capital in some cases. There

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<sup>413</sup> J Lorsch and E Maciver, *Pawns or Potentates: The Reality of America's Corporate Boards* (Harvard Business School Press, Boston 1989)

<sup>414</sup> A Demb and F Neubauer, *The Corporate Board* (Oxford University Press, New York 1992)

<sup>415</sup> R Charan, *Boards at Work: How Corporate Boards Create Competitive Advantage* (Jossey-Bass, San Francisco 1998)

<sup>416</sup> J Conger, E Lawler III and DL Finegold, *Corporate Boards: New Strategies for Adding Value at the Top* (Jossey-Bass, San Francisco 2001)

were increased hostile takeover activities. Mitchell and Mulherin<sup>417</sup> report that nearly half of all major US corporations received a takeover offer in the 1980s. During the 1990s there was a sharp change in corporate governance activity with a sudden decline and a later rebounding of the merger activity. However, the level of leverage and hostility was reduced to a great extent. At the same time other corporate governance mechanisms, such as executive stock options and the higher role of the board of directors in monitoring corporate functions along with the increased involvement of shareholders, also played a role.

### **3.8.2 Fears of Personal Liability and Harm to the Reputation of Directors**

As there is increased expectations of the role of the board of directors to change from that of a resource to oversight there is an automatic increase in fear in the minds of directors about their personal liability and harm to their personal reputation. With the increase in the expectations of shareholder activists and institutional investors on the directors, they automatically become more sensitized to personal liability and harm to their personal reputation on account of the events happening in or affecting the performance of the companies of which they act as the directors. There are a number of lawsuits involving directors and officers for negligence and misfeasance. In a recent case a Federal District Court has ruled for \$ 40 million damages to be paid by the directors of a private company for breach of their duties of loyalty and care. Another example can be found in the recent SEC initiative which has ordered an enforcement action against the Chancellor Corporation and its officers, directors and auditors for financial fraud. Mention should also be made of several actions initiated by various attorney generals of several states,

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<sup>417</sup> For complete details on the leveraged buyouts and their impact on corporate restructuring please see M Mitchell and H Mulherin, 'The Impact of Industry Shocks on Takeover and Restructuring Activity' (1996) 41 J Fin Econ 191-229.

specifically New York and Oklahoma, which have far reaching impacts on the personal liability of directors.<sup>418</sup>

### **3.8.3 Shareholder Activism and Institutional Investors**

Since there will be an increased demand on the provision of services by the board of directors it is natural that the demands and complaints of shareholder activist groups and institutional investors will receive maximum attention from the board. Furthermore, the provisions of the Sarbanes-Oxley Act had also given additional strength to shareholder activists and institutional investors to press their demands more forcibly for changes in corporate governance practices and increased accountability of the directors. While shareholder activists have taken advantage of the changed environment, institutional investors have also increased their oversight activity demanding the resignation of directors wherever there are events which cause financial loss to the companies.<sup>419</sup>

### **3.8.4 Success of Corporate Governance Systems in the US**

The reaction of US capital markets to the changed corporate governance norms has been fairly successful as compared to other countries of the world. However, in the 1980s some observers criticized the US corporate governance system comparing it with that which prevailed in Germany and Japan. They argued that the German and Japanese systems are superior since they had the ability to substantiate the long-term growth of the corporations. Kaplan<sup>420</sup> argues that the effects of corporate governance mechanisms in all three countries was found to be similar in so far as the fortunes of German and Japanese top executives were affected by stock performance

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<sup>418</sup> Dowdney (n 368).

<sup>419</sup> Ibid

<sup>420</sup> For a full description of the stock options to top executives as a corporate governance mechanism, see S Kaplan, 'Top Executive Rewards and Firm Performance: A Comparison of Japan and the U.S.' (1994) 102 J Pol Econ

and improvement in cash flows which is the same situation as prevailed in the US. But Kaplan points out one major difference in the US system in which US managers hold a much more significant portion of stock options and this has made them increasingly sensitive to the performance of their company stock which in turn depended on the financial performance of the company itself.<sup>421</sup>

Another point that contributes to the superiority of the US system of corporate governance is that since the US system is considered superior, Japan, along the same lines as in the US, has introduced a new law allowing companies to resort to repurchasing their own stock. The percentage in this respect was increased from 3 to 10. The country has also eliminated substantial tax levy on executive stock options as is the case with US. These measures adopted by Japan on the experience of the US go to prove that the corporate governance mechanism in the US has contributed to enhanced corporate performance.<sup>422</sup>

Despite the success of US corporate governance practices and the increased power of shareholders there were still some criticisms that the US system was flawed. But the increase in corporate takeovers and reduction in leveraged buyouts have suggested that US companies have been taking advantage of corporate governance practices. With the increased sophistication of institutional investors and boards of directors, companies are bound to derive more benefits from adopting the new and changed corporate governance practices.<sup>423</sup>

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<sup>421</sup> Ibid

<sup>422</sup> S Kaplan, 'The Evolution of US Corporate Governance: We Are All Henry Kravis Now' (1997) <<http://faculty.chicagogsb.edu/steven.kaplan/research/govern.pdf>> accessed 8 July 2008.

<sup>423</sup> Ibid

### **3.8.5 Impact of Sarbanes-Oxley Act and Private Equity Funding**

It has been pointed out that introduction of the Sarbanes-Oxley Act has increased the number of companies opting to private equity with a view to getting away from the compelling provisions of the Act. There has been a sharp increase in the amounts of private equity participation in US companies which almost equals the funding through stocks. It is thought that this is the result of over regulation in the direction of corporate governance. However, it is argued that while it may be true that there are some excessive costs imposed on small issuers by application of the provisions of the Act, resorting to private equity can be considered more because of the availability of such sources of funding.<sup>424</sup> It has been observed that between 2002 and 2006, private equity buyouts accounted for almost 11 percent of all mergers and acquisitions in the US and 10 percent in other countries all over the world. In fact this quantum of private equity financing is much higher than that during 1996 to 2002 which stood at two percent and three percent respectively. This increase may be partly due to the impact of the regulations and partly to the availability of more surplus cash in the hands of investors, banks and hedge funds. But this form of financing from private equities and foreign exchanges always limits the risk of issuers, and to that extent it can be considered beneficial to the companies affected by excessive regulation.<sup>425</sup>

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<sup>424</sup> Bartlett III (n 375).

<sup>425</sup> P Sapineza, 'Corporate Governance in the United States' (2007) <<http://www.smarteconomist.com/interview/17>> accessed 7 June 2008.

### **3.9 The World Financial Crisis and Banking Corporate Governance in the US**

The world financial crisis that spanned 2007-2010 had its share of impact on the banking corporate governance in the US.<sup>426</sup> In the following sections we will discuss the bank crisis in the US and the US response to the world financial crisis.

#### **3.9.1 The Bank Crisis in the US**

The 2008 bank crisis in the United States can be traced to the 2001 massive stock market and capital spending bubble.<sup>427</sup> The country was facing a recession and the Federal Reserve had to cut interest rates to 1% which remained until 2004. Because the interest rates were low, the lending industry saw opportunity and went into real estate, unaware that low interest rates are large risks. The money lost in the stock market could quickly be offset by increasing home prices and continued spending.

As sub-prime borrowers continued to default, by 2006 the market could no longer hold. But it was not until 2007 when HSBC issued a warning, after losing billions from its acquisition of subprime lender, Household International.<sup>428</sup> Policy makers initially ignored the warnings, believing the invisible hand would correct itself.<sup>429</sup> However, it became evident that things were not moving in the right direction when two Bear Stearns hedge funds blew up in 2007. Fear gripped the market in August of 2007 when BNP Paribas froze withdrawals. This marked the beginning of the credit crisis that would later extend to other parts of the world.

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<sup>426</sup> For general introductory remarks regarding the global effect of the crisis, see above on page 126.

<sup>427</sup> Thoma (n 284).

<sup>428</sup> E Harrison, 'The Dummy's Guide to the US Banking Crisis' (Credit Writedowns 2008) <<http://www.creditwritedowns.com/2008/09/dummys-guide-to-us-banking-crisis.html>> accessed 27 February 2011.

<sup>429</sup> P Coy, 'Behind the Financial Crisis: Info Failure' Bloomberg Businessweek (2007) <[http://www.businessweek.com/investor/content/aug2007/pi20070817\\_231912.htm](http://www.businessweek.com/investor/content/aug2007/pi20070817_231912.htm)> accessed 27 February 2011.

Fear spread not only in the stock market but also among financial institutions. Mutual distrust among banks made lending difficult, which made credit less available. The lack of credit started a downward spiral.<sup>430</sup> The first cases of mortgaged-related losses were concentrated on investment vehicles like RMBSs (Residential Mortgage Backed Securities), CDOs (Collateralized Investment Vehicles).<sup>431</sup> Among the leading investment institutions, Merrill Lynch became the first to report losses of \$5.5 billion in 2007.<sup>432</sup> By the end of 2007, Merrill Lynch has lost \$8 billion.<sup>433</sup> Aggregate losses grew to \$500 billion.<sup>434</sup> Lehman Brothers lost \$3 billion.<sup>435</sup> Next was GSEs.<sup>436</sup> The weakest companies, like Lehman Brothers, filed for bankruptcy.<sup>437</sup> No institution was too big to fail and assault on financial sector continued as AIG, also succumbed to the crisis.<sup>438</sup>

The growth of the housing bubble between 1997 and 2006 led to 124% increase in housing prices and sudden decline in prices caused homeowners to default on their loans.<sup>439</sup> Sub-prime lending became the biggest factor that contributed to the credit crisis. Other major factors include

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<sup>430</sup> D Chhabra, 'Financial Crises and Contagion Effects : Stock Markets, Debt Levels, and Exchange Markets in East Asia and Latin America in the 1990s' (DPhil thesis American University 2003)

<sup>431</sup> Ibid

<sup>432</sup> Ibid

<sup>433</sup> KM Bianco, *The Subprime Lending Crisis : Causes and Effects of the Mortgage Meltdown* (CCH, Wolters Kluwer Law & Business, Chicago 2008)

<sup>434</sup> Harrison (n 428).

<sup>435</sup> M Adalet, 'Capital Flows and Financial Crises: A Historical Perspective' (DPhil thesis University of California Berkeley 2004)

<sup>436</sup> DN Chorafas, *Financial Boom and Gloom : The Credit and Banking Crisis of 2007-2009 and Beyond* (Palgrave McMillan, Basingstoke 2009)

<sup>437</sup> Harrison (n 428).

<sup>438</sup> Ibid

<sup>439</sup> KMd Abdelal, 'Multidimensional Aspects of International Financial Crisis in East Asia' (DPhil thesis Kansas State University 2001)

deregulation and corporate governance.<sup>440</sup> Executives were less concerned with risk and more with profits; even after debilitating losses to shareholders, executives retained their salaries and bonuses.<sup>441</sup>

### 3.9.2 The US Response

The U.S. response to the economic crises was perceived to be inefficient by most people, though there was consensus that swift action had to be taken.<sup>442</sup> The Federal Reserve and central banks agreed to expand money to avoid deflationary spiral.<sup>443</sup> From 2008 to 2009, the United States executed stimulus package of approximately \$1.5 trillion.<sup>444</sup>

The Emergency Economic Stabilization Act of 2008 allocated \$700 billion to the Troubled Assets Relief Program (TARP).<sup>445</sup> These funds were used to buy dividends in the form of preferred stock. The government also provided cash for mortgage-related assets referred to as “toxic” or “legacy assets.” The goal was to improve the bank’s capital and at reduce the financial uncertainty in lending institutions.

In response, the Federal Reserve lowered the target for Federal funds rate from 5.25% to 2% while the discount rate was reduced from 5.75% to 2.25%.<sup>446</sup> The Federal Reserve also enabled institutions to lend directly financial institutions including Term Auction Facility (TAF) and

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<sup>440</sup> A Bardhan, 'Of Subprimes and Subsidies: The Political Economy of the Financial Crisis' 2008.

<sup>441</sup> R Bittner, *Confessions of a Subprime Lender : An Insider's Tale of Greed, Fraud, and Ignorance* (John Wiley & Sons, Hoboken, NJ 2008)

<sup>442</sup> VA Acharya, M Richardson and Leonard N. Stern School of Business, *Restoring Financial Stability: How to Repair a Failed System; an Independent View from New York University Stern School of Business* (New York University Stern School of Business, New York 2008)

<sup>443</sup> Ibid

<sup>444</sup> D Goldman, 'Cnnmoney.Com's Bailout Tracker' (CNN [2010]) <<http://money.cnn.com/news/storiesupplement/economy/bailouttracker/index.html>> accessed 27 February 2011.

<sup>445</sup> Acharya, Richardson and Leonard N. Stern School of Business, (n 442).

<sup>446</sup> R Blackburn, 'The Subprime Crisis' (2008) 50 NLR 63-106.

Term Asset-Backed Securities Loan Facility (TALF).<sup>447</sup> In 2009, the Federal Open Marketing Office (FOMC) increased the size of Federal Reserve balance sheet by an additional \$750 billion of GSE mortgage backed securities.<sup>448</sup> This increased these securities to \$1.25 trillion while improving private credit markets conditions.<sup>449</sup>

In 2008, President Obama signed \$168 billion in income tax rebate checks. In 2009 he approved \$787 billion of broad spending and tax cuts.<sup>450</sup> In 2010, Congress passed stiffer restrictions on financial institutions.<sup>451</sup> The new legislation grants government powers to break up companies that threaten the economy.<sup>452</sup> The law engenders a regulatory approach which includes a council of regulators to assess risks in the financial system.<sup>453</sup> Obama stressed his intentions to protect consumers and promote a safer financial system.<sup>454</sup> He explained that unless business operates on cutting corners, there was nothing to fear.<sup>455</sup>

However, investors feared their ability to increase value for shareholders.<sup>456</sup> When Obama announced the regulations, Goldman Sachs fell by 4.1% while JP Morgan Chase fell by 6.6% and Bank of American fell by 6.2%.<sup>457</sup> Such regulations elicited uncertainty in the stock market.

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<sup>447</sup> Ibid

<sup>448</sup> Ibid

<sup>449</sup> Ibid

<sup>450</sup> Ibid

<sup>451</sup> Fox News, 'Congress Oks Wall Street Crackdown in Burst of Financial Regulation Unseen since Depression' (Associated Press 2010) <<http://www.foxnews.com/us/2010/07/15/congress-oks-wall-street-crackdown-burst-financial-regulation-unseen-depression/>> accessed 27 February 2011.

<sup>452</sup> Ibid

<sup>453</sup> Ibid

<sup>454</sup> Ibid

<sup>455</sup> Ibid

<sup>456</sup> B Steverman, 'Obama's Bank Plan Flops on Wall Street' Bloomberg Businessweek (2010) <[http://www.businessweek.com/investor/content/jan2010/pi20100121\\_381787.htm](http://www.businessweek.com/investor/content/jan2010/pi20100121_381787.htm)> accessed 27 February 2011.

<sup>457</sup> Ibid

When investors thought they would benefit from dividends posted by big banks, suddenly the government taxed the profits.<sup>458</sup>

The Securities and Exchange Commission is bracing for a hard time as the new regulations come to force. The SEC will carry out these studies and has been given a deadline to write more than 90 new rules and complete about 20 studies.<sup>459</sup> SEC considers this to be the largest test since the agency was founded.

SEC officials are committed to implement two set of rules.<sup>460</sup> One creates a new office to oversee of credit-rating firms, another regulates the agency budget.<sup>461</sup> The SEC is experienced to handle the position given the 2002 Sarbanes-Oxley Act.<sup>462</sup> This act created an oversight board in response to the stock market scandals.<sup>463</sup> Though regulations have brought uncertainty to the financial sector, with time they will prove to be more stable.

### **3.10 Other corporate Governance Concerns**

Mark Gillen,<sup>464</sup> while discussing other corporate governance issues in the context of business income trusts, has identified the following issues that may determine the level of corporate governance measures that may be needed to enhance the confidence of investors: (1) external

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<sup>458</sup> Ibid

<sup>459</sup> K Scannell, 'Sec Enters Overdrive to Prepare for Overhaul' *The Wall Street Journal* (New York 12 July 2010) <<http://online.wsj.com/article/SB10001424052748704799604575357322407593694.html?KEYWORDS=SECs>> accessed 27 February 2011.

<sup>460</sup> Ibid

<sup>461</sup> Ibid

<sup>462</sup> G Farrell, 'Sarbanes-Oxley Law Has Been a Pretty Clean Sweep' *USA Today* (30 July 2007) <[http://www.usatoday.com/money/companies/regulation/2007-07-29-sarbanes-oxley\\_N.htm](http://www.usatoday.com/money/companies/regulation/2007-07-29-sarbanes-oxley_N.htm)> accessed 27 February 2011.

<sup>463</sup> HN Butler and LE Ribstein, *The Sarbanes-Oxley Debacle: What We've Learned; How to Fix It* (AEI Press, Washington, DC 2006)

<sup>464</sup> M Gillen, 'A Comparison of Business Income Trust Governance and Corporate Governance: Is There a Need for Legislation or Further Regulation?' (2006) 51 *Mcgill LJ* 370.

management contracts that may lead to diversion of funds from the parent organization, (2) methods of executive compensation – here also the concern is about the excessive outflow of funds from the business, (3) difficulties the income trust structure might encounter in an economic downturn, (4) methods of calculating and arriving at the distributable cash, and (5) ways in which the obtaining and disclosure of stability ratings are made.<sup>465</sup>

### **3.10.1 The Legal Origin of Corporate Governance**

The development of strong capital markets in an economy largely depends on the legal system prevailing in that economy. It has been substantiated by studies conducted showing that the interests of the shareholders are more protected by common law institutions while civil laws do not have a role in such protection. This differing ability of the legal institutions is responsible for making the capital markets of certain economies stronger, while in some other economies the markets remain weak. It has been proved that ‘transplanting the correct legal code (i.e. the common law) will enhance economic development.’<sup>466</sup> Economic development is achieved through the progress of financial markets, and the relationship between the legal system and the development of financial markets depends on ways in which the legal system protects the small investors. If there is an inherent fear in the minds of small investors that their investment will not result in any returns for them owing to the actions of insiders, they may not invest in those firms. If the shares are not bought by outsiders then there cannot be any development of the stock market in the country and this will affect the investments of big owners in such cases, while the interests of minority shareholders are protected by the common law systems. The protection of

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<sup>465</sup> A Business Trust is an Income Trust where the principal business of the associated corporation or other form of business organization is the manufacturing service or other general industrial sector. There has been an increase in the number of such trusts in the recent years which has necessitated looking into the governance of such trusts as well.

<sup>466</sup> D Berkowitz, K Pistor and J-F Richard, 'Economic Development, Legality, and the Transplant Effect' (2003) 47 Eur Econ Rev 165.

minority interests is ensured by the fiduciary duties cast by the judge-made systems under common law.<sup>467</sup> In common law, fiduciary duties range from controlling insiders to protecting the outside shareholders. The shareholders feel comfortable in buying shares when they are confident that there is some system prevailing to protect their interests.

It is often the case that protection systems offered by common law through fiduciary duties are facilitated by the various regulating bodies such as the Stock Exchanges and the SEC as well as the legislature. However, it is important to note that ensuring the discharge of fiduciary duties alone is sufficient to protect the shareholders' interests. 'Fiduciary duties do not protect distant stockholders from managerial mistakes or from managers' neglect of shareholders' interests.'<sup>468</sup> Since the business judgment rule affects the potential of impending lawsuits, shareholders are bound to look to other avenues or the action of other institutions for the protection of their interests against the mistakes that might be committed by management. Thus, in those cases where the managers are found to be less oriented towards the protection of shareholders, then the chances for the dominant shareholders to sell their holdings to other distant shareholders will not be bright due to the fall in value. This has required corporate law, especially in the United States, to depend on SEC and other regulatory agencies, apart from the common law means for the protection of shareholder interests.<sup>469</sup>

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<sup>467</sup> TM Madden, 'Do Fiduciary Duties of Managers and Members of Limited Liability Companies Exist as with Majority Shareholders of Closely Held Corporations?' (2010) Dusq BLJ <[http://works.bepress.com/cgi/viewcontent.cgi?article=1002&context=thomas\\_madden](http://works.bepress.com/cgi/viewcontent.cgi?article=1002&context=thomas_madden)> accessed 18 December 2010.

<sup>468</sup> MJ Roe, 'Legal Origins and Modern Stock Markets' (Harvard Law School, John M. Olin Center for Law, Economics and Business 2006) <[http://www.law.harvard.edu/programs/olin\\_center](http://www.law.harvard.edu/programs/olin_center)> accessed 20 July 2007.

<sup>469</sup> Ibid

### 3.11 Conclusion

Kai – Alexander Heeren and Oliver Rieckers seriously doubt the ability of the Sarbanes – Oxley Act to substantially improve capital market conditions and the regulation of corporate governance dependent thereon. They opine ‘In the long-run it may even cause adverse effects for US capital markets.’<sup>470</sup> The authors argue that it is for the legislature to decide whether it wants to ‘rely primarily on a strong internal corporate governance structure or if it wants to follow a more market-based approach.’<sup>471</sup> A study of recent US legislation shows that the country follows a hybrid approach to the provision and maintenance of a corporate governance framework. Such a combination of internal and external corporate governance elements will surely result in the US providing an overdose of legislative response to corporate governance which may prove detrimental to the development of the economy. This is so because any overregulation runs the risk of making the regulation itself inefficient, hence it is necessary that any hybrid approach such as that adopted in the US should be properly balanced to be more effective and to ensure efficient functioning of the capital market.

In conclusion, it became clear from our analytical study in this chapter that the United States, through the Sarbanes-Oxley Act, was able to enforce corporate governance rules and standards of market regulation, accountability, and transparency, thus rendering violators of the articles of this law subject to prosecution by the criminal courts. The US government was able through the Sarbanes-Oxley Act to restore confidence in the American economy by investors and impose a protection of shareholder wealth.

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<sup>470</sup> K-A Heeren and O Rieckers, 'Legislative Responses in Times of Financial Crisis – New Deal Securities Legislation, Sarbanes-Oxley Act and Their Impact on Future German and EU Regulation' (2003) 14 *European* 595.

<sup>471</sup> *Ibid*

## **4 Chapter Four: Saudi Capital Market Law and Corporate Governance**

### **4.1 Introduction**

In the final part of our analytical study, and after having discussed global standards of corporate governance in the previous chapters on the United Kingdom and the United States, and after we became familiar with the idea of governance in Islamic Sharia, this chapter discusses the laws and regulations of corporate governance in Saudi Arabia, comparing them with international standards as reflected in the reforms in EU, UK and the US.

Such study will enable us to answer the questions proposed by our research; namely, whether or not the laws and rules of corporate governance in Saudi Arabia meet international standards following the reforms in the EU, UK, and the US. Furthermore, what recommendations can be made in order to develop corporate governance standards in Saudi Arabia? This chapter will try to furnish general information about Saudi Arabia and its legislative system, as well as gain insights into government bodies related to matters of corporate governance.

Saudi Arabia is one of the largest economies in the Gulf region, with its comparatively higher Gross Domestic Product (GDP) and exposure to international trade. With the availability of modern infrastructural facilities and ongoing structural reforms, the country has paved the way for a greater participation of the private sector in the economic development of the nation.

During the early 2000s, the government introduced several reforms such as creation of the Supreme Economic Council and the Saudi Arabian General Investment Authority. Another milestone in the direction of greater privatization is the passing of the Capital Market Law, which was aimed at improving the investment climate for both domestic and foreign investors.

Enhanced investor protection and a higher degree of corporate governance were the economic objectives behind all the economic and structural reforms undertaken by the government.

The economic development of Saudi Arabia is further supported by the monetary stability of the country. One of the earliest challenges faced by the founder of the Kingdom, King Abdul-Aziz ibn Sa'ud, was the creation of a sound monetary system.<sup>472</sup> Stable and consistent currency convertibility, backing of the currency by foreign currency reserves and price stability are some of the evidences of the monetary stability of the country. Monetary policies have an important bearing on the growth of capital markets in any economy, and stability in exchange rate is critically important for garnering more foreign investments and reducing the cost of debt funds. In this respect, the Saudi Arabian Monetary Authority (SAMA), the highest banking institution in Saudi Arabia, has been following monetary policies that were commensurate with global monetary easing, thus promoting an environment for higher domestic investments. Such monetary policies led to rapid changes in the capital market in Saudi Arabia. Issue of the Capital Market Law, formation of the Securities and Exchange Commission and functioning of the privately owned Stock Exchange has augured the growth and development of the domestic capital market. However, there are greater challenges the government had to face to sustain the growth of the capital market and in maintaining investor confidence. There were issues in ensuring proper corporate governance, which also hampered the growth of the capital market. In this context, this chapter attempts to present an analytical report on the evolution and status of the capital market regulations and corporate governance in the Saudi Arabian economy.

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<sup>472</sup> AM Dukheil, *The Banking System and Its Performance in Saudi Arabia* (Saqi Books, London 1995)

## 4.2 The Legal System in Saudi Arabia

An understanding of the legal system in Saudi Arabia cannot be complete without looking at the historical and religious background in the country. It is the place where the Islamic religion emerged in the 7<sup>th</sup> century. In the eyes of the Muslim world; not only is Saudi Arabia the birthplace of Islam, but it is also seen by them as the guardian of the holy shrines, the mosques in Mecca and Medina, containing the most sacred sites of Islam. Given these historical facts, Saudi Arabia has been considered to be the protector of Islam, and the prime practitioner of Islamic teachings and principles. This has been the case since its inception and been carried out through the centuries.<sup>473</sup>

In 1924 the foundation for the establishment of a legal system in Saudi Arabia was laid by King Abdul-Aziz ibn Sa'ud, the founder of the nation. Being aware of his role in upholding the teachings of Islam, he inaugurated a legal system based on the principles presented by Islam's holy book of Qur'an and the traditionally accepted deeds and statements of the Prophet Mohammed known as Sunna.<sup>474</sup> It has been the customary practice of all successors of King Ibn Sa'ud to follow in his footsteps and uphold the principles of Islam in the legal system of the country. Furthermore, he made sure that Islam was at the core of any system of development or modernization in the country. It also gave the people of Saudi Arabia a sense of identity within the rest of the world, particularly the West.<sup>475</sup> As he began to unify and modernize the country, he concentrated his efforts on adhering to Islamic principles while at the same time adopting from the western world practices which would modernize his country without contradicting the

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<sup>473</sup> Almajid (n 19) 142.

<sup>474</sup> FIMI Al-Su'ud, *Islamic Political Development in the Kingdom of Saudi Arabia : Majlis Ash Shura : Concept, Theory and Practice* (National Association of Muslim American Women, Pennsylvania 2002) 41 & 65.

<sup>475</sup> P Menoret, *The Saudi Enigma: A History* (Zed Books, London 2005) 71.

teachings of Islam. In doing so, he was able to achieve equilibrium in the legal makeup between the momentum of economic change and the demands it brought along and the local social values and mores.<sup>476</sup>

While Chapter I covered the principles of Sharia and its primary and secondary sources in Islam in general, this section looks at the interplay between Sharia and the legal structure in Saudi Arabia; it becomes relevant, as it has to be taken into full consideration if any laws or rulings issued by Saudi kings were to have any chance of seeing the light of day. Sharia at the same time grants flexibility to the head of an Islamic state, in that he may pass rulings based on ‘consensus’ and ‘reason,’ as long as they are in compliance with its principles, and thus deal with conditions and situations which did not prevail at the time.<sup>477</sup> It is this flexibility that enabled King Abdul Aziz and his successors to borrow Western legal concepts, and after consulting with the senior and powerful religious leaders of the country, turn them into rulings. These legal concepts translated into Saudi Arabian policies that enabled the economic development of the kingdom in the areas of finance, insurance and industry.<sup>478</sup> Having said that, it is important to note here that there are no prescribed codifications to Sharia’s rulings as a basis of Consensus or Reason. Consequently, the rulings made by the king were the result of consultations with the senior religious leaders in the country, whereupon codes and rules were issued to govern various activities in the social, economic and political spheres.

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<sup>476</sup> Almajid (n 19) 144.

<sup>477</sup> Consensus (Ijma') and Reason (Qiyas) are the main secondary sources of Sharia. These were used by the Islamic Schools of jurisprudence in order to deal with unprecedented matters which were not covered in the Koran or the Sunnah. While both use the Koran and Sunnah as a basis, yet a consensus among the Islamic scholars had to be reached on these matters. There are other secondary sources of Sharia, but the two mentioned above are almost unanimously followed by jurists from the major schools of Islamic law (see also Chapter II). This is also discussed in detail in Almajid, (Ibid 147).

<sup>478</sup> Almajid (n 19) 148.

In 1924 King Abdul Aziz ibn Sa'ud established the National Council (al-Majlis al-Ahli) as a consultative body; the objective was to have an institution that would take over the powers except foreign and military powers, which were handled by the King himself. Several other Councils and Committees were formed following the formation of the National Council. King Abdul Aziz ibn Sa'ud established the first council of Ministers in 1953. By 1958, Faisal ibn Abdul Aziz (1964-1975) transformed the council of Ministers into a legislative, executive and administrative body having decision-making powers.<sup>479</sup> Faisal took serious efforts to introduce modern constitutionalism into Saudi Arabia between 1958 and 1960; but this attempt did not provide fruitful results. However, there were several developments that took place in the reign of King Faisal. For instance, he established the Ministry of Justice in 1970.<sup>480</sup>

During the 1980s, the Council of Ministers took greater participation in the regulation of the policies of the Kingdom and they were instrumental in the formulation of state policies for domestic and foreign affairs. It was during the reign of King Khalid ibn Abdul-Aziz (1975-1982) that the government formed a committee for the preparation of a constitution for the country. It was during the reign of King Fahad ibn Abdul-Aziz (1982-2005) that the constitution of Saudi Arabia was drawn, which is considered a major historical milestone in Saudi history.

On 1 March 1992, King Fahad promulgated three fundamental laws, established by royal orders, which completely changed the domestic political environment of the country. These three fundamental laws are: (1) the Basic System of Governance (hereinafter the Basic System), (2)

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<sup>479</sup> AF Ansary, 'A Brief Overview of the Saudi Arabian Legal System' <[http://www.nyulawglobal.org/globalex/Saudi\\_Arabia.htm#\\_ednref2](http://www.nyulawglobal.org/globalex/Saudi_Arabia.htm#_ednref2)> accessed 27 March 2009.

<sup>480</sup> AH Dahlan, 'A Study in the Internal Politics of the Kingdom of Saudi Arabia' 1984. 72-73.

the Consultative Council Law, and (3) the Regional Law.<sup>481</sup> Political reforms undertaken by the Saudi government during the 1990s resulted in the passing of several Royal Orders amending the fundamental constitutional laws. The fundamental laws and the amendments made to them recognized the importance of public participation in government.<sup>482</sup> While the Consultative Council Law and the Regional law are outside the realm of this discussion, a brief discussion of the Basic System will serve to shed light on the main idea in this work.

#### **4.2.1 The Basic System of Governance**

Being the first written constitution in the history of Saudi Arabia, the 83 articles of this law portray the role played by Sharia in formulating the legal system in Saudi Arabia. The first article unequivocally states that the constitution of Saudi Arabia draws its authority from the Koran and the Sunna, its primary sources. The article reads as follows: ‘The Kingdom of Saudi Arabia is a sovereign Arab Islamic state with Islam as its religion; God's Book and the Sunna of His Prophet, God's prayers and peace be upon him, are its constitution ...’<sup>483</sup> This is further affirmed in Article 7 which makes it very clear that the system of government draws its authority from the Koran and the Sunna, therefore exercising a kind of restraining influence on any laws issued in the Kingdom.<sup>484</sup>

After establishing Sharia as the basis behind the system of government, the Basic System divides it into three authorities; executive, judicial and regulatory. While stipulating that these authorities

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<sup>481</sup> See The Basic System of Governance, Royal Order No. A/90, (27/8/1412H, Mar. 1, 1992), O.G. Umm al-Qura No. 3397 (2/9/1412H, Mar. 5, 1992).; The Regional Law, Royal Order No. A/91 (27/8/1412H, Mar. 1, 1992), O.G. Umm al-Qura No. 3397 (2/9/1412H, Mar. 5, 1992).; The Shura Council Law, Royal Order No. A/91, (27/8/1412H, Mar. 1, 1992), O.G. Umm al-Qura No. 3397 (2/9/1412H, Mar. 5, 1992).

<sup>482</sup> AF Ansary, 'Succession Process in Saudi Arabia: A Brief Overview of the Historical, Religious, Legal and Royal Family Traditions' (2005) 7 WLBL Lib Cong 31-37.

<sup>483</sup> The Basic System, art. 1.

<sup>484</sup> The Basic System, art. 7.

will cooperate with each other in their duties, they will nevertheless refer to the king as the point of reference.<sup>485</sup> This provision of the Law gives complete powers in the hands of the king. The Basic System also establishes the rule of the land in the hands of the king, whose authority is transmitted to his successors upon his death.<sup>486</sup> As government rule is in the hands of the king, he has unlimited powers in leading the country, as long as the use of these powers does not conflict with the laws of Sharia.<sup>487</sup> Next, a brief discussion of the three authorities mentioned in the Basic System.

### The Executive Authority

The executive authority is made up of the King, the Council of Ministers, local governments, and other subsidiary and supplemental departments. Ultimate authority rests with the king, who is also the head of the Council of Ministers. All political, military, financial, internal and external policies are determined by the Council.<sup>488</sup>

### The Legislative Authority

The legislative authority (named 'regulatory authority' by the Basic System) lays down statutory laws and regulations. Its authority also includes approval of international treaties, agreements, regulations and concessions. The legislative authority is in the hands of the king, the Council of Ministers, and the Consultative Council.<sup>489</sup> In addition to religious laws carried by Sharia, there is a large number of laws dealing with all other areas, such as criminal, administrative and

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<sup>485</sup> The Basic System, art. 44.

<sup>486</sup> The Basic System also establishes Saudi Arabia as a monarchy, as mentioned in its Article 5.

<sup>487</sup> DJ Karl, 'Islamic Law in Saudi Arabia: What Foreign Attorneys Should Know' (1991) 25 Geo Wash J Int'l L 141.

<sup>488</sup> Ansary, 'A Brief Overview of the Saudi Arabian Legal System' (n 482).

<sup>489</sup> The Basic System, art. 77.

commercial, as there are other matters of importance to the common good of the kingdom that must be attended to, and which Sharia has no precedent on which to fall back. The Basic System looks at public interest (al-Maslahah al-Mursalah) as a matter of paramount importance in the development of the kingdom, as is the case of other countries, whether Muslim or non-Muslim. It is important to note here that such legislation is only permitted when Islamic law has no specific and clear text dealing with such matters.<sup>490</sup> These legislations are classified into three categories, depending on the areas they cover and the level of approval they have to go through before they are issued. They are:

#### Royal Orders

These are issued by the king and require no prior approval by any authority. They go into effect upon release. They are classified as the most powerful legal instrument of legislation. The Basic System (1992), the Council of Ministers Law (1993), and the Allegiance Council (Majlis al-Bay'ah) Law (2006) were all enacted royal orders.

#### Royal Decrees

Royal decrees rank second in Saudi Arabian legislation. They are issued by the Council of Ministers, and their significance in Saudi legislation lies in the fact that the Council of Ministers is a legislative authority in the kingdom. Once they are approved by the Council, they are turned over to the King for ratification.<sup>491</sup> They are a useful means by which to monitor various

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<sup>490</sup> See Royal Decree No. 19746 (22/9/1379H, 20 Mar. 1960).

<sup>491</sup> Almajid (n 19) 158.

economic, financial and social activities, including the codification of business law, especially investment and foreign trade. They are considered the closest to current European concepts.<sup>492</sup>

### Subsidiary Regulations

These regulations do not require ratification from either the king or the Council of Ministers. They originate in governmental agencies and can be issued by multiple authorities; executive, legislative or judiciary. However, they would have to be authorized for such tasks. Consequently, subsidiary regulations can be issued by the Council of Ministers, individual ministers, and other government agencies. Executive regulations, lists, codes, procedures, ministerial resolutions and decisions are examples of subsidiary legislation.<sup>493</sup>

### The Judicial Authority

The Judicial Authority covers the three types of courts in the Saudi court system:

#### The Sharia Court System

The Sharia court system was regulated by the Judicature Act of 1975,<sup>494</sup> which established a hierarchy classifying their courts into the Supreme Judicial Council at the top, superseded by the Courts of Appeal, and at the bottom of the hierarchy sat the Courts of First Instance.<sup>495</sup>

While a detailed discussion of these courts is outside the scope of this study, a brief overview of the roles played by the Supreme Judicial Council will shed further light on the role of Sharia in

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<sup>492</sup> Karl (n 487) 142.

<sup>493</sup> A Awwad, 'Legal Regulation of the Saudi Stock Market: Evaluation and Prospect for Reform' (University of Warwick 2000) 73.

<sup>494</sup> The Judicature Act was promulgated by Royal Decree No. M/64, dated 14/7/1395H (23 July 1975). See also Almajid 159-160.

<sup>495</sup> The Judicature Act, art. 5-25.

the judicial system of the kingdom. The Supreme Judicial Council, considered the highest authority in the judicial system, has the authority to carry four functions: administrative, judicial, legislative and consultative. The administrative function oversees the work of all courts, personnel related matters, including the appointment, evaluation, promotion and dismissal of judges.<sup>496</sup> Its judicial functions include review of severe judgments such as death sentences and other severe punishments. Its legislative authority enables it to establish principles and precedents that have to be followed by lower courts. In its consultative capacity it enjoys the privilege of reviewing and giving opinions regarding matters that the King or Minister of Justice refers to it.<sup>497</sup>

#### Board of Grievances

Outside the jurisdiction of the Sharia court system, the Board of Grievances is perceived to be the highest civil court. Established in 1955<sup>498</sup> and revised in 1982,<sup>499</sup> it stood as a separate entity alongside the Sharia court system, and was linked directly to the King. One of the Board's main functions is to handle grievances of civil servants or the general public and report its findings to the appropriate agency head.<sup>500</sup> With its amendment in 1982 the Board of Grievances was also entrusted with the function of adjudicating in matters of foreign investments and the execution of foreign judgments.

#### Semi-judicial Committees

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<sup>496</sup> The Judicature Act, art. 7.

<sup>497</sup> The Judicature Act, art. 8.

<sup>498</sup> The Board of Grievances Law was issued following Royal Decree No. 2/13/8759, dated 1374H (1955).

<sup>499</sup> The revised Board of Grievances Law was issued following Royal Decree No. M/51 dated 17/7/1402H (11 May 1982).

<sup>500</sup> GN Sfeir, 'The Saudi Approach to Law Reform' (1988) 36 Am J Comp L 745.

The Saudi Judicial Authority also includes a large number of administrative committees which operate independently of the Sharia Court system. The legislation that led to their creation came as a result of the opposition of religious leaders to the implementation of the Commercial Court Regulation (CCR) which were established to handle the boom in corporate business in the kingdom. Their function is to regulate a number of commercial and financial activities, such as ‘land and maritime commerce, bills of exchange, bankruptcy and commercial paper and arbitration rules.’<sup>501</sup>

As a result of the Sharia courts’ opposition to the implementation of government regulations as set in the CCR, on the grounds that such types of regulations were not set in accordance with the sources of Islamic law, the Ministry of Commerce was empowered by royal decree to include the CCR and other types of commercial relations under its jurisdiction.<sup>502</sup>

### Reforms of the Legal System

Before concluding the discussion of the legal system of Saudi Arabia, it is important to note that such a system was not static in nature, and underwent several reforms, the most significant being those decreed by King Abdullah in 2007, when the judicial system went through a major overhaul. Royal decrees established a High Court which replaced the prevalent Supreme Judiciary Council, and was vested with the highest judicial authority. Other radical changes included the establishment of new Courts of Appeal to replace the existing ones. Royal decrees extended the functions of the First Degree courts to include locations throughout the kingdom, according to the needs of the system. Furthermore, a new Board of Grievances Law was

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<sup>501</sup> Almajid (n 19) 164.

<sup>502</sup> Ibid 165.

promulgated which reorganized that Board in a new hierarchy; the highest ranking was the High Administrative Court, followed by the Administrative Courts of Appeals, with the Administrative Courts ranking lowest.<sup>503</sup>

In conclusion, although Sharia will still remain as the law, the new reforms have been as an attempt to interpret its demands and rulings in a more professional manner, thus giving rise to successful business ventures in the kingdom.

### **4.3 Ownership Structure in Saudi Arabia**

Ownership structure is one important factor that determines the efficiency of the corporate governance system in any nation. However, developing countries like Saudi Arabia do not possess enough information on the ownership structure.<sup>504</sup> The ownership structure is at the root of the agency problems arising out of the conflicts between managers and stockholders or between the controlling and minority group of shareholders and other external stakeholders. According to Panunzi et al.<sup>505</sup> (2002:6) it explains how in countries where there are different ownership structures, conflicts between the manager and controlling shareholders and between two of these interests combined with the minority shareholders are handled. Gorton and Schmid (1999) argue that the more dispersed the equity ownership of a firm the greater is the incentive for owners to manage the business by monitoring other's efforts.<sup>506</sup>

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<sup>503</sup> Ibid 165-166.

<sup>504</sup> I Chong Nam, Y Kang and J-K Kim, 'Comparative Corporate Governance Trends in Asia' (Corporate Governance in Asia: A Comparative Perspective 2001) 85-115. See also R La Porta and others, 'Legal Determinants of External Finance' (1997) 52 J Fin 1131-1150.

<sup>505</sup> F Panunzi, MC Burkart and A Shleifer, 'Family Firms' (Institute of Economic Research Harvard University 2002) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=298631](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=298631)> accessed 10 February 2010.

<sup>506</sup> G Gorton and F Schmid, 'Corporate Governance, Ownership Dispersion and Efficiency: Empirical Evidence from Austrian Cooperative Banking' (1999) 5 J Corp Fin 119-140.

Ownership pattern is found to exist in varying formats in different countries and are shaped according to the presence of some of the factors that determine those structures. The ownership structure has important implications for corporate governance initiatives.<sup>507</sup> For instance, the form and nature of company legislation that differs from country to country influences the financial system and ownership system substantially. Unlike the United States and other industrial nations, the ownership structure in developing nations consists of a high proportion of family and state ownership. Al-Ajlan observes that ‘the corporate structure in developing countries and in particular in East Asian countries, have generally been associated with a high concentration of ownership and control by few families, low level of property right protection and weak enforcement, high leverage of corporations, loose monitoring, and screening by lending institutions.’<sup>508</sup> Agrawal and Knoeber outline the importance of maintaining a good ownership structure to reduce agency problems.<sup>509</sup>

When there is concentration of ownership in few families, it will lead to a situation in which these families will possess a power to lobby the government agencies and authorities for preferential treatment and allotment of contracts. This would also affect the evolution of a proper legal system in the country. Therefore, the ownership structure of the corporate entities is an important phenomenon in the economic development of any nation. The ownership structure in Saudi Arabia is found to consist of majority holdings owned by families to the extent of 75% of the corporate entities. Government and individual founders own the shares in the remaining 25% of the firms. With the eagerness of the government to encourage private participation in the

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<sup>507</sup> A Shleifer and RW Vishny, 'Large Shareholders and Corporate Control' (1986) 94 J Pol Econ 461-488.

<sup>508</sup> WM Al-Ajlan, 'Corporate Governance in Saudi Arabia: The Roles and Responsibilities of the Board of Directors in the Banking Industry' (Nottingham University 2005) 99.

<sup>509</sup> A Agrawal and CR Knoeber, 'Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders' (1996) 31 J Fin Quan Anal 377-397.

economic development of the nation, the Saudi government has been embarking upon a number of privatization programmes. However, the government retains the control and ownership of large public utilities. Family businesses that existed over a long period of time have converted themselves into large companies and have gone through the route of Initial Public Offering (IPO) to get them listed in the stock exchanges. This is one of the major reasons for significantly large stockholdings by families. Since there is no provision to issue different classes of shares having different voting rights, the families consider it prudent to hold the shares in bulk with family ownership. Another reason for block holdings may be found in the nature of the Saudi societal framework. Traditionally commercial activities have been in the hands of only a few well-to-do Saudi families with the remaining families earning their living by hard labour. With limited sources of income, the other families were not in a position to enter into trading in stocks. Although there had been an increase in the per capita income of most of the people due to oil revenue, a small proportion of the population only took part in stock market trading. Moreover, until the beginning of the widespread economic and structural reforms during the early 2000s, investments in the stock markets were restricted to Saudi citizens. All these factors affected the liquidity of the Saudi stock market. This led to an ownership structure where large stock holdings were controlled by the government or large families.

#### **4.4 Capital Market Authority**

The existence of a well-functioning market is essential for an efficient allocation of resources in the economy.<sup>510</sup> Therefore, it becomes essential to control capital market activities effectively. Accordingly, the Capital Market Authority (CMA) a government organization was established with the objective of regulating the function of the capital market in Saudi Arabia. The Authority

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<sup>510</sup> K John and LW Senbet, 'Corporate Governance and Board Effectiveness' (1998) 22 JBF 371-403.

was created by Capital Market Law (CML) issued by a Royal Decree in 2003, whereby the organization possesses financial, legal and administrative independence in decision making.<sup>511</sup> Even though CMA functions independently it reports to the Prime Minister for control purposes.

#### **4.4.1 Duties and Responsibilities of the Capital Markets Authority**

The primary function of the CMA is to control the development of the Capital Market of Saudi Arabia through the formulation and implementation of appropriate rules and regulations governing the development of the capital market in the country. These regulations are framed in accordance with the Capital Market Law of the country. There are some major duties and responsibilities carried out by the CMA. First, the CMA acts as a custodian in protecting the interests of the investing public.<sup>512</sup> In this regard, the CMA ensures that there are no frauds, deceit or cheating of investors. CMA does not allow anyone to indulge in manipulation of the trading transactions or enter into any insider trading by declaring such transactions to be unlawful.<sup>513</sup> CMA takes care that securities transactions are entered into with complete fairness, fullest efficiency and complete transparency so that investors can feel confident about their investments.<sup>514</sup> The CMA also constantly develops various measures to improve the working of the capital market by reducing risks pertaining to transactions.<sup>515</sup> Taking adequate steps for the development and regulation of trading in securities and ensuring that a stricter monitoring and control of the trading transactions in the capital market is in place are the CMA's other responsibilities.<sup>516</sup> It also ensures the compliance of the various rules and regulations by all other

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<sup>511</sup> The CML can be accessed at <http://www.cma.org.sa/En/AboutCMA/CMALaw/Pages/default.aspx>.

<sup>512</sup> Article 5-a, para 4 of the CML.

<sup>513</sup> Article 50 of the CML.

<sup>514</sup> Article 23 of the CML.

<sup>515</sup> Article 5-a, para 1 of the CML.

<sup>516</sup> Article 59 of the CML.

entities, which are under the control of the CMA.<sup>517</sup> It insists on the presentation of the financial statements according to prescribed rules to ensure a perfect disclosure of information relating to the securities and their issues for the benefit of investors.<sup>518</sup> Overall CMA controls and oversees the proxy and purchase requests and similar other transactions including public offering of shares for raising capital.<sup>519</sup>

#### **4.4.2 Functioning of the Capital Markets Authority**

Establishment of the Saudi Stock Exchange where all the buying and selling of shares and securities are undertaken greatly helps regulating capital market functions. The responsibility of controlling the transactions of deposit, transfer, settlement, clearing and registering ownership of securities traded on the Stock Exchange is entrusted to the Securities Depository Centre affiliated to the CMA established by Capital Market Law.<sup>520</sup> The Committee for the Resolution of Securities Dispute (CRSD) deals with all the disputes relating to the transactions in securities trading as well as disputes arising under any other provisions of the Capital Market Law or under the rules and regulations issued by the CMA and the stock exchange. There is a provision for appeal by anyone aggrieved by the decisions of the CRSD to the Appeal Panel consisting of a council of ministers.

In order to discharge the above duties and responsibilities the CMA functions through different departments. The Authorization and Inspection Department is responsible for receiving and scrutinizing the applications for licenses to conduct securities business in Saudi Arabia, while the

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<sup>517</sup> Article 6-a of the CML.

<sup>518</sup> Article 42 of the CML.

<sup>519</sup> Article 51 of the CML.

<sup>520</sup> Capital Market Authority, 'Securities Depository Center' <[http://www.cma.org.sa/cma\\_en/subpage.aspx?secserno=6&mirrorid=274&serno=6](http://www.cma.org.sa/cma_en/subpage.aspx?secserno=6&mirrorid=274&serno=6)> accessed 24 March 2009.

Corporate Finance Department is responsible for reviewing the applications for offering securities in the country. The Enforcement Department looks after investigation and reporting on the complaints and disputes in the securities transactions with a view to resolving such complaints by CRSD. This department is also responsible for the implementation of the decisions and orders issued by the CRSD. The Market Supervision Department is responsible for the orderly running of the stock and securities business in accordance with the rules and regulations laid out by the CMA and the capital market law.

#### **4.5 The Saudi Stock Market**

Development of the Saudi stock market depended on a number of factors like the increase of listed companies, rise in Saudi GDP and the expansion of the regulatory framework. However, the number of listed companies does not represent the full resources of the economy.<sup>521</sup> The history of the Saudi stock market goes back to 1935.<sup>522</sup> Before the formation of the stock exchange in Saudi, the only option available for investment was to use the Saudi Arabia Investment Fund (SAIF) operating from London.<sup>523</sup>

‘Tadawul’ is the official and only stock exchange in Saudi Arabia. Tadawul is the eleventh largest in the world.<sup>524</sup> The CMA controls and oversees its functioning. As of April 2008, there were 115 publicly, traded companies listed in the exchange. It consists of members from banks, industries and service companies and organizations. According to the National Commercial Bank

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<sup>521</sup> M Malik, 'The Role of the Private Sector' in R Wilson (ed) *Economic Development in Saudi Arabia* (Durham Modern Middle East and Islamic World Series RoutledgeCurzon, London ; New York 2004)

<sup>522</sup> SA Banafe, *Saudi Arabian Financial Markets* (Ayyoubi Press, Riyadh 1993)

<sup>523</sup> B Bourland, 'Saudi Arabia Stock Market Opens to Foreigners' 1999 2.

<sup>524</sup> , 'Tadawul Saudi Stock Exchange' <[http://www.tadawul.com.sa/wps/portal/!ut/p/\\_s.7\\_0\\_A/7\\_0\\_49I/.cmd/ChangeLanguage/.!en](http://www.tadawul.com.sa/wps/portal/!ut/p/_s.7_0_A/7_0_49I/.cmd/ChangeLanguage/.!en)> accessed 4 July 2009.

of Saudi Arabia Website,<sup>525</sup> Tadawul controls trading in, clearing and settlement of shares of listed companies and the organization provides a stable and continuous, order-driven market. Tadawul with its technological infrastructure is able to provide up to the minute price, trading volume and precise company information, to the benefit of all investors. It combines all local equity trading into one market so that control is made easier. The stock exchange provides an efficient and short trading cycle through which investors can maximize their earnings. Tadawul ensures that the transfer of ownership takes place immediately after matching of buy and sell orders on specified securities. Investors are allowed to buy and sell many times during the day if the trading strategies require such transactions to be undertaken. Speedy and accurate settlement of transactions is ensured by the settlement taking place in the same day of transaction. Straight-through processing of transactions is facilitated by Tadawul with buy and sell orders processed from the stage of order entry to the stage of transfer of ownership. This provides adequate support for order delivery mechanisms such as through the internet.

With a GDP of \$ 382 billion, Saudi Arabia holds 25% of the total Arab GDP and is the largest single economy in the GCC region. The country also has the largest stock market in the region, with a market capitalization of \$ 480 billion (at 30 June 2008). However, compared to other stock markets of the world, Saudi's is still in an infant stage. The number of listed companies at 120 as of June 2008 is found to be low when compared with the size of the Saudi economy. With the number of companies listed from petrochemical, telecommunication and banking sectors accounting for three-fourths of market cap, the breadth of sectors available for investment is also narrow. In addition, the participation from domestic institutional investors is far below the level of domestic investments in other emerging markets. This is due to poor corporate governance

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<sup>525</sup> National Commercial Bank of Saudi Arabia, 'Tadawul' <<http://www.alahli.com/personalbanking/tadawul.asp>> accessed 4 July 2009.

practices, lower disclosure standards and lack of adequate transparency. However, these issues are found to be common among several other emerging markets.<sup>526</sup>

Saudi Arabia General Investment Authority (SAGIA) is playing a lead role in the promotion of investments in Saudi Arabia, by providing comprehensive licensing and support services for the domestic and foreign investors.<sup>527</sup> While the Authority helps investors in establishing their businesses, it serves as the central repository of information regarding doing business in Saudi Arabia. The Authority provides key economic news and reports on economic indicators, comparative industry analysis, general statistics and economic research. It also provides detailed information on the laws and regulations of the country governing business activities.<sup>528</sup> This helps investors largely to determine the nature and extent of potential investments in the country.

#### **4.6 Saudi Corporate Governance Rules**

Kay and Silberston argue that concern for corporate governance has increased in recent years due to increased corporate and accounting frauds.<sup>529</sup> According to Kar, East Asian countries and transitional economies are characterized by weak corporate governance regimes and financial systems.<sup>530</sup> Zhuang et al. found major weaknesses in the corporate governance systems of East Asian countries such as Indonesia and South Korea.<sup>531</sup> The first initiative in the direction of corporate governance in Saudi Arabia took place with the central bank of Saudi Arabia, the

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<sup>526</sup> M Farhan, 'Onward and Upward: Saudi Arabia's Market Quest' (2008) <<http://www.gulfnews.com/gnqfr/gnqfr32008/markets/10238423.html>> accessed 25 March 2009.

<sup>527</sup> The legal framework on the basis of which SAGIA operates is the Saudi Arabia Foreign Investment Law issued by Royal Decree No. M/1 on 5/1/1421 AH (1/1/2003 CE).

<sup>528</sup> SAGIA

<sup>529</sup> J Kay and A Silberston, 'Corporate Governance' (1995) NIER 84-97.

<sup>530</sup> P Kar, 'Corporate Governance in India' (Corporate Governance in Asia: A Comparative Perspective 2001) 249-274.

<sup>531</sup> J Zhuang and others, *Corporate Governance and Finance in East Asia : A Study of Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand* (Asian Development Bank, Manila, Philippines 2000)

Saudi Arabian Monetary Agency (SAMA) issuing a document containing the responsibilities of the board of directors of commercial banks in Saudi Arabia.<sup>532</sup> The document also stressed the need for the implementation of a system of accounting and internal controls among the banks. SAMA also issued a guidance document in 1996 on the role of the audit committee on the board, followed by a circular in 2004 outlining the role and responsibilities of bank directors and senior managers. Pursuant to a resolution passed in 2006, the CMA issued Corporate Governance Regulations. In Saudi Arabia, there was the need for corporate governance to be strengthened to face the challenges in such areas as information disclosure by listed companies, fair valuation of new issues of shares and dealing with issues in connection with the cross listing of stocks on regional stock exchanges.<sup>533</sup>

During the period when corporate governance norms were in the making, the sustainability and prospects of growth of the Saudi capital market was underlined by enhanced activities in the IPOs and rights issues of shares of different companies. The prospects for the equity and debt market were also good. In addition, there were promising opportunities in securitization of trade finance and commercial paper and the schemes of mergers and acquisitions signifying an increasing integration of GCC countries. However, the opportunities for capital market development were seriously hampered by the challenges faced by the Saudi capital market.

These challenges include ‘rapidly changing marketplace, the need for more enforceable information disclosure by listed companies, fair valuation of new issues, introduction of world-

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<sup>532</sup> The document was originally issued in 1981 under the title ‘Powers and Responsibilities of Members of the Board of Directors of Saudi Commercial Banks. It can be accessed on SAMA’s website at Saudi Arabian Monetary Agency (SAMA), ‘Powers and Responsibilities of Members of the Board of Directors of Saudi Commercial Banks’ (2010) <<http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD09.aspx>> accessed 19 December 2010.

<sup>533</sup> O Almotairy, ‘Towards Better Disclosure and Transparency in Saudi Firms: Overview’ (2004) <[www.hawkama.net/files/ppt/OBAIDALMOTAIRY.ppt](http://www.hawkama.net/files/ppt/OBAIDALMOTAIRY.ppt)> accessed 24 March 2009.

class regulatory standards, the strengthening of corporate governance and the cross-listing of stocks on regional stock exchanges.<sup>534</sup> In addition, there were other challenges facing the Saudi economy such as unemployment. With 56 percent of the population under 20 years, adult male unemployment was 28 percent in the 22–24 age groups. Another problem facing the economy was the lack of adequately qualified people, especially in finance services and other key areas. Despite these economic challenges, the Saudi capital market was expected to be buoyant; hence, from the consumer and investing public point of view, the new corporate governance regulations were expected to enhance the awareness by investors of the risks of trading in stocks.

Until 2003, SAMA was the authority in charge of regulating and monitoring capital market activities in Saudi Arabia. After establishment of the CMA in 2003, the organization became the sole regulator and supervisor of the capital market including overseeing the activities of ‘Tadawul’, the Saudi Stock Exchange. In 2004 CMA issued four implementing regulations to the Capital Market Law of 2003. These were expected to have serious impact on both investors and issuers by prescribing detailed regulations governing market ethics and conduct, securities offerings and rules of registration and listing.<sup>535</sup> The regulations were also expected to act as a deterrent for hostile takeovers.<sup>536</sup>

Kaufman et al. (2008) observe in their working paper for the World Bank on governance indicators, released in 2008, that although Saudi Arabia had improved its Regulatory Quality Indicator between 2006 and 2007, this still remains weak in terms of Voice and Accountability

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<sup>534</sup> Khaleej Times, 'Saudi Arabia's New Corporate Governance Rules by End '06' (2006) <<http://www.zawya.com/Story.cfm?id=ZAWYA20060716042334&pagenam=SukukMonitor>> accessed 26 March 2009.

<sup>535</sup> B Botts, 'Saudi Arabia: Saudi Arabia' (2005) IFL Rev

<sup>536</sup> RJ Girasa, 'The Quiet Revolution: The Opening of Saudi Arabia Securities Market to the West' (2005) <[http://www.pace.edu/page.cfm?doc\\_id=14450](http://www.pace.edu/page.cfm?doc_id=14450)> accessed 25 March 2009.

and Political Stability Indicators.<sup>537</sup> World Bank's Doing Business Report 2009, indicated that the investor protection in Saudi Arabia was higher than the average achieved by member nations of OECD and the average of other countries in the region. Doing Business Indicators encompass three dimensions of investor protection – transparency of transactions as evidenced by the Extent of Disclosure Index, liability for self-dealing indicated by Extent of Director Liability Index, and the ability of shareholders to sue the officers and directors of companies for misconduct revealed by Ease of Shareholder Suits Index. In the indices ranging from zero to 10 with higher values indicating better protection for investors, the index for Saudi Arabia stood at 8.0 as against the average of 5.9 for OECD countries and for other countries in the region.<sup>538</sup>

#### **4.6.1 Corporate Governance in the Saudi Arabian Banking Sector**

Commercial banks in Saudi Arabia are the most active sector in the economy.<sup>539</sup> Wilson observes that the monetary system in Saudi is stable as most of the deposits are placed in current accounts.<sup>540</sup> In order to bring stability in the operations of monetary systems and achieve a greater stability in issues relating to the country's currency, the Saudi Arabian government created the Saudi Arabia Monetary Agency (SAMA) in 1952.<sup>541</sup> In the discharge of its functions, SAMA recognized the necessity for regulation of the banking system and organizing the

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<sup>537</sup> D Kaufmann, A Kraay and M Mastruzzi, *Governance Matters Vii Aggregate and Individual Governance Indicators, 1996-2007* (World Bank, World Bank Institute, Global Programs Division, and Development Research Group, Macroeconomics and Growth Team, [Washington, D.C.] 2007) <[http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2008/06/24/000158349\\_20080624113458/Rendered/PDF/wps4654.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2008/06/24/000158349_20080624113458/Rendered/PDF/wps4654.pdf)> accessed 26 March 2009.

<sup>538</sup> World Bank, *Doing Business 2009 Country Profile for Saudi Arabia 2008* (World Bank ; Palgrave, Washington, D.C.; Basingstoke 2008) <<http://www.doingbusiness.org/Documents/CountryProfiles/SAU.pdf>> accessed 27 March 2009.

<sup>539</sup> AM Ahmad, 'Performance of Banking Sector in Saudi Arabia' (1999) 12 J Fin Man & Anal 30-36.

<sup>540</sup> R Wilson, 'Arab Government Responses to Islamic Finance : The Cases of Egypt and Saudi Arabia' (2002) 7 Medit Pol 143-163.

<sup>541</sup> SAMA was originally formed pursuant to Royal Decree No. 30141111047 issued on 25/7/1371 AH (20/4/1952 CE) and received its charter pursuant to Royal Decree No. 23 issued on 23/5/1377 AH (16/12/1957 CE).

functions of commercial banks in Saudi Arabia.<sup>542</sup> In the process, SAMA encouraged all the banks in Saudi Arabia to take serious steps to study and make improvements in the management of their operational and business risks and in the systems relating to the monitoring and control of internal procedures.<sup>543</sup> As a natural consequence, sufficient efforts were taken by SAMA for bringing corporate governance regulations into the banking sector in Saudi Arabia.

‘First, it required all banks to develop and strengthen their internal audit departments, and second it issued minimum internal control guidelines.’<sup>544</sup> In order to keep the accounting standards of the banks up to date and in line with international standards, SAMA also issued accounting standards and guidelines for the banks to follow which were in conformity with and on the same lines as recognized international accounting standards.

As a further development in the corporate governance area in the banking sector, SAMA also increased its focus on the working of Saudi banks by issuing further guidance. This covered the following issues: (1) the role and responsibilities of members of the board of directors, (2) guidelines on the creation and functioning of audit committees, (3) advice on the maintenance of minimum standards of internal control, (4) guidelines on the procedures relating to any special audit examination, and (5) defining the roles and responsibilities of internal and external auditors of the banks. The provision of these guidelines by SAMA created a highly conducive atmosphere for the banks to put into practice strong corporate governance principles, which could result in an

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<sup>542</sup> See SAMA’s list of functions at <http://www.sama.gov.sa/sites/samaen/AboutSAMA/Pages/SAMAFunction.aspx>.

<sup>543</sup> Saudi Arabian Monetary Agency (SAMA), 'Compliance Manual for Banks Working in Saudi Arabia' (2008) <<http://www.sama.gov.sa/sites/samaen/RulesRegulation/Rules/Pages/COMPLIANCE%20MANUEL%20FOR%20BANKS%20WORKING%20IN%20SAUDI%20ARABIA.doc>> accessed 19 December 2010.

<sup>544</sup> Saudi Arabian Monetary Agency, 'Development and Restructuring of the Saudi Banking System' (Bank Restructuring in Practice 1999) <<http://www.bis.org/publ/plcy06.pdf>> accessed 22 August 2007.

efficient management control culture and an effective risk management environment in the entire Saudi banking system.

#### **4.6.2 Role of Capital Market Authority in Corporate Governance**

As a part of the major economic reforms, the Saudi government enacted the Capital Market Law to provide a comprehensive and integrated framework for the country's capital market, so that its growth could be organized. The Capital Market Law 'contains detailed provisions setting out requirements to ensure transparency and accountability within the capital markets, as well as other provisions designed to eliminate market manipulation, insider trading and other unfair practices.'<sup>545</sup>

Pursuant to the passing of the law, the CMA was established to enforce the provisions of the legislation. One of the basic principles on which the CMA operates is to frame and enforce listing rules that govern the issues relating to the management of initial public offerings, various requirements of prospectus for the primary issue of shares, matters relating to secondary market offerings and other corporate governance obligations of the listed companies. The code of corporate governance for listed companies was recently added to the capital market regulations setting out the rules, guidelines and parameters that govern the management of listed companies with the best corporate governance practices.<sup>546</sup>

#### **4.6.3 Further Initiatives in Corporate Governance**

As a result of improvement of activities in the western stock markets and the downward trends prevailing in the GCC stock markets, there has been an increasing drive to improve the corporate

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<sup>545</sup> K Nassar, 'Middle East and India: Shifting Sands' (2007) LegalWeek  
<<http://legalweek.com/Navigation/20/Articles/1018570/Middle+East+and+India+Shifting+sands.html>> accessed 25 March 2009.

<sup>546</sup> Ibid

governance principles in the region, reported in the *Corporate Governance in the GCC – An Investor Perspective*, a study conducted by the Hawkamah, the Institute for Corporate Governance, and the Institute of International Finance. In order to deal with corporate governance in Saudi Arabia, Hawkamah took into consideration the price manipulations in the GCC stock exchanges as indicators of poor corporate governance regulations. With the increased number of IPOs, there was pressure from investors for intervention by the regulators, whose charge was to improve working systems and frameworks by improving existing corporate governance practices.<sup>547</sup>

The increased activities of GCC nations in international acquisitions and other investments in international markets<sup>548</sup> have showed substantial improvements in private sector activities in the finance and investment areas. Hence, it was essential that member countries adopt sound CG standards that were comparable to international standards.

‘Central banks in all six GCC countries have amended their banking regulations to include corporate governance-related requirements such as establishing transparency and disclosure in financial statements, establishment of a board level audit, nomination and compensation committees and improved risk management.’<sup>549</sup> This has necessitated a thorough revamping of CG regulations in order to accommodate the needs of various economic sectors. The regulators also found it necessary to improve the working practices and reporting standards of GCC listed companies as a result of opening up of the stock markets in GCC countries to foreign investors.

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<sup>547</sup> As per the Report 'Corporate Governance in the GCC: An Investor Perspective,' "Muscat and Abu Dhabi exchanges introduced codes in 2003 and 2006 respectively, while regulators in the UAE, Saudi Arabia, Bahrain, Qatar and Kuwait have draft codes that are expected to be implemented in 2007."

<sup>548</sup> GCC corporations have conducted USD 25.9 billions of acquisitions in the UK, Europe and North America so far this year, according to Bloomberg.

<sup>549</sup> Hawkamah The Institute for Corporate Governance, 'Corporate Governance Standards in GCC Undergoing Major Development' <[http://www.hawkamah.org/media\\_centre/archive/2006/12.html](http://www.hawkamah.org/media_centre/archive/2006/12.html)> accessed 27 March 2009.

The report made the following recommendations so that GCC countries would comply with the IIF corporate governance codes:<sup>550</sup>

a stronger commitment to better corporate governance from political authorities as well as from senior government officials involved with capital market development is needed for real change to take effect;

regulators in GCC countries should work more closely together on the development of equity markets;

creation of specialized courts to deal with enforcement of securities laws in their stricter senses;

increased transparency in financial statements in order to achieve maximum disclosure, especially in the annual reports of listed companies. Only then can investors be fully aware of the financial strengths of these companies;

establishment of a Registrar of Companies to insist on providing information from joint stock companies as well as sole proprietary concerns. In addition to meeting disclosure requirements of the IIF codes, such action would also be in the best interests of the investing public for ensuring that their invested funds are not misappropriated.

All the above recommendations apply equally to Saudi Arabia, a developing economy with rich oil revenues, thus needing stricter corporate governance standards regulations. With the crash in the Saudi stock market, after which investor confidence levels dropped sharply, it was necessary to improve CG standards in Saudi Arabia, especially if the country were to attract direct foreign investments.

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<sup>550</sup> Ibid

The CMA issued ‘Corporate Governance Regulations in the Kingdom of Saudi Arabia’ under the Resolution of its Board in November 2006. The provisions on the corporate governance are framed under the Capital Market Law primarily with a view to regulating management of the listed joint stock companies in the Saudi Stock Exchange. Under these provisions, listed companies are expected to ensure that they comply with best governance practices that would protect the rights of the shareholders as well as other stakeholders of joint stock companies. The rules are construed as the guiding principles for all those companies whose shares are listed in the stock exchange. The corporate governance rules provide for the definitions of certain terms connected with the corporate governance issue. The rules provide for the rights of shareholders and the general assembly, disclosure and transparency and the duties and responsibilities of the board of directors.

#### **4.7 Disclosure and Transparency under Saudi Capital Market Authority**

The Companies Law of 1965 was the first statute and the primary authoritative reference for the disclosure standards of companies functioning in Saudi Arabia. Saudi Arabia started developing its own accounting and auditing standards as early as the 1980s under the direction and control of the Ministry of Commerce and Industry (MoCI). The first disclosure standards that came into effect from 1990 related to the objectives and concepts of financial accounting, and general presentation and disclosure standard. The Saudi Organization for Certified Public Accountants (SOCPA) was made responsible for developing accounting and auditing standards including disclosure norms and by the end of 2003, the organization developed and put into effect almost 20 statements of Financial Accounting Standards. These standards covered the standards mostly in line with those of the UK and USA and covered some of the topics of local importance. Rules were prescribed under which all listed companies are mandated to announce quarterly and annual

financial results. The quarterly financial statements are to be submitted within three weeks of the quarter end. Three months is allowed to prepare and present the annual financial statements reviewed by the auditors. The companies are also required to form an audit committee. While most companies adhere to the mandatory reporting requirements, voluntary disclosure is rare.

The Ministry of Commerce and Industry, SOCPA and SAMA share the responsibilities for monitoring and enforcing the reporting and disclosure requirements. The MoCI has the function of reviewing the annual accounts and reports of listed companies. Overseeing the reporting and disclosure standards of financial and accounting standards is looked after by the SOCPA. SAMA is entrusted with the responsibility of reviewing the trading and daily transactions on the stock exchange. However, absence of a single regulatory authority and sharing of the responsibilities among three different entities has resulted in some loopholes in the disclosure and transparency aspects.

Disclosure requirements in the prospectus inviting subscriptions for new share capital show the improvement in governance norms initiated by the CMA. According to the current legislation, the prospectus or any portion of the document containing an invitation to the public should be published in the prescribed manner and the publication should be current for a specified duration. An issuer or an affiliate to an issuer has to file the necessary prospectus in the prescribed format with the authority, publish it according to the legislation and pay the required fees before proceeding to offer shares. There are provisions for exemption of the issuer from certain

requirements, depending on the manner and amount of the offering, the number of shareholders and their characteristics and the nature and characteristics of the issuer of the shares.<sup>551</sup>

Articles 8 and 9 of the Corporate Governance Regulations (CGR) issued by the CMA detail the requirements with respect to disclosure and transparency of limited companies. Article 8 states that every company should lay down the policies, procedures and supervisory role in respect of matters covering disclosure requirements in compliance with existing regulations. The companies should lay down such policies in writing. Article 9 deals with the disclosures in the report of the board of directors. The directors' report should contain all the relevant information as per the Listing Rules in the form of an attachment to the annual financial reports of the company. In addition, the report by the board of directors should include the following: (1) a statement on the implementation of the provisions of corporate governance regulations. This statement will highlight the regulations that have been implemented and those which have not been implemented. The statement will also contain the justifications for not implementing any of the provisions mentioned in the Regulations, (2) a list containing the names of other companies in which any of the members of the board act as a director, (3) a statement on the formation of the board including the classification of the directors into executive board members, non-executive members, and/or independent members, and (4) a descriptive statement showing the committees formed by the board – the statement should indicate the name of the chairman, names of the members of the committee and the number of meetings the committees convened. The statement should also describe the powers and duties of the audit committee, nomination and remuneration committee and any other committee formed by the board.

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<sup>551</sup> A Al-Harkan, 'An Investigation into the Emerging Corporate Governance Framework in Saudi Arabia' (Dissertation thesis University of Wales 2005) 115.

The report of the board of directors should contain details of compensation and remuneration paid to the chairman and the members of the board of directors and the top five executives who have been paid the highest remuneration. The compensation and remuneration paid to the CEO and the Chief Financial Officer should also be included in this statement, even if they are not included in the top five executives. The Regulations have defined the terms compensation and remuneration to include salaries and allowances, profits, annual or other periodic performance bonuses, long-term or short-term incentive schemes and any other rights that entitle the directors and the officers to any monetary or other benefits. The directors report should cover any punishment or penalty or other preventative restriction imposed on the company by the CMA or any other supervisory, regulatory or judicial body. The disclosure requirements also lay down that the board should report on the results of the annual audit of the effectiveness of the internal control systems followed by the company.

#### **4.8 Saudi Companies Law of 1965**

The economic growth of Saudi Arabia after the discovery of oil in the Eastern Region necessitated the establishment of the Commercial Court Regulation in 1931, a modern attempt to deal with financial matters, but touching lightly on issues pertaining to the regulation of corporations and with such matters as incorporation, dissolution, liquidation and other related issues.<sup>552</sup> The economic growth that followed, particularly in the 1960s, and the corresponding corporate boom that went along with this growth, rendered the CGR insufficient to deal with more concrete aspects of corporate regulation and governance.<sup>553</sup> The Companies Law of 1965 regulates the formation and operation of companies and business houses in Saudi Arabia. It was

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<sup>552</sup> DD Commins, *The Wahhabi Mission and Saudi Arabia* (I.B. Taurus, London 2006) 120-121.

<sup>553</sup> MH Khan, 'Governance, Economic Growth and Development since the 1960s' (2007) 2007 DESA Work Pap

promulgated in 1965 in accordance with Royal Decree M/6. It consists of 233 articles, providing for required annual financial statements and reports of the companies, the role of external auditors and the relationship between company and the external auditor. The provisions relating to the external auditor and the financial statements are contained in Articles 123 to 133.

The Companies Law came under criticism on the grounds that it was adapted from Egyptian law, which in turn is modelled after French law, and therefore was not Sharia compliant. However, the Saudi ulamas responded to this criticism by referring to a principle of the Hanbali Islamic school of Sharia, which they interpreted as follows: ‘In a profane activity, everything is allowed as long as no evidence (from the Koran and the Sunna) forbids it (explicitly).’

The Saudi Companies Law further endorses its compliance with Sharia in the preamble by referring to two sources of Sharia; the Hadith and the Ijma’ (consensus), as mentioned in Chapter I of the present work. The reference quotes a passage from the Hadith which states: ‘God says: I am the third partner between any two others as long as none of the two betrays the other; otherwise I withdraw.’

Under Article 1, a company has been defined as a contract pursuant to which two or more persons undertake to participate in an enterprise aiming at profit, by offering in specie or as work a share, for sharing in the profits or losses resulting from such enterprise. Under Article 2 a wide range of entities are included in the term company. The arrangements recognized under Article 2 of the Companies Law are: (1), general partnerships, (2) limited partnerships, (3) joint ventures, (4) corporations, (5) partnerships limited by shares, (6) limited liability partnerships, (7) variable capital companies, (8) cooperative companies. The provisions of Companies Law clearly state that any entity in Saudi Arabia intending to do business should be formed to conform to any of

the legal forms laid down by Article 2. Otherwise, the formation of any organization shall be declared null and void. Partners can contribute the capital in the form of cash or in kind represented by any capital asset. The capital may also consist of services except in cases where the Companies Law provides otherwise. However, only the influence or reputation of the partner cannot be considered as capital.

Every partner is considered as indebted to the company for the amount of share capital, which he has committed to pay to the company. In case the partner fails to pay within the committed date, the partner shall be made liable to the company for any damages arising to the company because of such delay. Except in the case of a joint venture, the memorandum of association of the company or any amendment made to it shall be recorded in writing in front of a registrar. If this provision is not followed, the memorandum or any amendment made to it shall not be considered as valid from the angle of third parties dealing with the company. Except in the case of a joint venture, any company established in accordance with the provisions of Companies Law shall arrange to have its head office in the Kingdom of Saudi Arabia. The company shall be deemed to have Saudi nationality. However, merely because of having its head office in Saudi Arabia, the company shall not enjoy the rights otherwise available to Saudi nationals.

#### **4.9 Rights of Shareholders in Saudi Arabia**

Articles 3 to 7 of part 2 of CGR issued by the CMA details the rights of shareholders and the General Assembly in Saudi Arabia. There are no different classes of shares with different rights attached prevalent in Saudi Arabia. Article 3 contains a detailed list of rights available to shareholders. These rights include: (1) the right to share the distributable profits of the company, (2) the right to share in the assets of the company when the company goes into liquidation, (3) the right to attend the general assembly and participate in deliberations and vote on relevant

decisions, (4) the right of disposition with respect to shares, (5) the right to supervise the activities of the board of directors and file responsibility claims against board members, (6) the right to inquire and have access to information without prejudice to the company's interests and in a manner that is not inconsistent with the provisions of Capital Market Law and the Implementing Rules.

Article 4 of the Regulations provides for the rights of the shareholders to access information on the functioning and performance of the companies. The provisions allow the articles of association of the company to specify procedures and the articles may also provide the precautions necessary for the exercise of the rights by the shareholders. The companies are mandated under the regulations to use effective means of communicating with the shareholders and provide them with comprehensive and accurate information and regular and periodical updates. There shall be no discrimination between shareholders in making information available to shareholders.

Shareholders representing at least 5% of the equity share capital can request the convening of the general assembly. Shareholders are entitled to attend and vote in the general assembly and it is mandatory that shareholders be informed about the rules governing the meetings and voting procedures. The shareholders are entitled to discuss all the matters listed in the agenda for the general assembly. They can also raise questions to the board of directors and the external auditor in connection with the items on the agenda. Sufficient information on the matters to be discussed

in the general assembly should be circulated to members. Shareholders are entitled to peruse the minutes of the general assembly.<sup>554</sup>

Shareholders are given the power of voting on issues in the general assembly, and are also entitled to appoint any other person who is neither a member of the board nor an employee of the company to attend the general assembly and exercise voting rights. This authorization shall be made in writing.

#### **4.10 Duties and Responsibilities of the Board of Directors in Saudi Arabia**

According to Prowse, in all the countries, the board of directors is made responsible for managing the company on behalf of the shareholders.<sup>555</sup> Jensen points out that issues concerning the corporate internal system start with the board of directors.<sup>556</sup> According to the Mexican Bankers Association (1993:3) as quoted by Al-Ajlan the general functions of the board of directors are to: (1) establish a strategic vision for the company, (2) ensure that the stockholders and the market have access to public information about the company, (3) establish internal control mechanisms, (4) ensure that the company has the necessary mechanisms to prove that it complies with the various legal provisions to which it is subject, (5) regularly evaluate the performance of the chief executive officer and other senior management of the company. These functions are in addition to the statutory obligations imposed by various measures such as the Companies Act and securities market regulations. It is recommended that independent auditors not connected with the business are included on the board so that the company can derive

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<sup>554</sup> Capital Market Authority, 'Corporate Governance Regulations in the Kingdom of Saudi Arabia' <[http://www.cma.org.sa/cma\\_cms/upload\\_sec\\_content/dwfile19/GOVERNANCE.pdf](http://www.cma.org.sa/cma_cms/upload_sec_content/dwfile19/GOVERNANCE.pdf)> accessed 9 February 2009.

<sup>555</sup> SD Prowse, *Corporate Governance in an International Perspective : A Survey of Corporate Control Mechaisms among Large Firms in the United States, the United Kingdom, Japan, and Germany* (Bis Economic Papers, No. 41, Bank for International Settlements, Monetary and Economic Dept., Basle 1994)

<sup>556</sup> MC Jensen, 'The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems' (1993) 48 J Fin 831-880.

benefits from their experience and skills. Article 10 to 18 of Part 4 of the CGR details the duties and responsibilities of the board of directors of limited companies in Saudi Arabia.

#### **4.10.1 Functions of the Board of Directors**

Monks and Minow observe that the board should be sufficiently involved in the day-to-day decisions of the company so that the board can ascertain how the company should be managed.<sup>557</sup> However, Fama and Jensen are of the view that the board is not an effective device for decision control unless it limits the discretion of top management.<sup>558</sup> According to Article 10 of the Regulations, responsibility to conduct the business of the company by formulating its strategic plans and objectives rests with the board of directors. The control role of the board normally includes a selection of the top executives including the CEO and the control function involves monitoring, evaluation and providing rewards for executive performance.<sup>559</sup>

This function is exhaustively described in Article 10 to include laying down the work plan of the company and devising the policies of the company relating to risk management. The board should also undertake a periodic review of such policies and update them as and when needed, decide on the financial objectives of the company including determination of the appropriate capital structure and approval of the annual budgets of the company, and form part of the functions of the board. The board shall undertake the supervision of the capital expenses of the company and the acquisition and disposal of its assets. The CGR has placed the key function of overseeing the performance of the company with the boards of directors. The board of directors

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<sup>557</sup> RAG Monks and N Minow, *Corporate Governance* (2. edn Blackwell Business, Blackwell, Oxford [u.a.] 2001)

<sup>558</sup> Fama and Jensen (n 389) 143-163.

<sup>559</sup> J Pfeffer, 'Size and Composition of Corporate Boards of Directors: The Organization and Its Environment' (1972) 17 *Admin Sci Q* 218-228. ; See also K Provan, 'Board Power and Organizational Effectiveness among Human Service Agencies' (1980) 23 *Acad MJ* 221-236.; P Stiles and B Taylor, *Boards at Work : How Directors View Their Roles and Responsibilities* (Oxford University Press, Oxford ; New York 2001)

is expected to accomplish this by evolving suitable performance objectives for senior executives and other management staff and ensure achievement of the objectives so established by the company executives.

Judge and Zeithaml observe that 'pressure for greater accountability in corporate decision making has focused on board investment in a strategic decision-making process'.<sup>560</sup> The board is also expected to make a periodic review of the organizational and functional structures of the company and make necessary amends to the structures to improve the performance of the company.<sup>561</sup> The supervisory board is also given the responsibility to participate and take long-term strategic decisions.<sup>562</sup>

Another major function of the board is to institute an effective internal control system and supervise the implementation of the systems so established. An important point that has been dealt with by the CGR is the development of a written policy, which can effectively regulate the conflicts of interest that may arise among members of the board of directors, executive management and shareholders of the company. This policy should cover aspects of protecting the misuse of the assets and facilities of the company and the arbitrary disposition of the resources of the company resulting from dealings with related parties. This provision has been included to prevent the occurrence of accounting frauds as happened in the case of Enron Corporation in the United States.

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<sup>560</sup> WQ Judge, Jr. and CP Zeithaml, 'Institutional and Strategic Choice Perspectives on Board Involvement in the Strategic Decision Process' (1992) 35 Acad MJ 766-794.

<sup>561</sup> Capital Market Authority, 'Corporate Governance Regulations in the Kingdom of Saudi Arabia'

<sup>562</sup> T Clarke and R Bostock, 'Governance in Germany: The Economic, Management and Financial Issues' in K Keasey, S Thompson and M Wright (eds), *Corporate Governance Economic and Financial Issues* (Oxford University Press, Oxford ; New York 1997)

The board of directors should ensure the integrity and correctness of the financial and accounting procedures, including those relating to the compilation of financial reports. The board is expected to ensure that control procedures are capable of managing the risks associated with the business of the company and disclose those risks transparently. Boards should also review the internal control systems periodically to improve upon them. However, the typical board meeting lasts only for a few hours. Since, the directors do not have much time to spend they get frustrated that they cannot concentrate on strategic issues.<sup>563</sup>

The CGR specify that the board of directors should ensure that a comprehensive corporate governance code for the company has been drafted and implemented. It is essential that the code so formulated should not contravene any of the provisions contained in the CGR. Supervision and monitoring of the effectiveness of the Code and making amendments when necessary are part of the functions of the board. Boards have been mandated to formulate and lay down specific and explicit policies governing membership of the board of directors, get them approved by the general assembly and implement them properly.

The board of directors is given the most important function of drafting a written policy that regulates the relationship with stakeholders so that there is adequate protection of their rights. The policies in particular should cover the following: (1) the ways in which the stakeholders can be indemnified in cases where there is a contravention of their rights under the governing law and the respective contracts, (2) ways in which the disputes and complaints between the company and the stakeholders can be settled, (3) mechanisms to promote cordial relationship with customers and suppliers of the company and at the same time ensuring protection of the

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<sup>563</sup> Conger, Lawler III and Finegold, See also CB Carter and JW Lorsch, *Back to the Drawing Board : Designing Corporate Boards for a Complex World* (Harvard Business School Press, Boston, Mass. 2004)

confidentiality of information that needs to be provided to them, (4) code of conduct for the employees and managers, which is drafted in accordance with proper professional and ethical standards,<sup>564</sup> (5) ways in which the company can discharge its corporate social responsibility obligations, (6) laying down suitable policies, systems and procedures which ensure that the company can comply with the laws and regulations governing the conduct of the business. It is the function of the board of directors to ensure that the company discharges its obligations towards disclosure of material information to shareholders, lenders and other stakeholders of the company.<sup>565</sup> However, it has been noted that the power of control in most firms rests with the CEO (President) and not the board of directors.<sup>566</sup>

#### **4.10.2 Responsibilities of the Board of Directors**

Stiles<sup>567</sup> shows that the responsibility of the board extends from working with top management on strategic decision-making until management's proposals are ratified. Henke<sup>568</sup> further elaborates the role of the board of directors in administering the affairs of the company. Demb and Neubauer<sup>569</sup> point out that providing strategic direction to top management is one of the major responsibilities of the board. Article 11 contains the detailed list of responsibilities of the board. In general, the board of directors of a company assumes all the powers necessary for the efficient conduct of the business of the company. However, these powers are subject to the competencies of the general assembly of the company. Even if there are committees outside the

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<sup>564</sup> This code of conduct has the purpose of regulating the relationship of employees and managers with the stakeholders. It is for the board of directors to lay down the systems and procedures for overseeing the implementation of this code and the compliance of such systems.

<sup>565</sup> Capital Market Authority, 'Corporate Governance Regulations in the Kingdom of Saudi Arabia'

<sup>566</sup> ML Mace, *Directors : Myth and Reality* (Rev. edn Harvard Business School Classics, Harvard Business School Press, Boston, Mass. 1986)

<sup>567</sup> P Stiles, 'The Impact of the Board on Strategy: An Empirical Examination' (2001) 38 J Mgmt Stud 627-650.

<sup>568</sup> J Henke, 'Involving the Directors in Strategic Planning' (1986) 7 J Bus Strategy 87-95.

<sup>569</sup> Demb and Neubauer (n 414).

board, set up for looking after specific functions, the ultimate responsibility for these functions would still lie with the board. This is the case even when the board has delegated some of its powers to third parties. It is in the best interests of the company that the board of directors should refrain from issuing general or indefinite power of attorney to any third parties. Goodstein, Gautam and Bocker identifies the strategic role of the board in involving important decisions that enable the organization to adapt itself to environmental changes.<sup>570</sup>

Moreover, the articles of association should contain the specific responsibilities of the board. The board of directors is expected to carry out its duties diligently and in a more responsible way and in good faith. The board should take business decisions based on proper and sufficient information from the executive management and/or from other sources that are completely reliable. A member of the board of directors is considered as the representative of all the shareholders of the company but not a particular group. Therefore, a member of the board is expected to function in the general interest of the company and not in the interest of any specific group that voted for the appointment of that particular member to the board. The board of directors, by exercising its power, will determine the powers that can be delegated to the top management of the company.<sup>571</sup>

The board shall also decide and arrive at the matters that will be specifically decided by the board alone. The board should also insist on the executive management submitting to the board periodic reports on the exercise of the powers delegated to them. There should be a thorough procedure laid down for the orientation of the new members of the board to the business of the

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<sup>570</sup> J Goodstein, K Gautam and W Boeker, 'The Effects of Board Size and Diversity on Strategic Change' (1994) 15 *Strat Mgmt J* 241-250.

<sup>571</sup> T McNulty and A Pettigrew, 'The Contribution, Power and Influence of Part-Time Board Members' (1996) 4 *CG* 160-179.

company, more specifically the financial and legal aspects of the business. New members of the board should also be trained in areas where they are lacking.<sup>572</sup>

It is vitally important that the board of directors ensure that sufficient and full information about the conduct of the business is made available to all members of the board. Such information should be made available more particularly to non-executive members of the board so that they will be able to discharge their functions more effectively and in the best interests of the company.

The Regulations also contain provisions relating to financial issues where the board has to fulfil its responsibilities without any deviation. The board is not entitled to enter into loan agreements, which extend for a period of more than three years. The board shall not also sell or mortgage the real estate properties of the company except with explicit approval set out in the articles of association of the company. Similarly, the company shall not also waive any of the debts of the company unless authorized to do so by the articles of association. In cases where the articles of association do not contain any provisions in this connection then the board of directors should seek the approval of the company in general assembly. Such approval may not be required if the act falls within the normal scope of the business of the company. Thus, as identified in the literature, the board of directors in Saudi Arabia is expected to play three important and interrelated roles in conducting the affairs of the company; service, strategy and control. While service includes the functions of the board to represent the interests of shareholders and stakeholders in the company and linking the company with the external environment, strategy demands the directors' involvement in evolving the business concepts of the company and defining its business policies. The control function involves ensuring the overall performance of

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<sup>572</sup> Capital Market Authority, 'Corporate Governance Regulations in the Kingdom of Saudi Arabia'

the company by directing the executive management and using information and its power to protect the interests of the shareholders.<sup>573</sup>

#### **4.11 Role of Audit Committees in Saudi Arabia**

The board appoints several subcommittees, which are expected to report to the board periodically and the board is entitled to delegate various activities to these subcommittees.<sup>574</sup> According to Renton and Watkinson since the board has little time to spend on the affairs of the company, it delegates some of the functions to the subcommittees.<sup>575</sup> The concept of the audit committee has been recognized as an effective mechanism for corporate governance throughout the world, especially after major corporate failures in the US and Europe. The passing of Sarbanes-Oxley Act in 2002 immediately after the collapse of Enron Corporation in the United States due to accounting frauds, underscores the importance of audit committees.<sup>576</sup> The Act entrusts the function of overseeing the accounting and financial reporting to an audit committee consisting of independent members of the board of directors.

##### **4.11.1 Formation of the Audit Committee**

The concept of the audit committee is not new and can in fact be traced to the 19<sup>th</sup> Century.<sup>577</sup> According to a report by Collier, the majority of large organizations in the UK had audit committees established before 1992.<sup>578</sup> In Saudi Arabia, Article 13 of the CGR elaborates the provisions relating to the formation and functioning of committees in general and Article 14

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<sup>573</sup> Al-Ajlan (n 508) 39.

<sup>574</sup> CA Mallin, *Corporate Governance* (Oxford University Press, Oxford ; New York 2004)

<sup>575</sup> T Renton and J Watkinson, *The Company Director's Guide : Your Duties, Responsibilities & Liabilities* (Kogan Page, London 2001)

<sup>576</sup> Saudi Arabian Monetary Agency 58.

<sup>577</sup> S Turley and M Zaman, 'Corporate Governance Effects of Audit Committees' 2002.

<sup>578</sup> P Collier, E Institute of Chartered Accountants in and B Wales. Research, *Audit Committees in Large UK Companies* (Research Board of the Institute of Chartered Accountants in England and Wales, 1992)

details the specific provisions relating to audit committees. In order to carry out their duties and responsibilities boards of directors can set up different committees in accordance with the need to conduct the affairs of the company. Those who are more knowledgeable in financial matters are more effective in earnings management.<sup>579</sup> Therefore, it becomes essential that the audit committee is formed and the preparation and presentation of the financial statements are overseen.

Committees will in general be formed in subordination to the boards and the duties, and the duration and the powers of the committees will be explicitly indicated by the board. The board will decide on the manner in which it can control and monitor the activities of the committees. It is the responsibility of the committee to notify periodically the board of their activities, findings and decisions with complete transparency and full information. On its part, the board will monitor the activities of the committees to ensure that responsibilities entrusted to the committees are discharged effectively and efficiently. Certain activities: (1) ensuring the integrity of the financial and non-financial reports, (2) reviewing the dealings with related parties, (3) nomination to membership of the board, (4) appointment of executive directors, (5) fixing of the remunerations, are likely to involve conflicts of interests among the concerned parties.

Article 14 has specific provisions regarding the constitution of audit committees. According to this Article, there must be at least three members. One of the committee members should be a specialist in financial and accounting discipline. The Article prohibits the appointment of

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<sup>579</sup> J Bedard, SM Chtourou and L Courteau, 'The Effect of Audit Committee Expertise, Independence, and Activity on Aggressive Earnings Management' (2004) 23 Auditing, 13-35.

executive board members to the audit committee, implying that audit committee members should be non-executive members of the board.

The audit committee is appointed by the general assembly of the shareholders on the recommendation of the board of directors. The general assembly also issues the rules regarding the appointment of the audit committee, including the duration of the committee and procedures for it to follow.

#### **4.11.2 Duties and Responsibilities of Audit Committees**

The audit committee provides the board with assurances on the control of the firm.<sup>580</sup> It functions as a tool to enhance the independence of the external auditor and provides more reliable financial reporting to the users of financial statements.<sup>581</sup> The primary duty of the audit committee is to ensure that the internal audit department of the company is functioning effectively and is executing the activities and duties entrusted to it by the board of directors. The audit committee also prepares a written report on internal audit procedures by reviewing the functions of the department. It is also empowered to make suitable recommendations for improving the function of the internal audit department. Another major function of the audit committee is to review the comments on reports submitted by the internal audit department and to ensure that corrective measures recommended by that department are implemented properly. The audit committee is entitled to make its recommendations to the board regarding the appointment, removal and remuneration of the external auditors.

The audit committee is responsible for supervising the activities of the external auditors. The committee has also to approve any work assigned to them beyond audit. The audit committee

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<sup>580</sup> LF Spira, 'Audit Committees: Begging the Question?' (2003) 11 CG 180-188.

<sup>581</sup> LF Spira, 'Independence in Corporate Governance: The Audit Committee Role' (1999) 8 Bus Ethics 262-273.

may review the audit plan along with the external auditors and make suggestions for improving it. The report of the external auditor on the financial statements is to be reviewed by the audit committee and the committee has to ensure that any follow-up actions are taken on comments made by the external auditors. It also reviews the interim and final financial statements of the company as prepared by the accounts department and audited by the external auditors before they are presented to the board of directors. The audit committee, upon reviewing these statements, has to express its opinion and recommendations. It also reviews the company's accounting policies. The committee needs to advise the board on the effectiveness of accounting policies and can also make suitable recommendations to the board for making alterations to those policies.

#### **4.11.3 Interview with the Board General Secretary of the National Commercial Bank**

In the course of our study of corporate governance rules in Saudi Arabia, I was able to obtain the opportunity to conduct a personal interview with the Secretary General of the Board of Directors of the National Commercial Bank, Mr Nasser al-Qawas, to ask some questions concerning the rules of corporate governance in Saudi Arabia, and to get acquainted with the views and opinions of a person who is familiar with the boards of directors of Saudi corporations. Mr Nasser al-Qawas is and has been very much concerned with corporate governance issues in the National Commercial Bank (NCB), especially since its chairman, Mr Abdullah Bahamdan, decided to implement corporate governance standards at the bank several years ago. The NCB contracted with the world-renowned firm McKenzie to formulate rules and regulations for corporate governance for the NCB which took into consideration international standards, in addition to applying them to all administrations of the NCB at its headquarters in Jeddah. Mr Nasser al-Qawas was responsible for coordinating between McKenzie Co. and the bank's board and all its

administrators, to arrive at an implementation of corporate governance standards in the NCB, one of the largest banks in the Middle East. In my interview with Mr. al-Qawas I asked him a number of questions to get an idea of his point of view, based on his 18 years of experience in the field of law, of which 11 were spent at the NCB, starting in the bank's legal department, until he was appointed secretary general of the board of directors. Mr al-Qawas' answers were as follows:

- 1- Do you think it is useful to introduce the corporate governance guidelines to Saudi Arabian public companies?**

*Yes, for all companies, and no one can deny their importance in the world of money and business.*

- 2- In your opinion, what is the scope for the implementation of the principles of corporate governance in Saudi listed companies?**
- **Rights of shareholders**
  - **Rights of stakeholders**
  - **Responsibilities of board of directors**
  - **Disclosure and transparency**
  - **Non-executive directors**

*To my knowledge, the responsibilities of the members of the boards of directors, and those of non-executive managers are the most applicable when it comes to Saudi corporate governance.*

- 3- How do you consider the implication of corporate governance for legal system?**

*There is no conflict between the legal system and corporate governance regulations in the Kingdom of Saudi Arabia.*

- 4- Do you think the disclosing information on financial and operating results very important among items relating to disclosure under the corporate governance framework in Saudi Arabian listed companies?**

**In your opinion, do you agree, if not, what sort of information that need more disclosure in the Saudi listed companies?**

*In the case of its clarity this is true. There is no dispute over this. However, they could be misleading, especially in the absence of standards for observation and follow up.*

- 5- Do you think that the corporate governance policy in Saudi listed companies will lead to an increase in the number of non-executive directors? If so, why?

*I do not think so. There is nothing in the system that forces companies to do so. Corporate governance is still optional and not enforced.*

- 6- In your opinion, do you think the increase in the number of non-executive directors in Saudi listed companies will help these companies to have stronger management and controlling systems? How?

*Yes – It will contribute to put a limit on conflict of interest, but once again, there is nothing official that holds companies to that.*

- 7- In your opinion, who should appoint the non-executive directors on the board?

*The shareholders should do that. The idea of a non-executive director is to protect the interests of all shareholders, without any difference.*

- 8- Do you think experience and professional qualifications ranked as the first and second factors that might influence the appointment of a board's non-executive directors.

*Experience with a variety of money and business matters undoubtedly have a big role in selecting non-executive directors.*

- 9- Are the non-executive directors playing a useful role in Saudi listed companies?

*Yes, such as the guaranteeing of neutrality and giving a sense of security for the shareholders.*

- 10- Do you think that the role of non-executive directors, the internal audit committee and the board of directors are all equally important as mechanisms of good corporate governance?

**If not, which mechanism do you consider is the most important?**

*Truly, and within the reality of companies in Saudi Arabia, especially banks, the board of directors is the most important, for it is at the top of the pyramid when it comes to importance.*

- 11- How do you evaluate the performance of the current corporate governance within Saudi listed companies?

*The absence of accountability in many corporate governance rules led to its weakness. Also, the optional corporate governance practiced by some Saudi Arabian companies is also weak and has not lived up to the required standard. We are still experiencing the problem of the one man show in a lot of our companies.*

- 12- Do you think that the lack of systems and procedures that govern company activities is a leading factor that is inhibiting the practice of good corporate governance in Saudi Arabia.**

*Yes, without a doubt.*

- 13- What is the importance of the following committees in Saudi listed companies? Audit committee -- Remuneration committee -- Nomination committee**

*The role of the audit committee plays the most important role in banks and most Saudi Arabian companies. It ranks in importance after the board of directors and its independence is relative. As for other committees, their importance is a function of their empowerment, and their roles are complimentary to that of the board of directors.*

- 14- Who should appoint the audit committees' members?**

*In the National Commercial Bank, the board of directors appoints the members of the audit committee.*

- 15- How do you evaluate the performance of the audit committee within Saudi listed companies?**

*Its role is very effective in the case of banks and corporations and is wide enough to cover all activities of the bank, according to the strength of the system. Unlike banks, with other companies its role is limited.*

- 16- How do you rate its effectiveness in preventing fraud and errors (audit committee)?**

*This depends on how well the committee members perform their duties, and also on the role played by the board of directors in facilitating the work of the committee members.*

**17- What is the level of the importance with the following areas to introduce the corporate governance framework in Saudi Arabian public companies?**

- Greater exposure and transparency in the annual report and financial statement.
- Separation of roles of chairman and CEO.
- Greater disclosure of directors roles
- Clearer separation of company ownership and management
- Clearer definition of directors' responsibilities
- More guidance on corporate governance

*In reality they all fall within one level of importance, but we can classify them in terms of importance as follows:*

- Greater exposure and transparency in the annual report and financial statement. *First place*
- Separation of roles of chairman and CEO. *In second place*
- Greater disclosure of directors roles *In third place*
- Clearer separation of company ownership and management *In fourth place; and after that, the rest come in terms of importance.*

**18- Do you think, new regulation and/or legislation are perceived to be the most important item among the respondents in the selected subject groups and company sectors.**

**In your opinion, do you agree, if not, how should corporate governance be introduced in Saudi Arabia? And Why?**

*New compulsory systems and awareness are definitely going to have an important role.*

**19- Who should monitor corporate governance in Saudi Arabia? And Why?**

*The Ministry of Commerce, if its operation is improved, as it has supervisory and auditing powers on all companies.*

**20- Are there any issues relating to corporate governance in Saudi Arabia that have not been mentioned in this interview, which you feel are important?**

*Yes. Making the internal audit committee responsible for implementing and interpreting corporate governance standards.*

#### **4.12 Saudi Capital Market Law Regulation and Codes that Meet International Standards**

The Corporate Governance Regulations proposed by the CMA contain provisions that are comparable to international standards. Nevertheless, there are no different classes of

shareholders with varying voting rights, as the disclosure requirements have been made stringent to provide maximum protection to all investors. After the stock market crash where a number of retail investors lost substantial amounts of money, the CMA made the disclosure requirements mandatory for all listed companies. The provisions in respect of duties and responsibilities of board of directors and the role and functions of audit committee as laid down in the CGR use international standards to improve investor confidence. Shareholders have been given their due rights and this has been authenticated in the GR.

The 2006 Financial System Stability Assessment by the International Monetary Fund (IMF) notes that the Capital Market Law and the Cooperative Insurance companies Control Law contain the requisite innovative provisions for dispute resolution and award enforcements.<sup>582</sup> The 'Country Profile' for Saudi Arabia in 2008 jointly published by the International Bank for Reconstruction and Development (IBRD) and the World Bank offering a forecast of the business climate in the country for 2009 has lauded the reform measures undertaken by Saudi Arabia.

Conclusion:

At the end of our analytical study for this chapter we looked at the corporate governance rules in Saudi Arabia, which led us to identify three government bodies which undertake the operation of issuing instructions and rules regarding corporate governance, accountability, disclosure and transparency. These government bodies also supervise and follow up on the implementation of these rules. They are the Ministry of Commerce and Industry, the Saudi Arabian Monetary Agency and the Capital Market Authority.

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<sup>582</sup> M International Monetary Fund and others, *Saudi Arabia Financial System Stability Assessment, Including Reports on the Observance of Standards and Codes on the Following Topics : Monetary and Financial Policy Transparency, Banking Supervision, and Payment Systems* (Imf Country Report, No. 06/199, International Monetary Fund, Washington, D.C. 2006)

The Ministry of Commerce and Industry has far-reaching authority on all companies, irrespective of activity. The Saudi Arabian Monetary Agency controls banks and insurance companies. Finally, the Capital Market Authority oversees all companies listed on the Saudi money market. We saw how each of these government bodies issued rules and standards pertaining to governance, market regulation and transparency. Adherence to principles laid down was monitored by the Ministry of Commerce and Industry through Saudi company law; needless to say that some resolutions are issued by the Minister of Commerce. Due to their transactions and activities, banks and insurance companies are required to have standards that can evaluate risk, which are subject to strict and binding standards issued by the Saudi Arabian Monetary Agency. These cover rules for governance, market regulation, disclosure and transparency. However, the rules issued by the Saudi Capital Market Authority are still not obligatory, being merely a list of guidelines; nevertheless, according to declarations by the majority of officials, the Authority is inclined to make them obligatory in the future.

In the course of our analytical study we also saw that corporate governance standards in the Saudi capital market were similar to world standards; however, they still need more development, care and follow up. This is not uncommon with emerging economies trying to develop a safe and competitive economic environment that would attract foreign investments, thereby widening the scope of its sources of income. Oil is still the sole source of revenue in the Kingdom of Saudi Arabia, a situation which has compelled the Saudi Arabian government to include in its growth plans the development of other economic sources. Such a scenario would lessen the country's dependence on oil as the sole source of income, especially as it is considered a finite resource, thereby making it indispensable for the country to expand its sources of wealth, open up economically to the world and create a safe and competitive economic environment.

Privatization plans, capital market development and the enforcement of rules and regulations protecting the market and the investor are all steps taken by the government of the Kingdom of Saudi Arabia. Such measures have led the government to follow up closely all developments going on in the world, so that it can be a major player in world economics. To achieve these measures, the Saudi government had to develop and modify several commercial, economic and legal rules and regulations in recent years. The enormous development in information exchange and communications has mandated that economic development along international standards is a necessary requirement for any country striving to advance and achieve prosperity for its people.

Concerning the personal interview conducted with Mr Nasser al-Qawas, it became clear that Saudi Arabian corporate governance standards, although concerning itself with world standards in their legislative and legal framework, suffered from insufficient coordination between the three governing entities. Such a state of affairs created a certain amount of confusion and disorganization among companies. Consequently, it became incumbent upon these three governance bodies to coordinate among themselves processes concerning corporate governance to prevent any misunderstanding or misinterpretation on the part of companies, specifically those in the capital market.

## **5 Chapter Five: Summary and Conclusion**

In this chapter we will begin by summarizing our findings as a result of the analytical study, and then we will make recommendations based on the results of the analytical study.

### **5.1 Summary**

As stated in the introduction, the thesis is divided into five chapters, including this. Chapter 1 discussed corporate governance in the Western and Islamic perspectives, starting with an overview of the various theories of corporate governance with a brief discussion of their interpretations of the concept. What linked those with the Islamic perspective is the concept of wealth and its preservation, which occupies a prominent position in Islam. It was necessary to go into a detailed discussion of the governance of wealth from the perspective of Sharia in general, since Sharia is the source of legislation in Saudi Arabia, and an understanding of its interplay with modern laws governing corporate governance would not be complete without a look at Sharia's concept of wealth and its preservation and effect on the individual in day to day activities.

Chapter 2 combined two discussions. The first presented an overview of the measures taken by the European Commission following the financial crises in the aftermath of the Enron and WorldCom scandals in the US, and later on the events that followed the Parmalat scandal in Europe. It was felt that corporate governance had become a matter that had to be addressed by the individual member nations in the European Union, and as fostered by the European Forum, all of which aimed at transparency and disclosure. The second part of the chapter discussed the concept of corporate governance in the UK, especially after joining the EU, and being presented with what had already been adopted on the Continent. The response to the European alternative

in the UK was the Combined Code and a series of reports that focused on corporate governance on the basis of 'comply or explain,' with a certain amount of voluntary action on the part of listed companies.

Chapter 3 focused on the United States, and its reliance on federal legislation in its regulation of corporate behaviour, going back to the Securities and Exchange Act, which was a precursor of the Sarbanes-Oxley Act, which followed the Enron and WorldCom scandals. It was also shown, through a detailed enumeration of the salient features of the Act, the extent to which federal regulation in the US had a part in enforcing sound corporate governance not only for US companies, but also for foreign corporations with operations on US territory. This lay diametrically opposed to the measures taken by the member nations of the European Union, although the UK did figure out closer to the US than the rest of the EU.

Chapter 4 discussed in detail the systems of corporate governance in Saudi Arabia, which were a result of the Saudi legal structure and the proximity of that structure to the influence of Sharia in the Kingdom. Mechanisms of corporate governance which were determined by the conditions of the Saudi environment were issued by the Capital Market Authority, which, acting on behalf of the Ministry of Commerce, presented guidelines that were both Sharia compliant and which protected shareholder wealth, while at the same time did not deter from realizing profits by the corporations concerned. Apart from basing its laws on Sharia, the Saudi corporate scene differed from the Western environment in that the former was characterized by concentrated ownership in families in one case, and by the state in another.

## 5.2 Conclusion and Recommendations

Based on our analytical studies in this thesis it has become evident that while Saudi Arabia has been trying to adopt corporate governance measures that meet international standards in the light of the reforms in the EU, UK and the US, it still needs to go further in order to be considered comparable or in full accord with these standards.

Current theories of regulation and enforcement seek to stress the responsiveness of regulators to the changing work environment and the evolving attitude of the regulated companies and organizations and also to take in to account the operating and cognitive frameworks of companies, the performing capacity of the existing regulatory regime and the environment of the various institutions.<sup>583</sup> As has been analysed in previous chapters, the Saudi Arabia regulatory corporate climate is guided and based on Shariah Law with other complementing sources of the law offering elaborations on the Shariah Principles. This analysis has been important in evaluating the efficiency and functionality of the existing regime in order to be know areas to improve.<sup>584</sup>

A number of grey areas have been noted particularly in respect to the regime's ability to achieve the goals of enforcement and compliance in a rapidly changing corporate world. Basing on the fact that Saudi Arabia is one of the strategic investment hubs in the Middle East and North Africa (MENA) and that it is one of the leading oil producing nations in the world, there is need for the Saudi government to institute new and vibrant corporate governance frameworks so as to enhance confidence among investors (local and foreigners) doing business in the Kingdom. In

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<sup>583</sup> R Baldwin and M Cave, *Understanding Regulation: Theory, Strategy, and Practice* (Oxford University Press, Oxford 1999) 35.

<sup>584</sup> See p 211- in Chapter 4.6-4.11

addition, these gray areas need to be addressed so as to avert a similar occurrence to the 2008 global economic crisis given that the kingdom is home to the largest oil reserves in the world.

As Baldwin and Cave posit, the Saudi government should begin right from the bottom so as to achieve the greatest impact insofar as influencing the behaviour of banking institutions is concerned. To this end, the Saudi government should pursue the three steps espoused by Baldwin and Cave.<sup>585</sup> These steps are: the creation of a set of laws and regulations capable of closing all the loopholes that banking corporations use to circumvent the existing regulations; creation of a responsive regulatory regime capable of enhancing compliance to the set regulations, and; applying the set regulations on corporations that infringe them.<sup>586</sup> It should be noted that none of these three critical steps is less important as they act in a complementary to each other. For instance, the third step which might be mistakenly perceived as less important is in actual sense the most critical given that it gives a sense of authority. To this end, the Saudi government should ensure that apart from enacting sound corporate governance regulations, there is an astute enforcement regime capable of remedying what Baldwin and Cave refer to as ‘design defects’ in the set regulations.<sup>587</sup> According to Baldwin and Black, one of the best ways to find out whether a regulatory regime is functional in ensuring efficient corporate governance is by looking at how it is able to address the various challenges that regulators face and on how fast it can be able to adapt to changes in the global environment.<sup>588</sup> The challenges encountered by enforcement agencies may be quite numerous, severe and hard to deal with. This is because enforcement

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<sup>585</sup> Baldwin and Cave, (no 583) 96.

<sup>586</sup> Ibid

<sup>587</sup> Ibid

<sup>588</sup> R Baldwin and J Black, 'Really Responsive Regulation' (2007) SSRN eLibrary <<http://ssrn.com/paper=1033322>> accessed 25 May 2011.

functions are often spread among various regulators and it is often hard to measure the level of failure or success of a certain regulation regime especially taking into account the various restrictive legislations within a state.<sup>589</sup> It would therefore at times prove to be an uphill task to improve a regulatory system just by changing strategies of enforcing rules and the various legal powers present.<sup>590</sup>

There are a number of enforcement theories and/or strategies that the Saudi government can utilize so as to add rigor to its corporate governance regime. For instance, the Saudi government can utilize the responsive regulation strategy which is by far the most popular among key players in the corporate world. Basically, this strategy (responsive regulation) allows regulatory authorities to adapt to various changes in the corporate environment in order to ensure optimal performance of the firms being regulated.<sup>591</sup> Moreover, this strategy is compatible with the banking industry given that the industry upholds high standards of information management through digitization. As a matter of fact, it is very easy to detect infringements in the rights of firms and individuals as well as monitor and address the compliance and enforcement issues since there are effective document keeping strategies. However, the process of monitoring and enforcing regulations in this industry involves quite a number of regulators whose functions, responsibilities and jurisdictions sometimes overlap occasioning loopholes that may be used by organizations for their weird agendas. This makes it hard to assess the effectiveness of the

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<sup>589</sup> Baldwin and Cave (n 583) 35.

<sup>590</sup> R Baldwin, 'Why Rules Don't Work' (1990) 53 MLR 321-337.

<sup>591</sup> J Black, *Rules and Regulators* (Oxford University Press, Oxford 1997).

regulation systems in detecting any arising issues and thereby in ensuring efficiency in enforcement and compliance processes.<sup>592</sup>

Even so, and based on the extensive literature reviewed in this dissertation, regulators and enforcers can utilize a wide range of mitigation strategies in enhancing effective regulation that addresses some of these arising challenges. For instance, Ayres and Braithwaite advance four strategies that can be utilized by banking institutions to enhance compliance with the set corporate governance regulations. These four strategies are ‘tit for tat’ responsive regulation, the target-analytic approach, ‘risk based regulation’ and ‘performance assessments regulatory approaches.’<sup>593</sup> These though have only been able to address corporate regulation to a limited point. They do not effectively show how non compliance can be detected and neither are they specific on design inspection strategies. They rather stress on how a non compliance can be responded to and the enforcements processes. These theories also do not look at how regulators can be able to deal with various resource constraints, the impact of some enforcement strategies on some aspects of regulations and conflicting institutional pressures.<sup>594</sup>

While building on Ian Ayres and John Braithwaite’s responsive regulation, Baldwin and Black argue that a ‘really responsive’ regulation which ensures compliance to performance and the firms operating, attitudinal and cognitive framework in line with various regulatory strategies and rules would be effective in ensuring that any arising challenge in corporate regulation is effectively addressed in a timely manner.<sup>595</sup> Responsive regulation as applied in the enforcement

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<sup>592</sup> Ibid

<sup>593</sup> I Ayers and J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press, New York 1992) 20, 40-42.

<sup>594</sup> Baldwin and Black (n 588) 46-47.

<sup>595</sup> Ibid

context refers to the capacity of organisations and institutions to respond to their changing conditions, both legal and environmental, while maintaining the integrity of their operations.<sup>596</sup>

On the other hand, ‘really responsive’ regulation applies regulations in all sectors affecting an industry and takes into account the various tasks involved in regulatory activities.<sup>597</sup> These tasks are detecting any undesirable condition, responding appropriately to the condition, enforcing various strategies to ensure compliance, assessing the effectiveness of the regulatory measure and modifying any part that may need to be. In this respect, the really responsive strategy is dynamic to changing environments, it is systematic in its approach and most importantly, it is performance sensitive. It constantly challenges the operations of the current regime and tries to analyse how effective it is in dealing with regulatory measures.<sup>598</sup> Corporate regulation in the banking industry worldwide has greatly evolved over the past decade and therefore requires a dynamic approach to the strategies of regulation to ensure that the changing scenario in the corporate world is properly and effectively addressed.

As has been shown by the study, the introduction of the CMA has been important as a regulator of the Saudi stock market. Its role in increasing the number of IPOs has already been shown in this study. The CMA’s major contribution to corporate governance has been the CGRs, which, like so many sets of rules and codes adopted worldwide, has become the foundation of the Saudi Arabian corporate governance system. Its rules and regulations show that it marks a step forward

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<sup>596</sup> Black (n 591)

<sup>597</sup> Baldwin and Black (n 588) 46-47.

<sup>598</sup> Ibid

in Saudi business life.<sup>599</sup> The study has also shown how the CGRs have enhanced the position of minority shareholders, in a system where the ownership structure of large corporations is concentrated either in families or the state. They have done this by recommending that corporations must take into account shareholders' interests by presenting legal guidelines to enable companies achieve this.

However, as was in both the UK before the introduction of the Financial Services Act 2010, Banking Acts 2008 and 2009,<sup>600</sup> there are still some shortcomings with the CGRs that need to be identified if the CMA wants to achieve its objectives. One such problem is whether and how the CMA will enforce such regulations. The study has shown that corporate governance is still optional and voluntary in Saudi Arabia; yet the extent to which companies should adhere to is not clear. While the rules and guidelines of such legislation as SOX in the US and FSMA 2000 could very well be integrated into the CGRs' rules, the extent of the adherence of corporations to such standards remains to be seen. The CMA would achieve its goal by identifying these rules and clarify them to corporations so they become part of company agendas.

In order to arrive at that stage, the CMA needs to create and empower a department to oversee compliance, even though it may not impose punitive measures as in the case of SOX. However, corporations would then be held accountable, and by following the UK model, adopt a 'comply or explain' policy, thereby imposing a measurable amount of regulation in the areas of disclosure, transparency and financial reporting. Such a department would be composed of legal and economic experts, much like the Winter Group is.

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<sup>599</sup> eStandardsForum, 'Saudi Arabia: Principles of Corporate Governance' (2010) <<http://www.estandardsforum.org/saudi-arabia/standards/principles-of-corporate-governance>> accessed 25 May 2011.

<sup>600</sup> A Georgosouli, 'The FSA Policy of Rule-Use: A Critical Appraisal' (2008) 28 LS 119-139.

Though the World Bank report on Observance of Standards and Codes (ROSC) on Corporate governance in Saudi Arabia showed that the corporate governance regulations, rules, laws and various institutional frameworks that have been established in Saudi Arabia ‘reflect international standards,’ it also points out that implementation of these frameworks is still in infancy stage.<sup>601</sup> In this regard therefore, it is important for Saudi Arabia to implement the various rules and laws that they have set down in order to improve CGR, strengthen the enforcement, educate market participants on how it is to be used and ensure effective compliance with the necessary regulatory institutions.

A responsive approach to regulation is very ideal to countries that have limited regulatory capacity such as Saudi Arabia. This is because it is capable of integrating within the corporate system ‘restorative justice and deliberative democracy.’<sup>602</sup> Responsive regulation done by nongovernmental and governmental regulatory networks allows for optimal networking and governance to cover capacity deficits. By maximally utilizing the responsive regulatory approach both to society pressures and NGOs, Saudi Arabia will be able cover the capacity deficits of the banking environment by encouraging private investors.<sup>603</sup>

Even so, it is imperative to note that the successful implementation of such regulatory regime will greatly be determined by the informed decisions made by the local regulatory authorities regarding the nature of infringements encountered. To this end and as Baldwin and Cave postulate, local regulatory bodies should know when to intervene, the most appropriate rules and

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<sup>601</sup>eStandardsForum (n 599).

<sup>602</sup> I Ayres and J Braithwaite (n 593).

<sup>603</sup> Ibid 216-219

styles of enforcement to utilize as well as how to enforce such rules.<sup>604</sup> Moreover, such regulatory bodies should always ask themselves the following questions before enforcing any regulation:

- a. What is the undesirable behaviour, or mischief at issue?<sup>605</sup>
- b. Who is responsible for the mischief?<sup>606</sup>
- c. Which enforcement strategies will best lead the mischief creators to comply?<sup>607</sup>
- d. Which types of rules best complement those strategies<sup>608</sup>

No doubt these questions not only guide the enforcement process but also serve as a framework for inducing sanity and certainty in the Saudi corporate governance regime since Baldwin and Cave postulate that ‘ill-enforcement can undermine the most sophisticated designs of regulation.’<sup>609</sup>

Precisely and while pursuing responsive regulation as the salient corporate governance regulatory strategy for its growing banking industry, the Saudi government should consider seeking compliance through engaging both formal and informal strategies espoused by Baldwin and Cave.<sup>610</sup> To this end, banking institutions found infringing the set out corporate governance regulations should be dealt with using either formal prosecutorial process or using one of the

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<sup>604</sup> Baldwin and Cave (n 589) 97.

<sup>605</sup> Ibid 102.

<sup>606</sup> Ibid

<sup>607</sup> Ibid

<sup>608</sup> Ibid

<sup>609</sup> Ibid 96.

<sup>610</sup> Ibid 96-97.

following informal strategies, ‘education, advice, persuasion, and education.’<sup>611</sup> Nevertheless, it is imperative to note that, within these lines, there should be a clear distinction between what can be termed as compliance strategies and deterrence strategies. Depending on the nature of the infringement, the Saudi government should apply either deterrence or compliance strategies so as to bring the maximum effect.

However and as Baldwin and Cave posit, compliance strategies are the most appropriate particularly having in mind that so far there have never been serious infringement cases as has been witnessed in the UK and US. Precisely, compliance strategies draw their strength from the notion that they are more likely to enhance conformity with the set regulations as opposed to deterrence strategies that are only concerned with retribution. Specifically, the persuasive faction of compliance strategy will not only enhance conformity with the set regulations but most importantly, it will help create awareness among operators.<sup>612</sup> In addition, compliance strategies will help reduce the huge costs associated with deterrence approaches. Moreover, court proceedings take a lot of time and may lead to hostility and loss of business as affected organizations may consider relocating to more accommodative investments hubs in the MENA region.<sup>613</sup> Even so, regulatory bodies should be keen so as to identify organizations that intentionally flout the set rules through what Baldwin and Cave term as ‘creative compliance’.<sup>614</sup> This is because the bottom-line of enforcement is to achieve the maximum compliance levels possible. As such, regulatory bodies should approach enforcement as a holistic endeavor that can only be accomplished through a progression of strategies that sometimes span both deterrence

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<sup>611</sup> Ibid 97.

<sup>612</sup> Ibid

<sup>613</sup> Ibid 98.

<sup>614</sup> Ibid 102.

and compliance realms. This notion draws its strength from Ayres and Braithwaite (cited by Baldwin and Cave)<sup>615</sup> postulations that dismissing ‘punitive regulation is naïve; to be totally committed to it is to lead a charge of the light brigade ... [and that] the trick of successful regulation is to establish a synergy between punishment and persuasion.’<sup>616</sup> As such, while this study advocates for compliance strategies it also cautions that the regulatory bodies have got the sole responsibility to apply deterrence approaches as may be determined the case(s) at hand.

In addition to pursuing responsive regulation as the salient compliance strategy, the Saudi government through the various regulators can institute measures that shift the burden of enforcement from the regulators to the banking institutions. According to Baldwin and Cave, this strategy is known as self regulation. Unlike the latter which imposes standards backed with sanctions and helps government to exercise control and ‘influence over the behaviour of citizens and companies by setting rules and regulations’ based on the corporate position of the society, self regulation enables organizations, companies and in specific, banking institutions to be able to progressively create rules, monitor compliance with the rules they have set and enforce them against members of the.<sup>617</sup> This enables banking institutions within Saudi Arabia to not only monitor development but to also maximize their capacity within the set Sharia Laws.

Our aim is not to offer a full account of the specific changes that must be made but to outline the general directions of the reform of corporate governance in Saudi Arabia. The Saudi Arabian government must realize that on the international level, corporate governance regulations are in a state of continuous development. Consequently these regulations and practices for disclosure and

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<sup>615</sup> Baldwin and Cave (n 583).66

<sup>616</sup> Ibid 99.

<sup>617</sup> Baldwin and Cave (n 589) 35.

transparency in Saudi Arabia are to be carried out on a regular basis, and to keep track of world developments in this respect.

We must not take profits as a benchmark for measuring performance of Saudi firms within the perspective of corporate governance, as this is a misleading and subjective standard, especially if we take into consideration the lack of competition and government support, an existing lobby consisted of the private sector (family owned companies) and individuals in the government. Furthermore, we must not be tricked by the Saudi companies' declarations of corporate governance principles; as such declarations could very well be for public relations purposes.

The reports and researches published by government bodies about corporate governance rules in the Saudi Arabia must reveal the resources of these published reports, especially if they are specialists in the field, thereby lending validity to the government reports.

Along lines similar to the guidelines for the operations of banks and money markets in the US, the Saudi government needs to make available a system that protects shareholders and provides transparency and monitoring of major banks, and to give a larger amount of leverage to monitor large corporations which, the bankruptcies of which would lead to a major economic disaster in the country.

Sir David Walker's report can be an invaluable source of benefit in the developing of corporate governance principles in Saudi Arabia. In like manner, the issuing of expert reports on corporate governance practices in the Saudi market would be most valuable in this instance. In addition to reports, the development of boards of directors and internal and external committees in corporations, banks and insurance companies is another essential step.

Contradiction of laws and regulations can be a major cause of financial collapses. Such a phenomenon leads to loopholes that would facilitate manipulation and fraud. Consequently the Saudi government should close all legal loopholes which may have an adverse impact on the investment and economic climate. What happened in the US and the UK are real live examples of the importance of the absence of contradictions in laws and regulations.

Although Saudi Arabia is an emerging economy, it nevertheless has an essential and large role to play, keeping in mind that it owns the largest oil reserve in the world. It also adopts a balanced oil policy that would avert an energy crisis, in addition to being a member of the G20 and the World Bank. These factors put heavy responsibilities for the development of its economic and financial policies.

In 2010 the CMA, in an effort to improve corporate governance in Saudi Arabia issued a resolution in which it amended certain articles of the 2006 CGRs.<sup>618</sup> Two of these amendments are stated in Articles 15 and 18. Article 15 deals with recommendations to the board of directors' memberships, annual review of board members, review of the structure of the board of directors and recommend changes, ensure the independence of the non-executive directors, giving a new definition of such independence, and draw policies regarding the remunerations of members of the board.<sup>619</sup> In 2010 the CMA issued a resolution which made Article 15 obligatory as of 1

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<sup>618</sup> Capital Market Authority, 'Corporate Governance Regulations in the Kingdom of Saudi Arabia' <[http://www.cma.org.sa/cma\\_cms/upload\\_sec\\_content/dwfile19/GOVERNANCE.pdf](http://www.cma.org.sa/cma_cms/upload_sec_content/dwfile19/GOVERNANCE.pdf)> accessed 8 April 2011.

<sup>619</sup> Capital Market Authority, 'Obligation of Article Fifteen and the New Definition of the Independent Board Member of the Corporate Governance Regulations' (Capital Market Authority 2011) <<http://www.cma.org.sa/En/Events/Pages/CorporateGovernanceRegulations.aspx>> accessed 2 April 2011.

January 2011.<sup>620</sup> Article deal with deal with conflict, in which it is clearly stated that board members are not to have any interest in any transactions made on behalf of the company, and should disclose his personal interest in such transactions.<sup>621</sup> These resolutions with their amendments are a good sign of the application of best practices of corporate governance. Yet it is too early to tell how these obligations are enforced.

Given that the concept of corporate governance is new to several Saudi businesses,<sup>622</sup> it would be beneficial that in order to help the already overworked CMA, an independent Saudi Arabian legal and business body be created in the private sector, formed by experts in various aspects of corporate governance with extensive legal and financial resources, empowered by the CMA, to act as monitor and a source of consultation in matters of corporate governance. Such a body should be mandated to carry out the following tasks:

1. create awareness among executive directors, board members, managers, investors and shareholders of the importance of corporate governance rules and the safety valve they provide which protects the interests of all parties concerned in a company;<sup>623</sup>
2. educate and train Saudi businessmen and trading houses, so they become aware of the importance and benefits of separating ownership from management, and that such a system would eventually lead to the longevity and success of their business operations;<sup>624</sup>

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<sup>620</sup> Ibid

<sup>621</sup> Capital Market Authority, 'Announcement Amendment of the Corporate Governance Regulations' (Capital Market Authority 2008) <[http://www.cma.org.sa/En/News/Pages/CMA\\_N413.aspx](http://www.cma.org.sa/En/News/Pages/CMA_N413.aspx)> accessed 8 April 2011.

<sup>622</sup> A unique exception is Samba Financial Group, a large financial services conglomerate with 70% government ownership. This corporation voluntarily applied strict measures of corporate governance, hosting a symposium on Banking Governance in May of 2007. For further details see [http://www.samba.com.sa/English/Common/HTML/updateMore\\_93\\_01\\_en.html](http://www.samba.com.sa/English/Common/HTML/updateMore_93_01_en.html).

<sup>623</sup> Such awareness has already been expressed and promoted in the online press. See T Hammad, 'Corporate Governance: Using the Stick and the Carrot' (Imam Shirazi International Institute for Studies ) <[http://www.siironline.org/alabwab/edare-%20eqtesad\(27\)/793.htm](http://www.siironline.org/alabwab/edare-%20eqtesad(27)/793.htm)> accessed 8 April 2011.

3. establish government research centres to handle methods of developing corporate standards and a mechanism to implement such standards, in addition to market regulation and follow up to ensure that companies respect these standards and abide by all instructions pertaining to them;<sup>625</sup>
4. in addition to previous forums and conferences on corporate governance,<sup>626</sup> it would be valuable to hold such events on a regular basis by academicians, specialists, business people, researchers and government representatives for the purpose of creating a confluence of viewpoints, familiarization with all opinions and arrival at recommendations; and
5. create an awareness of the dangers of forming alliances between business people and members in government for the purpose of achieving personal interests at the expense of the country's growth goals.<sup>627</sup> This will create a safe, stable and competitive environment in general and effectively implement corporate governance standards.

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<sup>624</sup> The Ministry of Higher Education has partnered with Ever-Team to design modules that can benefit Saudi Arabian students in enhancing their knowledge of corporate governance. See Ever Team, 'The Ministry of Higher Education in Saudi Arabia Unifies Its Student E-Folder by Providing a 360° View of Its Student Files with Eversuite' (Ever Team Arabia 2011) <<http://www.ever-team.com/en/mohe.html>> accessed 8 April 2011.

<sup>625</sup> The College of Business Administration at King Saud University with both its bachelor's program and its MBA program, shows no specific courses with a concentration on corporate governance. For details on their course lists see <http://www.cba.edu.sa/index.aspx>. Research centers dealing with corporate governance would be most beneficial to this aspect of business management, as a supplement to the core academic programs offered at these institutions.

<sup>626</sup> See AA Al-Elawi, 'Governance Enhances the Confidence of Inverstors: It Should Be Included in the Governmental Sectors' (The First Forum of Internal Auditing and Corporate Governance 2009) <<http://www.psu.edu.sa/cgf-ia.html>> accessed 9 April 2011. This was followed by a CMA sponsored symposium in 2010, which several experts on corporate governance attended. For more details see Capital Market Authority, *Corporate Governance Symposium* (Riyadh 2010) at <http://www.cma.org.sa/cgd/Seminar.html> .

<sup>627</sup> M Al-Hakeem, 'Corruption Cases on the Rise in Saudi Arabia' *Gulf News* (Manama, Bahrain 20 February 2008) <<http://gulfnews.com/news/gulf/saudi-arabia/corruption-cases-on-the-rise-in-saudi-arabia-1.85550>> accessed 9 April 2011. See also L Bashraheel, 'Is Bribe in a Gift Pack Acceptable?' *Arab News* (Jeddah 27 April 2010) <<http://arabnews.com/saudi-arabia/article47915.ece>> accessed 9 April 2011.

In closing, it is hoped that the analytical study in this thesis can serve as a modest attempt at analysing and evaluating corporate governance in Saudi Arabia. It is also hoped that more interest will be generated by this study to carry on further research on this subject, in the hope that it will bring more awareness to the kingdom of such an important phenomenon in today's business environment.

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